

6 May 2011

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

Dear Mr Pierce

Feedback on Discussion Papers

Hydro Tasmania welcomes the opportunity to provide high level feedback on the Panel's first three discussion papers.

Hydro Tasmania is concerned that the volume of information and analysis in the papers is at risk of obscuring the core issue for the Panel, which, in Hydro Tasmania's opinion, is the efficiency of the Tasmanian electricity supply industry and the reasonableness of prices being experienced by Tasmanian consumers of electricity.

In particular, the discussion papers do not consider the efficiency or recent history of Tasmanian wholesale electricity prices, which are at NEM-competitive levels and have reduced over the last two years. These wholesale prices are at efficient levels for contestable customers although at the current stage of introduction of retail contestability, are not yet available to all consumers.

Instead, the discussion papers replay hackneyed and unsubstantiated commentary on wholesale competition issues, which ignore material aspects of the Tasmanian electricity supply dynamic.

Hydro Tasmania considers that the Panel, in progressing its inquiries, needs to:-

- assess the efficiency of actual supply outcomes for customers;
- place in appropriate perspective, one-off, or, short term factors which do not impact customer outcomes such as price;
- ensure that any competition analysis that it undertakes is rigorously based on first principles and not presumptive or generalised;
- understand the challenges faced by Tasmania in securing efficient new entry (which revolve around the slow rate of load growth compared to efficient new entry size and the step increase between efficient existing supply costs and those applicable to new entrant supply);

- carefully consider the genuine pre-requisites for the introduction of full retail contestability in Tasmania. The existing dogma, that wholesale market reform is required, ignores the effect of differentiated vertical integration and the extent to which the wholesale cost component of the regulated retail price exceeds prevailing wholesale prices;
- understand the impact of extraneous factors (which include Commonwealth renewable energy incentives, and commodity price exposures for existing and potential industry participants) on the Tasmanian supply/demand balance; and
- test the extent to which Tasmanian electricity consumers are receiving value for money in the infrastructure investment costs they are being asked to bear by the industry.

Identification of the Core Issue

Over half of the issues that the Panel identifies in the discussion papers for further work relate to competition. Hydro Tasmania's view is that this focus on competition does not get to the core of the issues for consideration, although the need to do so is acknowledged by the Panel at page 44 of the "*The Evolution of Tasmania's Energy Sector*" discussion paper. The core issue has not changed since the Tasmanian Government's 1997 Directions Statement¹, quoted on page 3 of the *Evolution* paper:

"Introducing greater competition and customer choice into the Tasmanian energy and electricity market to drive lower prices and to maintain a national competitive advantage for Tasmania's economic base."

Competition is a means to an end. That end is efficient price outcomes for customers and it is those outcomes which are at the heart of what the Panel must assess, not measures of intermediate competition. This approach is consistent with the National Electricity Objective (NEO) which defines the underlying objective of the NEM and focuses on long run customer outcomes, being:

"to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to –

- a. price, quality, safety, reliability, and security of supply of electricity; and
- b. the reliability, safety and security of the national electricity system."²

¹ Directions Statement – Tasmania's Future Energy Strategy 1997

² <http://www.aemc.gov.au/Electricity/Electricity-Market.html>

Nowhere does the NEO define objectives in terms of competition. Competition is a tool not a panacea for efficient market outcomes. If one looks at wholesale price outcomes in Tasmania, Hydro Tasmania considers that there is no evidence of long run inefficient price outcomes with respect to any contestable element of the wholesale Tasmanian price or of inflated prices for end use customers. (There may, in contrast, be inefficient price outcomes with respect to the wholesale energy allowance to non-contestable customers.)

The Panel refers to specific instances of short term high spot pricing in Tasmania in section 6.4 of the *Evolution* paper. These price outcomes were associated with transitional issues, and their effect was limited to trading dealings between market participants and is not relevant to long run customer outcomes. At page 37 of the *Evolution* Paper the Panel refers to FCAS issues dating back to April 2009. These can and should be ignored by the Panel, not just because of their connection to transitional issues, their short duration and their non-material financial impact, but also because regulatory intervention by the Tasmanian Energy Regulator provides effective protection.

Details of Tasmanian spot price outcomes since 2006, when Basslink was commissioned, and Victorian spot price outcomes over the same period, can be found in Table 1 below. The table provides clear factual evidence that in terms of price outcomes there is no problem with wholesale competition in Tasmania.

State	Period	2006	2007	2008	2009	2010	2011
Vic	Q1	44.36	64.17	43.99	62.24	51.43	35.91
Tas		33.04	49.29	53.44	51.8	26.54	26.86
Vic	Q2	28.36	92.54	45.07	32.7	44.17	
Tas		35.94	72.35	59.39	94.91	36.93	
Vic	Q3	37.31	57.51	40.69	24.28	25.43	
Tas		41.25	62.62	43.2	23.01	36.29	
Vic	Q4	27.57	40.66	32.07	27.2	18.59	
Tas		36.46	43.37	43.48	30.46	20.77	
Vic	Annual	34.40	63.72	40.46	36.60	34.91	
Tas		36.67	56.91	49.88	50.05	30.13	

Table 1 Average Annual Spot Price for the Tasmanian and Victorian region by Quarter.

