Energy for the Future

Reforming Tasmania's electricity industry

May 2012

Tasmania

Contents

Background

Managing the electricity industry to ensure that prices are affordable and supplies are reliable while maintaining core electricity infrastructure in public ownership is a key priority for the Government.

Tasmania's electricity businesses

Over many generations, Tasmanians have invested significant public funds in the State-owned electricity businesses.

At disaggregation in 1998, the State's electricity businesses were divided into three, to prepare for a reformed electricity sector when Tasmania entered the National Electricity Market and Basslink could maximise the value of hydro-based generation in the NEM environment.

The businesses have evolved over time. Currently, there are three state-owned electricity businesses – Hydro Tasmania, Aurora Energy and Transend.

Hydro Tasmania is a vertically-integrated energy business, with both wholesale and retail activities backed by physical hydro generation assets and long-term contracts for wind farm output. Its subsidiary, Momentum, is an electricity retailer based in Victoria which serves customers in Victoria, South Australia, Queensland, the Australian Capital Territory and New South Wales. Its consulting arm, Entura, provides power engineering, renewable energy, water and environmental consulting services to governments, utilities, developers and international companies and operates as a standalone business in Australia, Asia and Africa.

Aurora Energy (Aurora) is a generator, wholesaler, distributor and retailer of electricity. Aurora also sells natural gas in Tasmania and Victoria. Amongst other things, Aurora owns and operates the Tamar Valley Power Station (through its subsidiary Aurora Energy Tamar Valley), which uses natural gas piped from Victoria to generate electricity. Aurora is also the sole distributor of electricity in Tasmania. Households and small businesses in Tasmania can currently purchase electricity only from Aurora.

In addition, Aurora is also a wholesale optical fibre-based telecommunications service provider to the Tasmanian market.

Transend owns and operates the Tasmanian electricity transmission system. The system transports electricity from generators to Aurora through a network of substations, switching stations and almost 4 000 circuit kilometres of transmission lines. Electricity is also transported directly by Transend to a number of large customers, such as smelters and paper mills. Transend also has a communications network, which includes a microwave radio system complemented by fibre circuits installed as part of the electricity transmission network.

Current state of the electricity industry

The Tasmanian electricity industry has been the subject of ongoing reform for almost 20 years, commencing with the disaggregation of the Hydro-Electric Corporation into separate generation, transmission and retail/distribution companies in 1998 and most recently with entry to the National Electricity Market through Basslink in May 2005.

A key objective of successive governments throughout this reform period has been the development of competition, in the retailing of electricity in particular.

Accommodating the unique Tasmanian electricity supply industry under the NEM framework has presented very significant challenges. Tasmania's integrated hydro-electric generating system was developed as a set of complementing schemes to maximise differing rainfall patterns in different areas of the State, as well as balancing short term and long term water storages and seasonal electricity demand. This is not compatible with the competitive generation model envisaged for the NEM, which was largely founded on several large standalone generators in each region.

The introduction of Basslink and the associated contractual arrangements has added an additional layer of complexity. Several years of technical investigation and modification of the rules and processes have been required to mitigate frequent occurrences of adverse market outcomes that were seen with the commencement of Basslink operation.

The efficient operation of the electricity industry requires a careful balance of central dispatch, demand-side participation in load shedding schemes by all major loads and anticipating the preferred future state of the power system to enable Basslink flows and real-time water management. These conditions do not exist in other NEM regions and are not contemplated in the generic NEM design. Further, the variability in supply-side energy availability and the probabilistic value of firm and non-firm energy capacity is not captured in the competitive NEM pricing framework.

For these and other reasons, it is now apparent that the Government's objectives for the Tasmanian electricity industry are not being realised as well as could be the case. Strong competition has not emerged in the wholesale or retail markets and the future prospects for strong competition are weak. The electricity businesses are not making commercial returns to their shareholders and there is inherent conflict between Hydro Tasmania and Aurora. Tasmanian customers continue to experience significant increases in the price of electricity, although this experience is consistent with that in other NEM jurisdictions.

Expert Panel Review

In 2010, the Parliament established the independent Expert Panel to undertake a detailed review of the industry and make recommendations to guide and inform a Tasmanian Energy Strategy. The Panel's review was undertaken over a 17 month period and involved a number of stages of consultation with the public and the electricity businesses. The Panel's final report was tabled in Parliament on 29 March 2012.

