



**Tasmanian Small  
Business Council**  
Uniting Small Business

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# Office of the Tasmanian Economic Regulator

## Review of the Wholesale Contract Regulatory Instrument – Issues Paper

### Submission

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January 2016

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# 1 Introduction

The Tasmanian Economic Regulator (the Regulator) proposes to undertake a pricing investigation into the approvals contained within the Wholesale Contract Regulatory Instrument (the Instrument). The Instrument is used to by the Regulator to regulate and monitor Hydro Tasmania’s contracting activities in the Tasmanian wholesale electricity market. The Regulator published an Issues Paper in December 2015, which is intended to provide context for, and stimulate discussion about, the scope of the proposed investigation.

The Tasmanian Small Business Council (TSBC) welcomes the publication of the Issues Paper and supports the Regulator’s intent in publishing it. We appreciate the Regulator’s invitation to respond to the Issues Paper and do so through this submission.

## 1.1 Small Business in Tasmania and the TSBC

Small business is the ‘engine room’ of the Tasmanian economy. There are more than 37,000 small businesses in Tasmania, 30,000 of which are employers, employing over 70,000 full and part-time people. Numerically, they make up in excess of 96 per cent of all businesses in Tasmania and the sector provides more than half of the State’s private sector employment. Understanding the small business sector, its aspirations and needs is of vital importance to small enterprises themselves, as well as Governments and regulators as decision-makers. The resources to address the future needs of the state can only come from the generation of new wealth and healthy, vibrant small businesses are critical to this.

The Tasmanian Small Business Council (TSBC) is an “association of [small business] associations”, each of which represents their market grouped industry sector. The TSBC provides a representative voice for small business in Tasmania. The TSBC’s role in facilitating meetings of and forums for these trade associations, whose members are predominately small businesses, is paramount to providing informed insights and advice to governments and regulators, including through submissions such as this one.

## 1.2 TSBC's Interest in the Wholesale Market and the Wholesale Contract Regulatory Instrument

Small business in Tasmania is theoretically able to choose an electricity retailer to buy electricity from. However, Aurora Energy is currently a virtual monopoly supplier to Tasmanian small businesses and in reality many small businesses remain on regulated retail tariffs.

The operation and performance of the wholesale electricity market is important to small businesses, who benefit from competitively priced electricity. Wholesale prices account for around 25 per cent of the delivered cost of electricity to Tasmanian small businesses.

Hydro Tasmania is a near monopoly generator in the Tasmanian market. This has acted as a deterrent to the entry of new retailers into the Tasmanian market, a situation that has worked to the overall disadvantage of small business and its need for competitively priced electricity.

The Instrument has an important impact on the wholesale prices which impact on retail prices. It was also intended to subdue Hydro Tasmania's significant market power, reduce the risks of its dominance as counter-party to retailers and facilitate the entry of new retailers into the Tasmanian electricity market, thereby stimulating retail competition. **It has thus far failed to do so in a number of these respects.**

These factors underpin our interest in the Regulator's proposed review of the Instrument.

## 1.3 The Remainder of This Submission

The remainder of this submission is structured as follows:

- In the next section, we consider the need for a fundamental review of the Tasmanian wholesale and retail electricity markets.
- This is followed by our responses to matters raised in the Regulator's Issues Paper.
- Finally, we provide our main conclusions.

## 2 The Need for a Fundamental Review

The TSBC recognises that this review of the Instrument is not about government policy in relation to the Tasmanian wholesale electricity market but rather about one element of the current regulation of the wholesale market. We also recognise that the Regulator has been given a difficult task in regulating Hydro Tasmania's wholesale contracts in a way that meets

the objectives of this regulation. Nevertheless, it is worth recalling some of the key points about wholesale market regulation made in our earlier submission on the establishment of the Wholesale Contract regulatory regime:

*The TSBC strongly supports the need for competitive electricity in Tasmania with consumers being the primary beneficiaries, including small businesses. It is disappointing that small business in Tasmania have yet to experience any type of choice in their electricity retailer or gain access to competitively priced electricity. We note that small business in every other part of the National Electricity Market (NEM) has had a choice of their electricity retailer for some time and this makes the need for reform in Tasmania even more pressing for our small businesses if they are to keep pace.<sup>1</sup>*

Unfortunately, more than two years later small business in Tasmania still **has little access** to a choice of retailer in Tasmania and is yet to see any substantive benefits of retail competition. Apart from ERM Business Energy's mainly larger business focus, no other retailers have entered the Tasmanian electricity market and small business is effectively left with a 'choice' of a single retailer, Aurora Energy. One of the objectives of the wholesale regulatory arrangements, including the Instrument – which we consider to be a very important objective – was to encourage new retailers to enter the market. On this basis the wholesale regulatory framework operating in Tasmania at the moment is unfortunately **failing the needs** of small business for competitive electricity.