An omission, therefore, from the Panel's Discussion Papers, is reference to the need for the Panel to identify effective measures of market outcomes.

The challenge of finding appropriate measures of market outcomes is not new. The New Zealand Ministry of Economic Development, responding to the NZCC's 2009 investigation into New Zealand electricity markets, suggested that a useful benchmark when inquiring as to whether there is sustained or long run market power would be to compare average wholesale spot prices with the cost of new capacity or LRMC. Hydro Tasmania would go further and extend this consideration to contract prices, provided that customers have no barrier to accessing contract cover.

A similar “health check” was used in the AGL case³. Further, in the 2005-2007 European Commission energy sector inquiry, a model of efficient new entrant cost (based on Combined Cycle Gas Turbine (CCGT) technology) was used in a similar indicative fashion to assess how electricity prices in the six countries studied contributed to fixed costs, in particular whether they would be sufficient to sustain investment in efficient new plant.⁴

The 7 May 2010 *IES Report Review of Energy Wholesale Price for Period 2010-2013* (at page 20-21) calculated the LRMC of least cost supply to meet the total Tasmanian load using efficient new plant (a portfolio of CCGT and OCGT) as being \$68.83 for 2010 -11.⁵

Table 1 shows that Tasmanian spot prices have consistently come in below this mark and have been across a similar range to Victorian spot prices over the same period.⁶

The average spot price over the period 2006-2010 has been \$42.02/MWh in Victoria and \$44.73/MWh in Tasmania and Tasmanian average spot prices have been lower than those in Victoria in 2007, 2010 and 2011 (to the end of April).

Hydro Tasmania’s contracting prices come in below the same conceptual mark, being the LRMC of CCGT for flat swaps and are consistent with prevailing spot market and contract market prices across the NEM.

A further indication of the efficiency of Tasmanian wholesale market outcomes is the steady decline in price over the period since 2009, matching a NEM wide trend. An examination of contestable customer energy costs over the last two years in Tasmania is conspicuously missing from the Panel’s first three discussion papers. This issue goes right to the heart of what the Panel is seeking to address. This has therefore led to an inappropriate concentration on wholesale competition rather than an examination of wholesale and retail price outcomes and understanding what is driving those outcomes.

³ AGL v ACCC (No3) [2003] FCA 1525

⁴ See the February 2001 report for DG competition by London Economics at:
http://ec.europa.eu/competition/sectors/energy/inquiry/electricity_final_part4.pdf

⁵

[http://www.economicregulator.tas.gov.au/domino/otter.nsf/LookupFiles/101754_Review_of_Wholesale_Energy_Price_for_Period%20_2010_2013_%20Intelligent_Energy_Systems_Report_for_OTTER_100510.pdf/\\$file/101754_Review_of_Wholesale_Energy_Price_for_Period%20_2010_2013_%20Intelligent_Energy_Systems_Report_for_OTTER_100510.pdf](http://www.economicregulator.tas.gov.au/domino/otter.nsf/LookupFiles/101754_Review_of_Wholesale_Energy_Price_for_Period%20_2010_2013_%20Intelligent_Energy_Systems_Report_for_OTTER_100510.pdf/$file/101754_Review_of_Wholesale_Energy_Price_for_Period%20_2010_2013_%20Intelligent_Energy_Systems_Report_for_OTTER_100510.pdf)

⁶ One aspect of spot dispatch outcomes in Tasmania that Hydro Tasmania does find puzzling is the level of gas-fired generation at relatively low spot prices. This dispatch pattern does not appear consistent with either modelled gas-fired generation costs such as those contained in IES’ 7 May 2010 report referred to above or the behaviour of other gas-fired generators in the NEM. It may be explicable in terms of sunk costs incurred by the generator, but if this is the case that cost should be a burden on the generator’s profits, not its customers.

Wholesale Competition

While Hydro Tasmania considers that overall market outcomes lie at the heart of the Panel's task, given the role of competition to deliver these outcomes, the Panel will need to examine the competitive dynamic in Tasmania. Previous commentary on wholesale competition in Tasmania has been overly simplistic, ignoring the complexity of the Tasmanian dynamic and equating Hydro Tasmania's size with market power and a competition problem. This ignores a range of very significant constraints on Hydro Tasmania, including reliance on a small number of Major Industrial (MI) customers, the presence of a vertically integrated retailer with a significant monopoly activity, statutory restrictions on water use and the variability of inflows. It is critical to the Panel's process that myths concerning Tasmanian wholesale companies not be perpetuated, but critically examined and placed in proper perspective.