The Panel's key finding is that effective retail competition for households and small businesses is worth pursuing but will not be delivered without significant structural reform of the wholesale market. The Panel concluded that this is because Hydro Tasmania possesses substantial market power in the wholesale market, which would dissuade new retailers from entering the retail market.

The Panel has developed a structural reform package that it considers will facilitate genuine and enduring retail competition and deliver significant economic benefits to the State, as well as lower prices to customers. This reform package includes the sale of trading rights to Hydro Tasmania's output to three new, competing State-owned entities, the sale of Aurora's retail customer base to three competing privately-owned retailers and a merger of the two network businesses.

The Panel has also identified a number of priority issues that it considers require the Government's immediate attention, including the regulatory framework for determining non-contestable customer electricity prices, the commercial position of the Tamar Valley Power Station and the governance and oversight arrangements that apply to the electricity businesses.

The Panel also found that:

- Basslink has proven to be an effective and cost-efficient means of securing the State's energy supply during times of drought, enabling Tasmanian demand to be met at a materially lower cost to Hydro Tasmania than would have been the case under alternative scenarios;
- Hydro Tasmania has not, until recently, been able to use Basslink to profitably trade electricity at the levels or value expected prior to Basslink's commissioning, primarily due to severe drought conditions. With inflows returning to more typical levels, Basslink is proving to be a profitable opportunity for Hydro Tasmania;
- Tasmanian non-contestable customers are not subsidising Basslink through their electricity prices;
- contemporary major industrial customer pricing does not reflect cross subsidies from other electricity users;
- the technical performance, including overall reliability, of the electricity supply industry in Tasmania is generally comparable to that in other states;
- each of the electricity businesses generates sufficient cash to fund operating activities and to have available an amount of 'free cash' to utilise for capital investment in core business assets or diversification/growth activities, repay debt or return dividends to shareholders/taxpayers;
- the electricity businesses's financial performance has been relatively weak, particularly with regard to dividends distributed to the Government; and
- governance changes that drive accountability for performance are starting to emerge which, if sustained, can be expected to improve the financial performance of the electricity businesses, but there remains scope for further improvement.

The Government agrees with almost all of the Panel's conclusions relating to the key issues facing the industry and the areas that require reform. The priority areas are:

- competition arrangements in the retail market;
- regulatory or structural reform of the wholesale market;
- the method used to set the regulatory allowance for wholesale electricity purchasing for non-contestable customers;
- the financial performance and market situation of the Tamar Valley Power Station;
- Hydro Tasmania's mainland growth strategy; and
- structural reform of the network businesses.

Overview of the Reform Package

Objectives

The Government has adopted four objectives for electricity policy in Tasmania:

1. Lowest sustainable electricity bills.

2. Long-term safe, secure and reliable supplies of electricity.

3. Maximise the value of Tasmania's low carbon advantage and the brand benefits of clean Tasmanian electricity.

4. Financially viable state-owned electricity businesses that run efficiently and effectively and maximise the overall economic benefit to Tasmania.

The Government has developed an integrated reform package to meet these objectives and facilitate retail competition for all customers, improve the efficiency of the industry and put downward pressure on prices in the short, medium and long term.

The intended features of the package are outlined below. Some elements of the package may require refinement through the detailed design phase to optimally meet the Government's objectives.

Key features

The key features of the reform package are:

- Full retail competition will be introduced from 1 January 2014.
- The Government will sell and transfer Aurora's retail customers in blocks to new, competing private sector retailers, from the start of FRC on 1 January 2014.
- Aurora's distribution system and Transend's transmission network will be integrated to form a single combined network business. The businesses will be merged from 1 July 2014.
- Independent regulation of Hydro Tasmania's wholesale market activities by the Tasmanian Economic Regulator from 1 July 2013.

Supporting features

- Hydro Tasmania will continue to grow its clean energy retailing business, Momentum, subject to relevant approvals and ongoing reviews to assess whether the venture is an appropriate investment of public capital;
- Aurora's retail services functions will be merged with Momentum's functions, once the transition of retail customers to new retailers is complete, to optimise the businesses' previous investments in retail services; and
- An assessment of the Tamar Valley Power Station assets will be obtained and where the strategic value of state ownership of the assets, or parts of the assets, exceeds a sale value, those assets will be transferred to Hydro Tasmania.

