6 May 2011

Mr John Pierce
Chairman
Electricity Supply Industry Expert Panel
GPO Box 123
HOBART TAS 7001

Dear Mr Pierce

RE: APRIL 2011 DISCUSSION PAPERS – AURORA ENERGY SUBMISSION

Aurora Energy (Aurora) welcomes the first three Discussion Papers released by the Electricity Supply Industry Expert Panel. They are well-considered and well-researched documents that provide a much-needed perspective on the complex issues surrounding electricity prices in Tasmania. Aurora is acutely aware of the impact of rising electricity prices on Tasmanian households and businesses and is focussed on meeting customer needs at the lowest sustainable cost. Aurora hopes the papers will provide Tasmanians with some clarity around the drivers for increasing prices and help explain this complicated industry.

Aurora would like to comment on a number of issues raised in the Discussion Papers. Many of these issues are common to the three papers, so Aurora does not intend to address each Paper individually. The comments below are Aurora's initial, high-level comments on some of the matters raised in the papers. Aurora will provide a more detailed response in future submissions. Aurora is not outlining our perspective on potential solutions to issues at this stage but hopes this submission will be considered an input into the Panel's forthcoming Issues Paper.

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Wholesale Energy Market

Aurora is encouraged that the Panel intends to explore the level of effective competitive outcomes in the Tasmanian electricity spot and contract markets. Aurora notes the Panel's observation that wholesale energy costs have been the single largest driver of price increases for non-contestable customers since 2000, contributing about 40 per cent of the increase. Energy purchase costs also make up about 40 per cent of household and small business electricity bills and are the single largest cost in the electricity supply chain.

It is Aurora's view that the operation of the wholesale energy market in Tasmania is the key issue that needs to be addressed by the Panel. It is important to be clear that the issue relates to the market structure and not any particular entity. All participants are operating within established market rules and frameworks. Our comments reflect statements made by a range of market observers and participants which highlight issues in the application of those rules in the current Tasmanian market structure.

As the Panel highlights, informed observers including the Tasmanian Economic Regulator (TER), have made observations that efficient market outcomes are not being achieved in the Tasmanian wholesale generation sector. These issues have also been the focus of the ACCC and the Australian Energy Regulator (AER), with extensive commentary also in the PricewaterhouseCoopers Review of Strategic Options for Tasmania's State Owned Electricity Businesses. The 1997 "Nixon report" and the 1999 "Garlick report" also discussed the potential for wholesale market issues under the current market design. Garlick noted:

"Market power is generally considered to be a problem when an entity can use a position of market dominance to extract higher prices in sales to customers, and to impede entry of new competitors. A single HEC as generator would certainly be in a position of market dominance even with an assumption of a 300 MW Basslink in service. However it is the abuse of market power, not the possession of market power, that is the problem. In any free bidding spot market trading period, HEC could theoretically give up say 25% of market share to imports, thereby constraining the link, and then be free to set the pool price in Tasmania anywhere up to VoLL."[1]

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[1] Garlick, Peter (1999), "National Competition Policy Review of the Structure of the Hydro-Electric Corporation's Generation & System Control Functions", Issues and Options, p. 51.

As the Panel has noted, the AER report regarding wholesale market events on 19 November 2010 stated that:

"On 19 November 2010, the spot price in Tasmania reached $12 400/MWh for the 7am trading interval, the equal highest spot price ever recorded in the National Electricity Market. The high price resulted from Hydro Tasmania's bidding strategy and its control of non-scheduled generation output."

Further, the AER report observed that imports across Basslink and output from other Tasmanian generators was insufficient to meet demand. This meant that only a small amount of Hydro Tasmania's high-priced capacity was required to be dispatched and set the price.

The clearest outcome to date of concerns over market power was the action taken by the Tasmanian Economic Regulator to regulate Frequency Control Ancillary Services (FCAS), due to the Regulator's view that market power was being misused.

We note that the ACCC and AER supported the Tasmanian Economic Regulator's decision to declare FCAS. The ACCC observed that Hydro Tasmania's conduct has had serious implications for other market participants as well as ultimately for consumers as end purchasers of electricity. However, in this instance, the ACCC formed the view that the evidence did not establish to a sufficient extent that Hydro Tasmania's exercise of market power was a contravention of section 46 of the Trade Practices Act 1974.

The ACCC noted that as the incumbent and dominant provider of FCAS in the Tasmanian regional node of the NEM, Hydro Tasmania has a continuing obligation to not utilise its position for an anti-competitive purpose as prescribed by section 46 of the Act including that of:

- Eliminating or substantially damaging a competitor;
- Preventing the entry of a person into any market; or
- Deterring or preventing a person from engaging in competitive conduct in any market.