A fundamental step in any competition assessment is consideration of whether there are any barriers to entry (if there are no barriers, then new entry is a constraint on existing participants). Hydro Tasmania considers there is no evidence of any barrier to efficient new entrant generation in respect to price signals.⁷ Further, none of the commentary on wholesale competition in Tasmania has identified any such barriers. In practice, Hydro Tasmania positively facilitates new entry into the Tasmanian generation sector rather than preventing it.

Hydro Tasmania is, however, concerned that the National Electricity Market (NEM) pricing model may not provide an adequate signal for the efficient new entry in the Tasmanian situation. To Hydro Tasmania, it appears that there is a substantive timing problem which can be seen as follows.

In Tasmania, existing hydro-electric generation is more cost efficient than any available form of new entry. Aurora Energy's submission to the Tasmanian Economic Regulator on the *Draft Report, Investigation of Maximum Prices for declared Retail Services on Mainland Tasmania 2009-10*, noted that it ".....agrees with the LRMC methodology used and Regulator's draft report outcome"⁸, so Hydro Tasmania takes the new entrant costs calculated by IES⁹ in that process to be a reasonable representation.

⁷ At page 42 of the *Evolution* paper, the Panel raises the possibility of Hydro Tasmania driving prices to unsustainably low levels. Apart from appearing to be a breach of the *Competition and Consumer Act*, Hydro Tasmania's reliance on a finite water resource, which is insufficient to meet Tasmanian demand, and the fact that NEM dispatch will call on low priced hydro generation for export to Victoria, makes this entirely impossible. If this is meant to be an oblique reference to recent low spot prices, these are simply an extension of low prices prevailing across the NEM in general, and evidence that Tasmania is not a separate market.

⁸ Pg 6 Aurora Energy's submission to the Regulator on the Draft Report, Investigation of Maximum Prices for declared Retail Services on Mainland Tasmania 2009-10, 30 September 2010.

⁹

http://www.economicregulator.tas.gov.au/domino/otter.nsf/LookupFiles/101754_Review_of_Wholesale_Ener

In contrast, the NEM market price for the non-contestable load structure is less than the new entrant LRMC calculated by IES. Further, Hydro Tasmania can profitably hedge the non-contestable load at that market price, indicating that it is more cost effective than a new entrant.

The problem arises because, as the Panel observes, Hydro Tasmania is energy constrained and so new entry is required to meet load growth. However, that new entry is not cost competitive, and so can only price profitably at the marginal load, but this load is significantly less than the minimum efficient new entry size, so the new entrant is left with significant excess capacity, from which it cannot extract a sustainable return, or will defer its entry, creating a system security issue.

This problem arises regardless of whether the new entrant arrives in response to a market price signal, forward calculations of supply requirements, or, a drought, or, other system security events.

The problem of the inability for marginal new entry to compete with more cost efficient and therefore effective existing supply is not limited to the Tasmanian Electricity Supply Industry. It can be seen most dramatically in the water supply constraints affecting most Australian capital cities and the issues surrounding the cost of desalination. Where there is a step increase in the cost of supply from an essential new entrant, the question of how to share the cost of that new entrant between customers is a difficult one.

A further factor which demonstrates that there is no wholesale competition problem, either, per se, or, as a barrier to new entrant retailers, is that Hydro Tasmania stands ready to contract with all comers to Tasmanian load. As a result, any retailer or contestable customer in Tasmania has access to efficiently priced electricity.

The promotion of competition is not simply a function of ensuring a greater numbers of competitors¹⁰. A proper competition assessment involves the identification of constraints on market participants which are not just horizontal i.e. between competitors.

For the Tasmanian Electricity Supply Industry, the Panel needs to consider the constraining effect of:

- the reliance by wholesale suppliers on the continued presence of a very small number of major industrials; and
- a vertically integrated, dual fuel retailer with a substantial monopoly non-contestable load.

gy_Price_for_Period%20_2010_2013_%20Intelligent_Energy_Systems_Report_for_OTTER_100510.pdf/\$file/101754_Review_of_Wholesale_Energy_Price_for_Period%20_2010_2013_%20Intelligent_Energy_Systems_Report_for_OTTER_100510.pdf

¹⁰ Telstra [2007] A Comp T 3 at paragraphs 98 and 99

The Panel also needs to consider the constraining influence of hydrological variability, and Hydro Tasmania's statutory prudent water management obligation. Increasingly international economic studies acknowledge that traditional models for analysing socially optimal dispatch of thermal generation systems cannot be applied to hydro systems which have the characteristics of both a storable good and an exhaustible resource. The focus has to be on long run usage of capacity (scheduling) rather than short run dispatch.