Immediate actions

There are a number of significant factors which, in the absence of any immediate action by the Government or the electricity businesses, would have resulted in electricity prices increasing substantially from 1 July 2012.

To provide price relief to customers from 1 July 2012:

- The Government has changed the way the Tasmanian Economic Regulator calculates prices for households and small businesses. This will reduce the price increase on 1 July 2012 by seven per cent on average, at an annual cost to the Government of $37 million. This will be funded from the proceeds made by Hydro Tasmania arising from the introduction of the carbon price.
- Aurora has asked the Australian Energy Regulator to smooth the under-recovery of its distribution services revenues from previous years, which will reduce the price increase on 1 July 2012 by almost two per cent on average. This will provide price relief to households and small and medium businesses.
- Transend has elected not to increase revenues by the extent allowed by the Australian Energy Regulator and will only increase revenues by half a per cent less than the increase in the Consumer Price Index. This will reduce the price increase on 1 July 2012 by more than three per cent on average for households and small and medium businesses. This will also be important for some major industrial customers that have expressed concerns over sharply rising network costs in recent years.
- Under the National Electricity Rules, distribution businesses are able to request a limited merits review of the pricing decisions made by the Australian Energy Regulator. In the past, the limited merits review has been used by some network businesses to appeal and increase the prices they can charge. Aurora will not request a merits review of the recent pricing decision made by the AER and will operate the distribution network within the allowance determined.

Expected Outcomes

Principle 1: Customers should be able to choose their electricity retailer and should receive a price benefit from having this choice:

Action 1.1: Full retail competition will be introduced from 1 January 2014. This timeframe has been set as the earliest possible to enable Aurora's Distribution Business to build the information systems required to support FRC and develop the supporting regulatory framework.

Action 1.2. To deliver a direct price benefit to customers before the introduction of FRC, the Government has prepared regulations to require the Tasmanian Economic Regulator to reduce the energy price component of regulated electricity, which will take effect on 1 July 2012. Thereafter, further price benefits are expected to be delivered through increased competition under an FRC environment and further efficiency improvements.

Principle 2: There should be lower risks for taxpayers and electricity retailers from the operations of the Tasmanian market:

Action 2.1: Competing retailers will be encouraged to set up in Tasmania through ensuring they are not exposed to unnecessary wholesale price risk. This will be achieved through regulating the prices charged by Hydro Tasmania to electricity retailers in Tasmania.

Action 2.2: The Government will remove the unnecessary and inefficient competition between the government businesses — principally Hydro Tasmania and Aurora — by withdrawing Aurora from energy generation activities. Unless an assessment indicates that there are strong reasons not to, the Tamar Valley Power Station will be transferred from Aurora to Hydro Tasmania, which will operate TVPS under a regulated wholesale market regime. Some peripheral assets may also be transferred to Hydro Tasmania or sold to the private sector.

Principle 3: Tasmania should have a secure supply of energy through a transparent wholesale energy market.

Action 3.1: Hydro Tasmania's wholesale market trading in Tasmania, in particular its contract offers and prices, will be regulated by the Tasmanian Economic Regulator. Wholesale energy prices will be transparent.

Action 3.2: Hydro Tasmania will be given explicit responsibility for managing energy security for the State. It will have the ability to achieve this through its control of hydro generation; the Tamar Valley Power Station and Basslink. This will remove any risk that Tasmanians will be exposed to power rationing as a result of commercially-driven strategies by competing government-owned electricity generators. This responsibility will also be enshrined in a way that ensures that Hydro Tasmania cannot pursue commercial interests on the mainland at the cost to energy security in Tasmania.

Principle 4: The value of Tasmania's carbon advantage will be maximised to the benefit of the Tasmanian community.

Action 4.1: Hydro Tasmania will continue to grow its clean energy retailing business, Momentum, on mainland Australia, and will merge with the retail services functions, including billing systems and the call centre, currently operated by Aurora.

Details of the Reform Package

Retail market

- Full retail competition will be introduced from 1 January 2014.
- Aurora's retail customer base will be divided and sold, from or before FRC commences;
  - a scoping study will examine the optimal division of the retail book;
  - PAYG customers will be offered as a separate bundle.
- Hydro Tasmania's Momentum strategy will continue, subject to relevant approvals and ongoing reviews to assess whether the venture is an appropriate investment of public capital.
- Aurora's retail services functions will be merged with Momentum's functions, once the transition of retail customers to new retailers is complete, to optimise the utility of the businesses' previous investments in retail services.
- The current retail price determination will be extended from 1 July 2013 until the commencement of FRC by regulation and the wholesale energy price for that period will be set as the average of the long run marginal cost and the market price.