In its 2015 Retail Competition Review, the Australian Energy Market Commission commented that:

*Customer satisfaction with the level of choice in Tasmania was the lowest of all NEM jurisdictions. Residential customers are not able to choose their electricity retailers, and only some small businesses are able to do so. Customers in Tasmania are interested in better energy deals but do not have alternative retailers available. Over*

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<sup>1</sup> TSBC, *Proposed Changes to the Interim Price-Regulated Electricity Retail Service Price Determinations & Draft Electricity Wholesale Contract Guideline, Submission to the Tasmanian Economic Regulator*, November, 2013, p. 10 at <http://www.energyregulator.tas.gov.au/domino/otter.nsf/8f46477f11c891c7ca256c4b001b41f2/1d8b676f4eea9102ca257b8d001948ba?OpenDocument#The%20Regulator%20sought%20comments%20on>.

*forty per cent of surveyed Tasmanian residents and over half of small business customers were looking for a better energy deal or interested in doing so.<sup>2</sup>*

This clearly supports that the needs and expectations of many smaller consumers in the Tasmanian electricity market are not being met by the current arrangements.

Whilst welcoming the review of the Instrument, we believe it is time for a fundamental review of the existing structures and arrangements covering the wholesale and retail electricity markets to determine why they have failed to deliver meaningful retail competition to Tasmanian electricity consumers (especially residential and small business customers) and we intend to bring this to the Government's attention.

In relation to the wholesale market, TSBC holds the view that regulation, no matter how well intentioned, structured or administered, will never prove to be a good substitute for actual competition. As a starting point, the Government could re-examine the 'gentrader' model favoured by the Electricity Industry Expert Panel in its final report.<sup>3</sup> We also note that the Panel rejected wholesale market regulation of the type now in place as an inferior option to competitive market approaches and did not believe it would be effective in stimulating retail competition. However, any review should not preclude the efficacy of reform options other than the Expert Panel's preference.

### 3 TSBC Response to Matters Raised in the Issues Paper

Our response to matters raised in the Regulator's Issues Paper is set out in the table below. Our response particularly reflects the interests of Tasmanian small businesses and their desire for an improved environment for retail competition within the context of the Instrument and the broader regulation of Hydro Tasmania's wholesale contracts.

| Issue                                | TSBC Response/Comments   |
|--------------------------------------|--|
| <b>Changes to related regulatory</b> | We note the Regulator's comment that in view of the relationship |

<sup>2</sup> Australian Energy Market Commission, *2015 Retail Competition Review, Final Report*, AEMC, 30 June 2015, Sydney, p XI.

<sup>3</sup> Electricity Supply Industry Expert Panel, *An Independent Review of the Tasmanian Electricity Supply Industry, Final Report*, vol 1, 29 March 2012 at [http://www.electricity.dpac.tas.gov.au/final\\_report](http://www.electricity.dpac.tas.gov.au/final_report).

| Issue  | TSBC Response/Comments  |
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| <b>instruments</b>   | between the Wholesale Guideline, the Statement of Regulatory Intent and the Instrument, the Regulator is open to receiving comments on both. We also note the Regulator’s intention to consult on any consequential changes and support this. At this stage, we have not examined these other documents.  |
| <b>Objectives of the Investigation</b>                     | We note the objectives for the investigation set out on pages 11 and 12 of the Issues Paper. We particularly support the need for the Regulator to consider “The promotion of efficiency and competition in the electricity supply industry” and “The protection of the interests of electricity consumers.”  |
| <b>Timing of the Investigation</b>                         | A timetable for the Investigation is set out on page 12 of the Issues Paper. We believe this provides an adequate basis for the Investigation and for effective consultations.  |
| <b>Evaluation Criteria</b>                                 | We note the evaluation criteria set out on page 13 of the Issues Paper. We particularly welcome the inclusion of a need to satisfy the demands of consumers; to encourage stakeholder participation; and to produce outcomes reflective of competitive markets, and that provide sufficient certainty for new and existing market retailers.  |
| <b>Market based framework or prescriptive regulation</b>   | The natural tendency of the TSBC is to favour market based outcomes. Within the context of the Instrument, we would lean towards a market based framework rather than a prescriptive approach. However, we note that this is unlikely to mirror prices set in an actual market context. The application of the current framework involves complexity, detail and approximations in trying to determine surrogate market prices. This can also have unintended consequences. We believe that the questions of what framework to use and whether the current framework, if retained, should be changed are questions best answered in a detailed Investigation. |
| <b>Does the Instrument support full retail competition</b> | On the basis of evidence before us, we do not believe that the instrument has been effective in supporting full retail competition. Whilst the wholesale regulatory framework, including the Instrument, formed part of the policy decision to move to Full Retail Competition, it has not encouraged any new retailers to enter the Tasmanian electricity market. Smaller customers have little or no choice in who they buy their electricity from. Price competition is extremely limited and the significant  |

