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Electricity Supply Industry Expert Panel
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To the Panel

Electricity Supply Industry Expert Panel – Draft Report

TRUenergy welcomes the opportunity to provide comments on the Draft Report: An Independent Assessment of the Tasmanian Electricity Supply Industry.

TRUenergy is one of Australia's largest integrated energy companies and is focused on becoming Australia's best customer-focused energy management group.

With the recent acquisition of EnergyAustralia, the Delta West gentrader rights and NSW generation development sites from the NSW Government in early 2011, TRUenergy has a portfolio of approximately \$9.3 billion of generation and retail assets and employs around 1,600 employees and contractors across National Electricity Market. TRUenergy provides gas and electricity to approximately 2.75 million household and business accounts in New South Wales, Victoria, South Australia, Queensland and the ACT.

In addition to managing risks with our physical assets we also trade extensively in a wide range of financial instruments with a number of counterparties with a focus on delivering risk management outcomes that are consistent with the expectations of our shareholders.

TRUenergy is strongly interested in the further development of the Tasmanian reform options and is willing to assist the Panel with further information if required.

Overall we believe that reform and competition provide the following benefits to both the Government and residents of Tasmania.

- Competition produces the most efficient and affordable long term price;
- Providing customers with choices places incentives on retailers to provide higher levels of service that meets the needs of customers; and
- Releases funds from potentially risky Government investments to use for other pressing Government needs.

Key Points

Our submission broadly supports the Panel's findings and recommendations.

TRUenergy commends the Panel on producing a significant volume of work that seeks to explore the current state of the Electricity Supply Industry. We note that this was done in a factual manner and provided significant insight and rebuttal of some commonly held myths in the local market. Having all interested stakeholders being aware of the relevant background to the current issues allows for an informed debate on the options moving forward.

Specifically we agree that one of the major issues inhibiting a competitive retail market in Tasmania is lack of counterparties in the wholesale market with which to trade risk management products.

In light of that main conclusion we support the following draft recommendations made by the Panel:

1. That TVPS be funded transparently and put on a commercially sustainable footing. TRUenergy also recommends that the future of TVPS is considered in light of the other proposed wholesale reforms and pragmatic decisions are made with regards to ownership and dispatch.
2. Reforms are implemented to address the absence of effective competition under the current structure of the wholesale market. TRUenergy specially supports reform path 2: creation of energy trading entities.
3. Following the reform of the wholesale market, full retail contestability, be introduced.
4. The Tasmanian Government begins a scoping study to determine an appropriate number of tranches for sale into the market. Specifically we support the sale of Aurora customers via three parcels.
5. The Tasmanian Government develops a publically available Energy Business Ownership Policy that more clearly articulates its overarching, strategic objectives for the SOEB's.
6. SOEB oversight continues to be refined to a provide a clear "line of sight" between Shareholder expectations and the requirements of the regulatory framework on one hand and Board, management and staff performance on the other.

With regards to the recommendation on the current regulatory framework for the determination of wholesale energy allowances for non-contestable customers our preference is for full retail price de-regulation which makes the issue of wholesale energy allowances irrelevant. However we recognise that this is a significant step for the Government especially in the context of the broader reform package. We also recognise that root cause of the Panel's recommendation is based on the methodology that currently uses the LRMC of a notional new generation to meet the demand of the non-contestable customers. The Panel recommends a methodology that also takes into account the current hydrological environment. While not disagreeing with the underlying views of the Panel we strongly urge that the Panel recommends the development of retail pricing principles that retailers can rely on in order to make investment decisions in Tasmanian.

Issues

TRUenergy agrees with the summary on pg 11 of the Draft Summary Report.

“The principle ‘gap’ between reform expectations and observed outcomes is the degree to which the wholesale market in Tasmania has failed to deliver the choices for risk mitigation that are required to underpin participation in that market. This has in turn prevented the development of effective retail competition and the introduction of customer choice for all customers.”