Rationale

Reforms in retail competition arrangements are intended to improve the performance of the industry in terms of the following objectives:

- lowest sustainable electricity bills; and
- financially viable state-owned electricity businesses that run efficiently and effectively and maximise the overall economic benefit to Tasmania.

Full retail competition will be implemented by removing the existing legislative prohibition on retailers other than Aurora selling electricity to small customers. Following the implementation of the National Energy Customer Framework, which has recently passed through the Tasmanian Parliament, an adequate small customer protection framework and market arrangements exists to support FRC. The implementation of NECF is a very important facilitator of FRC and has removed the need for a detailed Tasmania-specific retail framework to be developed.

Retail price regulation is not covered by NECF and price regulation will be retained under FRC until the Government is satisfied that competition is fully effective. The regulated price will set the overall level of revenue per customer available to cover the costs and profits of supplying small customers, but a small amount of the profit will be transferred to customers through competition.

Under a competitive market, a nominated retailer will be given responsibility for safety-net arrangements for a bundle of customers and must offer a regulated "standing offer" contract to any small customer who requests one in its area. That retailer is called the "local" retailer. Regulation of the standing offer contracts of local retailers in other jurisdictions closely resembles the current approach to regulating Aurora's tariffs for non-contestable customers.

Competitive market contract offers from retailers in other jurisdictions have generally been made at a discount from the standing offer price, for the first several years of competition at least.

Active competition in the retail market may drive retailers to seek more competitive offers in the wholesale electricity market, or to develop more cost-effective risk management strategies. Because the cost of energy comprises almost 40 per cent of the total retail price, small gains in efficiency in the wholesale side of the market would result in savings to customers, when combined with active competition in the retail market. In addition, the scale efficiency benefits of national retailer costs through competitive offers will give Tasmanian customers access to further price reductions.

In addition, customers would gain non-price benefits from FRC, including:

- choice in electricity retailer;
- further assurance against monopolistic pricing through the ability to change retailer;
- equality with larger electricity customers, who currently enjoy choice of retailer; and
- increased service standards and product diversity over time, including expanded dual fuel retailing (that is, combined electricity and natural gas retailing).

While FRC is focussed on delivering the benefits of competition to small customers, bringing in additional retailers to Tasmania is also likely to benefit larger customers.

Reforms to other areas of the electricity supply industry are necessary to support the move to full retail competition. In particular:

- wholesale market reforms are considered necessary to encourage entry into the Tasmanian retail electricity market;
- Aurora Energy would have no rationale to operate the Tamar Valley Power Station, and so these reforms are not possible unless alternative arrangements are made with respect to the power station;
- without retail customers or generation assets, Aurora Energy would effectively become a distribution network company. Network integration and the efficiency benefits arising from it will therefore be progressed; and
- Aurora's retail services functions can be merged with Momentum's functions, once the transition of retail customers to new retailers is complete. This will optimise the utility of previous investments in retail assets from a Tasmanian Government whole-of-portfolio perspective.

These supporting and consequential reforms are discussed in more detail below.

Concession and hardship arrangements

Existing concession, hardship and customer protection arrangements will be continued with private retailers, through regulations. This is the established practice in all other NEM states.

Aurora Pay As You Go customers

The APAYG product is a specialised product in the Australian market and the penetration of prepayment meters in the Tasmanian market is unique in Australia. Aurora is the only retailer in Australia that specialises in prepayment metering and has 37 000 APAYG customers.

The Government will seek to find a buyer for this non-standard product, which may be the same buyer as one of the purchasers of the rest of the customer base, or may be a buyer only interested in acquiring this group.

Wholesale market

- Hydro Tasmania's wholesale market activities will be regulated by the Tasmanian Economic Regulator, to be introduced by 1 July 2013:
    - form of regulation to be mandated contract offers of standard swap, cap, inter-regional swap and net system load load-following hedge;
    - prices regulated by Tasmanian Economic Regulator at opportunity value in Vic region;
    - cap, inter-regional and load-following premiums to be set by the Tasmanian Economic Regulator;
    - Hydro Tasmania not required to contract above firm capacity, as determined by Tasmanian Economic Regulator;
    - robust and transparent monitoring and compliance regime, administered by Tasmanian Economic Regulator;
    - not preclude bilateral contracting outside the regulated framework
- From the commencement of FRC, the Tasmanian Economic Regulator will establish the method for determining the wholesale energy price for the regulated standing offer contract, subject to a number of principles.