| Issue                               | TSBC Response/Comments  |
|-------------------------------------|---|
|                                     | <p>discounts available to small business in other NEM jurisdictions simply do not exist in Tasmania. We believe that Aurora’s costs have also been inflated by the prospect of competition, which has not materialised, through the addition of higher retail margins and unnecessary costs to serve customers.</p> <p>Nevertheless, the Instrument itself is only part of this unfortunate rubric. The former Government did not support a competitive wholesale market and opted instead for the regulation of wholesale contracts, which is at the nub of the problem. In our view, it is very unlikely that the current Instrument will encourage new retailers to enter Tasmania.</p>  |
| <b>Term of the Instrument</b>       | <p>Given that the Instrument has not been able to encourage new retail entry, we believe that a new Instrument should be subject to another Investigation after three years of operation.</p>   |
| <b>Overlap</b>                      | <p>The issues of overlap between the operation of the existing and any new Instrument should not impact on any decisions to put a new Instrument in place which is more beneficial to consumers.</p>  |
| <b>Amendments to the Instrument</b> | <p>We agree that there is a lack of flexibility in the current approach to amending the instrument which may well justify some changes. The exact nature of these changes should be subject to more detailed consultations as part of the Regulator’s Investigation. <i>Prima facie</i> we can see advantages to having a streamlined and more flexible approach to minor amendments, to correct errors or for purely administrative changes.</p>   |
| <b>Types of Contract</b>            | <p>We believe this to be one of the most important issues in the Investigation.</p> <p>In order to deliver the crucial objective of encouraging new entrant retailers, it is imperative that a retailer can manage its wholesale market risk. Having a wholesale market that is liquid with a range of products is therefore critical. Most retailers favour using physical and financial solutions to manage the risks. Given the low likelihood of new generation into the Tasmanian market, apart from renewables encouraged by the Renewable Energy Target, the market will continue to have the inherent risk of a dominant generator exercising control. As a consequence, even more so than other States, it is imperative that a complete range of financial risk management instruments is available so that retailers can apply their own risk management strategies to offer</p> |

| Issue   | TSBC Response/Comments   |
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|   | <p>customers competitive market offers. We note that the regulated wholesale contract market is meant to support this but appears not to be doing so to date.</p> <p>To the extent that regulated contracts are intended to provide a 'safety net' for new entrant retailers, it might be argued that the types of regulated contracts on offer should be limited to the current four. On the other hand, new entrant retailers seeking a more diverse range of unregulated contracts also face the dominance of Hydro Tasmania as a potential obstacle to negotiating these and would be less exposed to this market power with a more diverse range of regulated contracts.</p> <p>Currently, regulated products are limited to over-the-counter trades subject to the credit risk policies of Hydro Tasmania, which are not public (inconsistent with the Evaluation Criteria). If a margining product was introduced, then the counterpart's credit risk can be better managed, and more participants would likely qualify to trade with Hydro Tasmania. Using Victoria as an example, most new entrant retailers are smaller organisations with smaller balance sheets and use the ASX margining products to manage the risks.</p> <p>A greater range of products with margining are more likely to entice trading houses to speculate on market prices, which will create greater liquidity. Retailers are likely to feel more comfortable in entering into an expanded market. Ideally, the market needs more non-Government players to enter, to reduce the regulatory risks.</p> <p>We comment in more detail on CAP products below.</p> <p>We are of the view that the Regulator needs to consider this matter in detail as part of its Investigation.</p> |
| <p><b>Alterations to Standard Forms</b></p>   | <p>We support allowing both parties to agree to the use of non Hydro Tasmania standard forms without approval by the Regulator. We note that the need for approval by the Regulator may act as a deterrent to the use of non Hydro Tasmania standard forms and could discourage new entrants wishing to use these.</p>   |
| <p><b>Calculation of prices for peak period swap, baseload swap and load following swap</b></p> | <p>We have some concerns in this area. As mentioned earlier, given that these are regulated products, we doubt that they can satisfy some of the evaluation criteria as well as market based outcomes.</p>   |