TRUenergy trades with Hydro Tasmania in other NEM regions. This is in the context of a market with multiple participants. However from a risk management point of view we seek to minimise our market risks. It is the process of managing risks that drive a number of key business strategies. If the proposed economic benefits from a Tasmanian retail investment are positive, it is the existence of the sole wholesale counterparty risk that becomes the barrier to entry. Furthermore even if terms and conditions entered into today are generous, it is the risk that a major strategic change in business direction of our counterparty that could adversely impact our investment that makes the investment untenable. It is virtually impossible to contract “niceness” into a commercial arrangement.

The commercial reality is that retailers can choose to enter into other wholesale markets because of the wider choice of counterparties and the lack of significant retail competition in Tasmania is a reflection of the current market environment.

Aside from the issue of dealing with a sole counterparty and the lack of equal negotiating power as additional risk arises when the sole counterparty in the region also has a reasonable understanding of the extent of your potential spot market exposure. This information asymmetry reduces economic efficiency.

Structural Reform of Wholesale Markets in Tasmania

TRUenergy agrees with the Panels view that wholesale reform is a condition precedent to the development of a competitive retail market.

Reform Path 1: Auction of Contracts

TRUenergy does not support reform path #1: auction of contracts for the following reasons:

1. The reform path proposes a regulatory approach in determining an auction design and a model for setting reserve prices. Different organisations will advocate for different proposals in both auction structure and the reserve pricing model both at the initiation of the auction process and more importantly on an ongoing basis. This increases regulatory risk for both Hydro Tasmania and any retailers operating in Tasmania. If the regulatory risk is deemed to be significant by potential retailers this will deter entry resulting in a potential loss of choice for Tasmanian customers.
2. The products from a standardised auction are unlikely to be useful to either larger retailers or smaller niche retailers. In the case of a larger retailer a standardised product degenerates the business model in to a “pass-through” commodity with the retailer simply collecting a margin. It limits the retailer’s inclination and ability to develop risk management products. A smaller niche retailer would require smaller auction lot sizes to manage load exposure thus

increasing administrative auction costs. Secondly there is a high probability that for a niche retailer that their customer load profile maybe significantly different from the average consumer and that a standard product would not suit their risk management needs. For both larger and niche retailers they would then be forced to deal direct with Hydro Tasmania to create additional premium products. Since these are the products that are ultimately required the trading environment reverts to the one that exists today, namely dealing with a sole counterparty.

3. Fundamentally the “auction plus premium products from Hydro Tasmania” is a close proxy to the status quo. There is only one choice to manage risks in the Tasmanian market whereas in other States there are a number of counter parties that are willing to deal with multiple parties for a number of different product offerings.

Reform Path 2: Creation of Energy Trading Entities

TRUenergy supports reform path#2: Creation of Energy Trading Entities. This addresses a number of the concerns raised in the above discussion of reform path#1: auction of contracts. The main reasons for this support include:

1. It creates a competitive environment for the trading entities to develop products that their retailer customers would want. In short it places the right incentives on the relevant participants in a market based environment.
2. There is already a precedent in the National Electricity Market for a separation of ownership and trading rights – with both government and privately owned assets.
3. It also allows Hydro Tasmania to continue operating and maintaining the hydro assets. This is one of Hydro Tasmania’s core strengths. The key performance indicator would be some form of operational efficiency and availability.
4. Furthermore it separates the hydrological risk from the Hydro Tasmania business. TRUenergy’s view is that the Government should seek to sell the trading entity businesses. It is likely that these businesses would operate to a risk profile that would be substantially different to that of a Government. While the prospects of ongoing dividends maybe attractive, consideration also needs to be given the significant downside risk associated with trading business and the willingness of the Government to provide additional financial support as a consequence of adverse trading decisions made by management.

However we also note that this is not a simple pathway forward and suggest that the Panel also considers the following:

1. Engagement with AEMO at the early stages of design to ensure that issues such as the Special Protection Scheme (SPS), FCAS and Basslink operation are effectively managed from a security of supply perspective.
2. Clear operating rules around SPS, FCAS and Basslink are made available. This is because the interaction of these three elements can produce what may appear to be non-intuitive spot price outcomes.
3. Differ the sizes of the trading entities so they do not create natural match-ups with the Aurora retail parcels. This will ensure that parties do not create virtual vertical integration and remove the competitive tension in the wholesale market. All parties will have under/over’s that will require them to trade with each other. This will also allow the potential for participants to own both a retailer and energy trading block – if there is a reasonable mismatch between block sizes.