Rationale

Reform of the wholesale market will impact on all four of the Government's electricity objectives:

- lowest sustainable electricity bills (when linked through the regulatory allowance);
- long-term safe, secure and reliable supplies of electricity;
- maximise the value of Tasmania's low carbon advantage and the brand benefits of clean Tasmanian electricity; and
- financially viable state-owned electricity businesses that run efficiently and effectively and maximise the overall economic benefit to Tasmania.

The Panel's review of the Tasmanian wholesale market concluded that Hydro Tasmania possesses substantial market power through its dominant position in the contract market and its ability to control the Tasmanian spot price. The Panel considered that, while Hydro Tasmania's market power remains latent most of the time (ie. is not exercised), Hydro Tasmania engages in strategic bidding to set the Tasmanian spot price when its contract position and market circumstances present the opportunity.

Because of these factors, the Panel concluded that Hydro Tasmania's market position is the main barrier to new retailers entering the Tasmanian market and that some form of wholesale market reform is required to manage wholesale price risk and enable effective retail competition to develop in Tasmania.

The risks outlined by the Panel are likely to create a perception that wholesale market risk is higher in Tasmania than in other NEM regions and that there is a credible chance that new entrant retailers will perceive this risk as sufficient to threaten their financial returns if they entered the Tasmanian market.

Wholesale market reform is therefore necessary to provide sufficient confidence to larger retailers that their risks can be appropriately managed. This will increase the likelihood that larger mass-market retailers will enter the Tasmanian market and hence facilitate active competition in the retail market. Wholesale market reform may also provide an incentive for Hydro Tasmania to focus actively on controlling its costs and remove transaction costs between the State's competing energy businesses.

Wholesale market reform will be guided by the following principles:

- the reform option should be designed to provide market participants with sufficient confidence that they can manage their wholesale risks appropriately;
- the risks of operating in the Tasmanian market should be commensurate with those in other NEM jurisdictions;
- market participants should have the flexibility to manage wholesale market risk using similar business models to those used in other NEM jurisdictions;
- the reform option should not unduly constrain Tasmania's ability to maximise the carbon value accessed through Basslink; and
- the reform option should recognise the interaction between the spot and contract markets and not create unintended incentives or consequences (such as a risk or value transfer between these markets or between market participants).

The Government has decided that a regulatory approach best meets these principles and will support the introduction of FRC. Hydro Tasmania will be required to make available the following products at all times:

- standard financial swaps, which are the main financial hedging instrument used in the NEM;
- a range of caps ($100/MWh and $300/MWh caps), which place an upper limit on the price to be paid by the other counterparty in times of high spot prices, with a regulated maximum premium;
- inter-regional swaps, which would potentially enable other market participants to hedge across Basslink; and
- load-following hedges for the small customer load, with a regulated maximum premium, which would effectively transfer volume risk from the other counterparty to Hydro Tasmania and remove Hydro Tasmania's opportunities to profit from spot market exposures.

A number of these products are already offered by Hydro Tasmania. The regulatory model will improve transparency around these products.

The Tasmanian Economic Regulator will be given the responsibility for regulating the premium of caps, inter-regional swaps and load-following hedges. Tasmanian contract prices will be set by reference to Victorian contract prices, which reflect the opportunity cost of Hydro Tasmania selling into an alternative market. However, the regulatory framework will not require Hydro Tasmania to sell contracts that exceed its physical ability to meet those contracts. The Tasmanian Economic Regulator will have an oversight role in reviewing Hydro Tasmania's firm net sold position and whether Hydro Tasmania's contract sales exceed this via a reporting framework.

The overall regulatory framework will allow for market participants to negotiate with Hydro Tasmania outside of the regulated products. It will also include additional disclosure obligations relating to the Tasmanian spot price and Hydro Tasmania's market position. This will mitigate the information asymmetry that currently exists in the Tasmanian market and allow other market participants to manage potential exposures and risks.