Aurora's experience in operating in the Tasmanian wholesale energy market has been well documented. Following the Government's decision to have Aurora purchase, finalise construction and operate the Tamer Valley Power Station, Aurora experienced significant difficulty competing in the Tasmanian wholesale market and the Aurora Energy Business sustained significant operating losses in 2009/10.

The Tasmanian Government has also identified concern with the operation of the wholesale market. On 16 June 2010, the Tasmanian Government announced that it would "...immediately seek to regulate the relationship between the Hydro Tasmania and Aurora Energy, to ensure Aurora is able to buy energy at a fair and reasonable price, and operate sustainably" and also stated that, "Put simply, we need to ensure Aurora isn't required to buy wholesale power at a higher price than it can possibly sell it."

While a commercial agreement was ultimately reached between Aurora and Hydro Tasmania, the Government's move to regulate the relationship was crucial in ensuring an acceptable commercial outcome was achieved and put the Aurora Energy Business on a sustainable footing. However, there continues to be issues regarding the operation of the wholesale market in Tasmania.

Going forward, there are considerable risks for Aurora's Energy Business, particularly following the expiry of the agreement with Hydro Tasmania on 30 June 2013. Aurora agrees with the Panel that risk management is a fundamental aspect of business operations and is highly complex. While there are a wide variety of financial instruments available in the NEM to protect generators and retailers from movements in the spot price of electricity, Aurora's experience in Tasmania is that there is no competitive market for these products, given the current structure and operation of the market and the dominance of the incumbent generator in both the spot and contract wholesale markets.

Aurora is preparing detail on the challenges of Tasmania's wholesale energy market for the Panel's consideration, along with discussion of potential contractual, regulatory and physical solutions address the issue of market power. Aurora will also provide information in subsequent submissions on the impact the wholesale market structure has on competition and customers.

Basslink

A key issue relating to the effective operation of the wholesale energy market is the operation of Basslink. Basslink has been a clear success in managing hydrological risk and security of supply in Tasmania during the recent drought. However, Aurora is of the view Basslink has not met its market based objectives in facilitating market competition from Victorian generators and in providing trading opportunities for all Tasmanian based generators.

In practice, Tasmanian electricity retailers have to accept very high risks in order to directly access the Victorian generation market. The failure of the Inter-regional revenue (IRR) auction process, originally set up to facilitate jurisdictional generation competition under the ACCC Basslink Access Undertaking, is testament to the issues surrounding Basslink's operation.

The TER has noted the relationship between the wholesale energy market and Basslink in that the comparative price differences between the Tasmanian and Victorian regions during Basslink flows is an indicator of the extent to which Hydro Tasmania, as the dominant Tasmanian generator, may be in a position to exert its influence in the market to maintain Tasmanian prices barely below Victorian prices in export, thus ensuring that Tasmanian pool prices are as high as they may be while still maintaining export, and maintaining Tasmanian prices substantially above Victorian prices during periods of Basslink import. The TER also observed that there are currently no market restraints on such a strategy.

It is important to recognise that even if the operating structure of Basslink were changed, the incumbent generator would continue to have the ability to control the Tasmanian spot market and the flows over Basslink, given its overall dominance and the import and export capacity restrictions over Basslink. Addressing Basslink issues is therefore only a component of addressing the broader operation of the wholesale energy market in Tasmania.

Aurora will provide further detail regarding issues associated with Basslink's operation in future submissions.

Retail Competition

Aurora supports retail competition to the extent it delivers clear benefits to consumers. The TER recognised in its 2008 public benefit test of Full Retail Competition (FRC) that there are FRC implementation costs and aspects of the Tasmanian wholesale energy market that need to be addressed in order to ensure Tasmanians see benefits from FRC.

In particular, the TER noted that the Government should take appropriate steps to ensure that the governance of the wholesale electricity market is conducive to the development of competition, so as to maximise the benefits of FRC, and that the possible negative distributional effects of introducing FRC, particularly transitional price increases for some customers, be appropriately managed by Government.

Of note was the TER's recommendation that:

"The Tasmanian Government seeks ways to ensure that the governance of the wholesale market is conducive to the development of competition in this sector. At a minimum, this should include a standing terms of reference for an independent review and report on the development of and impediments to competition in the Tasmanian wholesale and retail electricity markets. It may extend to requiring greater transparency in offers of market contracts and inter-regional risk management instruments and other intervention."[2]

Aurora agrees with the TER that wholesale energy market issues are a key issue that need to be addressed in order to deliver effective retail competition, given that wholesale costs represent 40% of customer prices, compared to much less than 10% for the contestable retail component.