| Issue   | TSBC Response/Comments   |
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| <b>products</b>   | <p>Within these limits, they may perform reasonably but some concerns remain. The existing regulated products are not meeting the needs of small business in relation to retail competition.</p> <p>We are also concerned that prices for both peak and baseload swaps, as shown in Figures 2.2 and 2.3 of the Issues Paper, are significantly higher than in Victoria and that the difference has been increasing over time. There is no explanation for this in the Issues Paper. Whilst it may reflect legitimate differences between the two envisaged in their calculation and acknowledging that parties are free to negotiate unregulated contracts below this, it would be useful for the Regulator to undertake a more detailed analysis of this as part of its Investigation.</p>  |
| <b>Calculation of the maximum baseload \$300 cap contract price</b> | <p>We have concerns about the structure and performance of this product.</p> <p>To begin with, the prices shown in Figure 2.4 of the Issues Paper are three times those shown for a similar product in Victoria. This difference needs to be thoroughly investigated and explained.</p> <p>Secondly, we note that concerns with the methodology currently being used were expressed by stakeholders during its development. As Hydro Tasmania has not sold any of these products since their inception, this also raises concerns that they are priced at an unrealistic level. For example, using the costs of new entrant peaking plant as a key input is problematic. The use of static inputs with a set construction year (2022) and discounting back to the relevant contract year is unrepresentative of how markets determine the price of this product. Market determined caps are reflective of a range of dynamic market factors rather than such a deterministic approach. The inputs used, reflecting values set in 2013, are also likely to be out-of-date and in need of review.</p> <p>Thirdly, a common strategy for a new entrant retailer is to buy \$300 caps and then accept the below \$300/MWh risk. Using the prices offered under the existing scheme makes such a strategy uneconomic because the cap price is over-valued. As a consequence, new entrant retailers would struggle to compete with the incumbent retailer. Entry by smaller retailers, who are very active and capturing market share in other parts of the NEM,</p> |

| Issue | TSBC Response/Comments  |
|-------|---|
|       | <p>could be particularly discouraged.</p> <p>Hence, and given that these contracts are traded in the market, greater reference back to market outcomes seems to be a useful starting point for considering changes to the current approach.</p> <p>We also believe that a single \$300 cap regulated product could be too limited. Adding other products, such as \$100 and \$200 cap products, would improve risk management. As evidenced by the recent failure of Basslink, spot prices are not settling at extreme levels but rather around the \$100 range. A retailer with an everyday price in the \$100 range may bleed slowly, but could fail eventually, so more risk management options are required. Hydro Tasmania is a natural capacity seller, not an energy seller, so more capacity type derivative products should presumably suit them.</p> <p>We note that the Issues Paper has flagged that there could be risks and unintended consequences flowing from changes to the \$300 Cap methodology and the setting of its inputs given the linked nature of the Instrument to other parts of the regulatory framework.</p> <p>We support a detailed review of the calculation of the \$300 cap contract price and the addition of other regulated capped products, including the risks and consequences of making changes.</p> |

## 4 Conclusions

Whilst the TSBC welcomes the Regulator’s Issues Paper and believes that its Investigation of the Instrument could bring about some beneficial change, it also supports a more fundamental review of Tasmania’s wholesale and retail electricity markets. Current arrangements have been in place for 2 years and have not delivered the benefits foreshadowed at the time they were developed. In particular, apart from ERM Business Energy, no new retailers have entered the Tasmanian market, Aurora Energy continues as a government owned retailer to almost all smaller customers and Hydro Tasmania continues as near monopoly generator. Tasmanian small business is disadvantaged as a result vis-à-vis small business in most other parts of the NEM. Its need for access to competitive electricity

supply and competitive prices remains unmet. Reform of the Instrument may deliver some benefits but is very unlikely to mirror competitive market outcomes.

We recognise that not all these matters are in the province of the Regulator and will bring them to the attention of the Tasmanian Government, but they are difficult to separate from regulation of the wholesale market and the lack of competition it has delivered to date.

In regard to the Regulator's Issues Paper and Investigation into the Instrument, we believe that there are several matters of significance that require detailed investigation such that a major Investigation is justified. These include:

- The inability of the Instrument to encourage any new entrants and the reasons for this.
- The consequent desirability of reviewing whether a change in the method of regulating Hydro Tasmania's contracts is required, including either a change in the existing market based approach or moving to a more prescriptive one (though we doubt the latter would be beneficial).
- Considering the need for a more diverse range of regulated contracts of the kind that will help to develop the Tasmanian wholesale electricity market and be more likely to encourage new entrant retailers. This includes a margining product that would assist market development and new entry, including by smaller retailers, who are gaining market share in other parts of the NEM and may be attracted to Tasmania if they faced lower risks from entry.
- Consideration of whether the significantly higher prices for Tasmanian regulated peak and baseload products compared to Victoria are justified.
- Investigating further the Tasmanian regulated \$300 cap product including why it is three times that of Victoria's market based product, concerns with the inputs used in its calculation and the desirability of a more expansive range of regulated cap products.
- The flow through impacts to other parts of the wholesale regulatory framework.