Retail competition

Hydro Tasmania's observation as a wholesale supplier and a customer is that there is competition in the Tasmanian retail sector, albeit that there are only two competitors¹¹. This refutes, in Hydro Tasmania's opinion, the proposition that some change to Tasmanian wholesale arrangements is required to facilitate full retail competition (FRC).

Retail competition is not a means by which retailers act as a proxy for competition between wholesale suppliers. In the NEM, retailers provide valuable services in their own right. These include customer services, wholesale risk management (a critical aspect of NEM for all participants) and price competition on matters such as retail costs and margin. The value of these services is already allowing retail competition in Tasmania.

Hydro Tasmania encourages the Panel to talk to customers who have switched retailers about their experience and to potentially develop case studies around the switching experience. It is Hydro Tasmania's experience as a wholesale supplier that different retailers employ different risk management techniques which may influence customer outcomes regardless of utilising a common wholesale supplier.

The independence of outcomes between wholesale and retail activities has also been identified by the AEMC in its recommendation that retail price caps be retained in the ACT, due to concerns about the effectiveness of retail competition, despite the fact that wholesale supply in the ACT is part of the NSW region of the NEM and considered to be competitive.

In addition to competition in retail services, FRC provides an additional competitive benefit by enabling customers to access wholesale market prices rather than the new entrant prices used in setting regulated tariffs. This combination of inputs provides ample opportunity for customers to gain benefits from FRC without any change to the existing wholesale arrangements.

¹¹ There are currently five retailers licensed to retail in Tasmania.
<http://www.energyregulator.tas.gov.au/domino/otter.nsf/8f46477f11c891c7ca256c4b001b41f2/919e3c7e7a6c6a55ca256cb1001c846f?OpenDocument>

The need for further efficient new entry

The Panel has expressed an interest in the incentives for new entrants at the generation level. The Tasmanian new entrant generation currently identified in the Australian Energy Market Operator's *Electricity Statement of Opportunities* (ESOO) is all driven by factors other than electricity price. Wind farms are predominantly a response to renewable energy subsidies. The other new entrant is co-generation (Gunns Pulp Mill) which is driven through by-product economics.

As can be seen from the ESOO, there is no call for new entry in Tasmania to meet increased demand over the entire 10 year planning period of the ESOO. Hydro Tasmania sees very little commercial incentive for electricity supply driven entry in Tasmania. The only exception to this would be where a new entrant is able to secure matching new demand. However, this type of situation raises a number of other competition issues.

Network costs

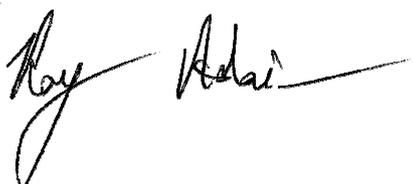
In Hydro Tasmania's view, the timing sequence of the release of the Panel's discussion papers has tended to obscure the very significant contribution of network pricing increases to customer outcomes. The heavy focus on wholesale competition in the Overview and Evolution papers and the quantitative nature of the Pricing paper fail to make clear the impact on customers of:

- increasing network costs;
- the absence of FRC; and
- subsidised support arrangements for renewable energy.

Hydro Tasmania notes that the drivers of network prices may be considered in the further discussion papers on the efficiency and effectiveness of electricity entities. It should not, however, be an answer to the question of network price increases that these have resulted from the Australian Energy Regulator determinations, if either the regulatory regime being applied by the AER does not produce the most efficient outcomes or there has been some misapplication of that regime.

Some more specific comments on errors or incomplete information in the discussion papers are contained in Appendix 1. If you have any queries about any of the matters raised in this submission please contact Rachel Steven on 6230 5471 or via email at rachel.steven@hydro.com.au.

Yours sincerely



Roy Adair
Chief Executive Officer

Appendix 1 Errata

Although these are not particularly material, Hydro Tasmania would like to note some corrections to the discovery papers.

Figure 14 in the *Overview* paper is incomplete, as while it sets out the network of relationships around Aurora Energy, it does not do so for Hydro Tasmania. The figure should identify relationships between Hydro Tasmania and:

- Aurora Energy Retail (hedging of customer load, including non-contestable customers)
- other retailers (hedging of contestable customer load)
- very large contestable customers (negotiation of long term supply arrangements)
- Basslink (funding of Basslink through Basslink Services Agreement)

The primary aim of Hydro Tasmania's capital investment in hydro generation plant is the maintenance of efficient production not the improvement of system efficiency, as suggested on page 39 of the *Overview* paper. Hydro Tasmania's operating plant is not self sustaining; it requires significant ongoing operational and capital maintenance, a rough proxy for which is the depreciation cost for that plant recorded in Hydro Tasmania's financial statements.

The NEM does not operate as distinct regional markets as suggested on page 43 of the *Overview* Paper. This proposition was rejected by French J in the AGL case.