Reform Path 3: Combine Victorian and Tasmanian Regions

TRUenergy does not support reform path #3: Combine Victorian and Tasmanian regions for the following reasons:

1. This is not a decision that the Tasmanian government can implement. It would require a significant rule change that will take several years to implement. The factors that supported that abolition of the Snowy region do not apply to Tasmania.
2. Basslink is a significant constraint in the NEM. Embedding the Basslink within a region will reduce transparency and significantly increase disorderly bidding.
3. The demands in Victoria and Tasmania are not strongly correlated – creating a situation where Tasmanians will be exposed to very high spot price outcomes during periods of low demand in the State, but high demand in Victoria (and vice versa). This will send very perverse price signals that will not create suitable incentives for demand management.
4. Hydro Tasmania will have no incentive to generate when the regions price is low but the demand in Tasmania is high. In order to alleviate constraint and security issues there is a strong possibility that Hydro Tasmania will have to be directed in the spot market and/or enter into network support agreements – where again they have the sole power to set prices.

Retail Competition

The Panel has considered three options for the development of effective competition in the retail market. Fundamentally TRUenergy supports retail competition. All of our comments below are on the assumption that there is some form of workable competition in the wholesale electricity market. TRUenergy also suggests that the Panel consider the relative size of the Tasmanian market compared to mainland markets when assessing the different options and that features of those options. In order to make the Tasmania customer base attractive consideration should be given to minimising barriers to entry relative to other States.

The other key point relevant to a discussion on retail competition is the commitment that is required to enter a retail market, in particular with residential and small business customers. Our expectation is that entry into a retail market is a long term commitment, at least a decade. By taking on obligations as the financially responsible market participant we would be unable to easily exit if the environment was not conducive to our long term business direction. Furthermore brand damage via an exit is significant. In summary a commitment to a region is a significant business decision.

Retail – Status Quo Option

We do not support the status quo option. TRUenergy has a Tasmanian retail license but does not actively trade in Tasmania. In some circumstances we will consider retailing to a customer with which we have a long term relationship on the mainland. In those cases we would seek a hedge contract with Hydro Tasmania and simply pass on the direct cost to the customer with a small margin to cover our costs. The main benefit to this low cost business model is that it reduces the exit risk if we only contract with larger commercial customers for fixed terms. We would continue to carry the credit risk from the customer for both energy and network charges. A ‘clip the ticket’ business model is not our preferred option as at best we are simply a reseller for Hydro Tasmania.

Retail – Organic FRC

TRUenergy does not support an organic FRC option for a number of reasons:

1. From a retailers perspective acquiring 55,000 to 75,000 customers (equal to a market share of 25-33%) would be a reasonable target for organic growth by a retailer. To obtain that number of customers in the mainland is easier than acquiring the same number of customers simply because there are more customers in other regions.
2. This option also leaves Aurora with a declining customer base in terms of numbers and quality of customers as the more preferred customers will be targeted by new retailers. Over time the value of Aurora will decrease and most likely require State support in order to service the residual unprofitable customer base.
3. Retailers will also be hesitant to enter against a large incumbent retailer (even under a non-compete arrangement). The amount of time required to erode the incumbent retailer to a significant degree could take several years (even a decade). This creates a significant perception issue with consumers who are “sold” the idea of retail competition but not receiving the benefits for a number of years.

Retail – Sale of Aurora customers in parcels

This is TRUenergy's preferred option. If this process is managed well it will realise the best value to the Government and provide choice for all Tasmanian customers in the near term. It addresses the issues raised in the two previous options, as it provides an attractive entry option into the Tasmanian market for a wide range of retailers. The ideal option is that three parcels are created. Our preference would be for two parcels given the size of the market, but accept that in the customers mind when deciding if there is retail choice they will consider it from the number of retailers they could switch to – not including their current retailer. Therefore customers are unlikely to believe they have a choice if they can only switch to one other retailer (other than their own). Therefore three parcels represent a reasonable compromise between choice and economies of scale.