Aurora has undertaken a high level review of the range of cost inputs it provided to the Regulator's public benefit test process and expects the quantum of system implementation costs, primarily the IT systems required to permit customer churn between retailers, would broadly be in line with those outlined in the TER's 2008 report. Including increases in retail margins, this was in the order of $35-70 million over seven years or $50 to $80 per customer per year for those that remained on a regulated standing offer contract. The FRC implementation costs ultimately will need to be paid for by electricity consumers.

[2] Office of the Tasmanian Energy Regulator (2008), "Public Benefit Assessment for Electricity Retail Competition in Tasmania", Final Report, p. 7.

There are also a number of other issues to be considered, including:

- the small size of the Tasmanian market and whether strong retail competition will be established in practice;
- Aurora's cost to serve disadvantages given its small scale versus mainland competitors and the possible impacts on shareholder value;
- Aurora's need to be responsive to shareholder expectations in terms of how Aurora operates and the services that are provided;
- the impact of higher standing offer tariffs on low income customers, given the expected higher retail margins and FRC implementation costs; and
- the possibility that only higher income households with good credit histories will be targeted by retailers and be the primary beneficiaries of FRC.

Aurora again emphasises it does not oppose FRC but is seeking to highlight that there are a number of significant issues that need to be addressed to give comfort that all customers will benefit from FRC.

Aurora also wishes to emphasise that while much of the recent public focus has been on retail competition, it notes the Panel's analysis that the retail component is only a small component of electricity bills and has been smallest contributor to electricity price increases since 2000.

Electricity Networks

Later this month, Aurora's Distribution Business will be submitting its regulatory proposal to the Australian Energy Regulator, with the determination to commence from 1 July 2012 for a five year period. The previous pricing determination by the TER saw significant increases in both capital and operating expenditure to ensure the performance of distribution network was in keeping with the State's economic growth and in order to meet more stringent reliability and safety standards.

Following a major review of the Distribution Business strategy in mid-2010, Aurora considers that investment in the network is now at an appropriate level and consolidation in expenditure can occur. In developing the strategy, the Distribution Business has strengthened its focus on the customer, with an aim of improving electricity price outcomes through operational efficiencies and the implementation of a smarter network through the deployment of innovative and new technologies.

Aurora expects the Panel will consider the efficiency and operations of the Aurora Distribution Business and Transend Networks, including whether the merging of the two entities could realise efficiency improvements and cost savings. In line with Aurora's reviewed Distribution Business strategy, Aurora is already implementing solutions to improve efficiencies between the two companies, such as the recent re-location of Aurora's Fault and Operations Centre with Transend's Network Control Centre. The two businesses already have a close working relationship, with Aurora Network Services division contracted to undertake the majority of Transend's operation and maintenance work and fault response.

Aurora recognises that there are a number of additional areas that could benefit from a closer relationship between the businesses, including potential cost savings from improved operating efficiencies and operational and asset management advantages such as changes to voltage demarcation boundaries.

Aurora is therefore open to further examination of network integration. However, Aurora notes previous work by PWC which highlights that network integration may be costly, complex and risky and that the associated savings may not be significant in light of these issues. Potential legal and regulatory obstacles also need to be understood, particularly the likelihood that Aurora's generation, wholesale and retail activities would have to be separated into a stand-alone company given restrictions on combining transmission and generation activities, meaning that network integration would still result in two separate companies continuing to exist. Aurora further notes that network integration, while an import issue for examination by the Panel, is unlikely to result in significant reductions to customer electricity bills and is a lesser order issue compared to key matters such as the operation of the wholesale energy market.

Conclusion

Thank you for opportunity to respond to the discussion papers. As highlighted above, the issues to be considered by the Panel are highly complex, with many implications for Tasmanian electricity consumers. Aurora hopes this submission will assist the Panel in framing its forthcoming Issues Paper and expects to provide a more detailed response to issues, including possible solutions, in future submissions.

Aurora is a strong supporter of the Expert Panel process. Our goal is to achieve an outcome that is in the best interests of Tasmanian electricity consumers and the State overall. Should any member of the Panel or the Panel Secretariat require clarification on any aspect or would like to discuss any of the matters raised in this submission, please contact Rick Inglis, General Manager, Strategy and Corporate Affairs.

Yours sincerely

for Dr Peter Davis
Chief Executive Officer