Tamar Valley Power Station

An assessment of the Tamar Valley Power Station assets will be obtained and where the strategic value of state ownership of the assets, or parts of the assets, exceeds a sale value, those assets will be transferred to Hydro Tasmania.

The Government's in-principle position is that the assets should be transferred to Hydro Tasmania.

Rationale

Reforms relating to the Tamar Valley Power Station will impact three of the industry objectives:

- lowest sustainable electricity bills;
- long-term safe, secure and reliable supplies of electricity; and
- financially viable state-owned electricity businesses that run efficiently and effectively and maximise the overall economic benefit to Tasmania.

At the time that the Tamar Valley Power Station was acquired by Aurora, it was intended that the power station would be operated as a merchant plant, with Aurora selling rolling financial contracts to Aurora's retail business and other retailers, and participating actively in the spot market. However, since that time it has become clear that the merchant strategy is not viable, due to a high cost base, lack of opportunities and exposure to significant risk in the spot market. Aurora now operates the plant through an internal tolling arrangement with its wholesale energy division, which has the effect of removing the power station from the competitive wholesale contract market.

The Panel found that the power station's underlying financial performance is weak, based on the gap between potential energy revenue at current market prices and operating costs. The Panel argues that Aurora's risk profile increased materially by owning the Tamar Valley Power Station, and that these risks have been realised with the improvement in the supply-demand balance in Tasmania.

It is important that the Tamar Valley Power Station can be operated as part of a sustainable portfolio in order to contribute to Tasmania's energy markets and security, as the average annual energy output of the hydro system is by itself not sufficient to meet Tasmanian demand.

Alternative options for the Tamar Valley Power Station and associated gas contracts are to sell them to the private sector, or, if they cannot be sold to the private sector for fair value, transfer them to Hydro Tasmania.

If sold to the private sector, this would complement the other proposed wholesale market reforms. Selling the Tamar Valley Power Station concurrently with Aurora's retail customers may therefore facilitate the retail sale process. It would also be consistent with the commitments made by the Government at the time of acquiring the power station that it would sell the assets within three to five years of commencing operations.

Alternatively, if transferred to Hydro Tasmania on the basis of their contribution to energy security, a key aspect of energy policy, the efficiency and performance of the Government's energy portfolio will be enhanced compared to the status quo. Further, because the station is currently operated through an internal tolling arrangement, the impact on competitive outcomes would be negligible.

The Government will obtain an assessment of the Tamar Valley Power Station assets and associated gas contracts to inform a sale of those assets and contracts to the private sector or alternatively transfer them to Hydro Tasmania. The Government's in-principle position is that the assets should be transferred to Hydro Tasmania.

Network integration

Aurora's distribution and telecommunications functions will be merged with Transend Networks from 1 July 2014.

Rationale

A network merger will impact on the following industry objectives:

- lowest sustainable electricity bills (when linked through the regulatory allowance);
- long-term safe, secure and reliable supplies of electricity; and
- financially viable state-owned electricity businesses that run efficiently and effectively and maximise the overall economic benefit to Tasmania.

Benefits from merging the two businesses could arise through a number of sources:

- improved operational efficiencies and reductions in overlapping corporate functions;
- dynamic efficiency gains through improved decision making; and
- stronger strategic and cultural alignment.

The potential to merge the network businesses has been considered in three previous reports: a KPMG study for Aurora in 2007, PwC in its 2009 report and the Panel's report. All three studies found that there are likely to be net benefits from combining the businesses.

It is not possible to merge Transend and Aurora while Aurora remains in its current form, so that a single business manages both networks and the Aurora energy business, including generation. This would be inconsistent with the State's obligations under the COAG Competition Principles Agreement, which prevent a business owning both generation and transmission assets given the potential to treat the internal generation more favourably than a competitor.

A network merger can consequently only be pursued in conjunction with other reforms. This is why a network merger has not been pursued before now, as it can only be progressed once other key reform elements have been completed.

However, Aurora and Transend have already been operating under a "collaboration" model, which has removed duplication between the two businesses. Full network integration is the next step to capture the remaining benefits of merging the two networks.

A key aim therefore is not simply to combine the businesses, but to create a single business that operates a single network in terms of planning, capital investment, operations and maintenance. This intent recognises that many of Transend's assets would be regarded as distribution assets in other NEM jurisdictions.