Our other comments in relation to this option include:

1. Customers are allocated by random NMI selection, not regions, as this will encourage competition if adjoining residences can compare their supplier.
2. TRUenergy's preference is that price de-regulation is introduced at the same time as the sale of customers. This in combination with harmonisation of non-price regulation potentially with Victoria can reduce the barriers to entry for the numerous Victorian based retailers if the process of obtaining a customer can be as simple as processing a new Victorian customer. If price de-regulation cannot be considered at this time then development of retail price path principles that apply for the next 3-5 years will reduce regulatory risk.
3. In order to save costs and the time to implement full FRC systems for Aurora consideration is given to the use of the AEMO bulk transfer of allocated customers to winning retailers as well as a parallel process to provide other non-AEMO data to the winning retailer.
4. An initial 6-12 month period is provided to allow the new retailers to successfully migrate customers into their existing systems. This will reduce issues around delayed customer switching and billing that may occur during large transfers.
5. The Power Purchase Agreements and any renewable energy certificate creation by Hydro Tasmania are also allocated to the new retailers as they are the parties with the REC liability.

6. As noted above the size of the retail parcels differ from the energy trading entities to ensure that a competitive wholesale market is developed and retained.
7. The Pay As You Go (PAYG) business is also sold either separately or included in one of the retail parcels.

Momentum Energy

TRUenergy's understanding is that Momentum Energy allows Hydro Tasmania to manage surplus generation in Tasmania (through managing the basis risk over Basslink) by selling the energy to Victorian customers via Momentum Energy. If the trading entity option proceeds then the rationale for continued Hydro Tasmanian ownership is diminished. The question then is does the Government wish to have exposure to a Victorian based retail business. This would be illogical if either the organic FRC competition or the retail parcel sale options were to proceed. TRUenergy suggests that the Panel considers the merits of State ownership of Momentum Energy.

Tamar Valley Power Station

Other than the re-establishment of the financial viability of Tamar Valley Power Station (TVPS) the Draft report does not provide a clear indication of the ongoing future of TVPS. In our view three main options exist:

1. Retain the status quo: This option is inconsistent with the other reform options presented and would effectively place a distribution company in the business of power generation.
2. Sell Tamar Valley Power Station outright: An expression of interest process could be initiated to ascertain potential buyer interest.
3. Integrate into Hydro Tasmania to allow for the bundling of the dispatch rights with the energy trading entities. This option does begin to complicate the operation of the dispatch rights – it may be easier to sell the trading rights to one party or alternatively some shared rights and operation protocols may be developed.

Basslink

An additional source of wholesale competition tension is via Basslink, as it allows mainland generators the opportunity to sell generation into Tasmania or alternatively allow Tasmanian based retailers the opportunity to purchase energy interstate. In either case the participant is then required to manage the basis risk over Basslink. There are a number of financial transmission rights auctions that could be implemented over Basslink to allow for the management of basis risk. TRUenergy does not express a preference for any particular model but instead notes the desirable characteristics that a model should produce. These are:

1. Financial transmission auctions that allow generators and retailers to model and price basis risk and produce results that are broadly reflective of market outcomes.
2. Relatively simple process to enter into auctions. i.e low barriers to participation and not an excessive bureaucratic procedure.
3. A few products of differing time periods and vintages.
4. The reduction of the ability for any one party to control specific price outcomes at each end of Basslink.

Summary

In summary TRUenergy generally supports the reforms as outlined in the Draft Report. Overall TRUenergy believes the Panel has done a comprehensive and thorough review. We note that the options presented are at a high level and that considerable work still needs to be developed detailed recommendations. TRUenergy sees no particular reason why the electricity consumers in Tasmania are not afforded the option of a competitive retail market.

Please feel free to contact Ms Lana Stockman, Wholesale Regulatory Manager on (03) 8628 1632 if you have any questions.

Yours sincerely,

A handwritten signature in cursive script that reads "L Stockman".

Lana Stockman
Manager Wholesale Regulation
TRUenergy Pty Ltd