Maximising Tasmania's Clean Energy Advantage

- Hydro Tasmania will continue to grow its clean energy retailing business, Momentum, subject to relevant approvals and ongoing reviews to assess whether the venture is an appropriate investment of public capital; and
- Aurora's retail services functions will be merged with Momentum's functions, once the transition of retail customers to new retailers is complete, to optimise the businesses' previous investments in retail services.

Rationale

Reforms relating to maximising Tasmania's clean energy advantage have the capacity to influence the following reform objectives:

- maximise the value of Tasmania's low carbon advantage and the brand benefits of clean Tasmanian electricity; and
- financially viable state-owned electricity businesses that run efficiently and effectively and maximise the overall economic benefit to Tasmania.

Tasmania's renewable energy supply system is the envy of Australia and is something of which Tasmanians are very proud. Tasmania is uniquely placed to capitalise on our natural resources, our investment in renewable energy, and our brand and reputation as a world leader in this field.

Realising the true value of the State's investment in clean energy will be best achieved by retaining Hydro Tasmania's subsidiary mainland retail company Momentum and allowing that business to continue growing in a carefully managed way. In addition, the optimal positioning of Tasmania's electricity retail assets – people and physical – will ensure that the energy portfolio runs efficiently and effectively.

In a market environment, stand-alone generators are generally price takers. Similarly, renewable generators are also price takers for Renewable Energy Certificates. Hydro Tasmania sells a proportion of its renewable electricity in Victoria, which is a highly competitive market. Without a retail business, Hydro Tasmania would receive a premium for its ability to sell into high demand periods, but it would be a price-taker in the wholesale market for much of the time. The wholesale electricity market will not pay a premium for renewable electricity.

Hydro Tasmania's proposed business model is based around a vertical integration strategy, which grows Momentum in mainland markets to mitigate strategic risks it would face as a standalone generator focused on its Tasmanian assets and capture a premium for its renewable electricity brand.

It is important to share the benefit of our clean energy advantage with Tasmanian electricity customers. In 2012-13 the Government will commit $37 million, partly funded by Hydro Tasmania's proceeds from the price on carbon, to change the way the Tasmanian Economic Regulator calculates prices for households and small businesses.

The Government will merge Aurora's retail services functions with Momentum's functions once the transition of retail customers to new retailers is complete. This will ensure that the existing investments by the Tasmanian energy businesses in retail assets and resources will be optimised.

A key challenge for the Government is ensuring that appropriate oversight and governance arrangements are in place to manage Momentum's pace of growth, customer mix, and gross margins to ensure it is delivering profitable growth without detracting from Hydro Tasmania's performance in the wholesale market.

Implementation

Timing

The key milestones of the reform package are:

Date	Milestone
1 July 2012	Reduce the price paid by non-contestable customers, funded from the proceeds made by Hydro Tasmania arising from the introduction of the carbon price.
1 January 2013	Confirm transfer of Tamar Valley Power Station to Hydro Tasmania, or commence sale process.
1 January 2013	Complete scoping study for customer tranche sale and commence divestment process.
1 July 2013	Commence regulating Hydro Tasmania's wholesale contracts.
Before 1 January 2014	Complete transfer of customers to new retailers, supported by Aurora retail services on a transitional basis.
1 January 2014	Commence full retail competition.
1 January 2014	Commence price regulation of standing offer contracts.
1 July 2014	Merge Aurora retail services functions with Momentum's functions; new Tasmanian retailers responsible for servicing their own customers.
1 July 2014	Aurora distribution and Transend commence operating as a fully integrated business.

Method of implementation

Wholesale market reforms will be implemented by legislation.

Other aspects of the reforms that involve the internal restructure of assets between the electricity businesses will be implemented under Tasmanian legislation that specifically allows for the transfer of assets between the businesses.

The sale of any non-core assets identified for divestment will be completed following normal government divestment processes.

The Government will not make separate decisions on the commercial merits of a particular business acquiring a particular asset, but will instead reallocate the assets and relevant employees to the new business structure on a basis that optimises the Government's overall electricity business portfolio and best meets the Government's electricity policy objectives.

It is currently intended that, following transfer or sale of the relevant assets and contracts, a capital restructure of the residual Government electricity business portfolio will be conducted, to ensure that gearing of each of the businesses is appropriate to the market and operating environment.

A project team will be established in the Department of Treasury and Finance to implement the reform package, with oversight from the relevant Ministers, government agencies and in consultation with the electricity businesses.