

24 May 2010

The Regulator  
Office of the Tasmanian Economic Regulator  
GPO Box 770  
Hobart TAS 7001

Dear Mr Appleyard

**INVESTIGATION OF HYDRO TASMANIA'S PRICING POLICIES IN THE PROVISION OF RAISE FCAS TO MEET THE TASMANIAN LOCAL REQUIREMENT**

AETV Power is pleased to submit the attached discussion paper in response to the Terms of Reference for the investigation published by the Regulator, and Hydro Tasmania's submission.

AETV's discussion paper covers three main areas:

1. AETV's view concerning the main focus during this stage of the price control regulatory process;
2. AETV's response to the Regulator's Terms of Reference; and
3. AETV's initial response to Hydro Tasmania's proposals as regards appropriate price control mechanisms.

The paper concludes with a summary of AETV's recommendations for the Regulator's investigation.

Should you require any further information regarding this paper please contact Shaun O'Loughlin on 03 6237 2542 or [shaun.oloughlin@aetvpower.com.au](mailto:shaun.oloughlin@aetvpower.com.au).

Yours sincerely



**Michael Brewster**  
Chief Executive Officer

Encl.



## **AETV Power Submission**

**Investigation of Hydro Tasmania's pricing policies in relation to the provision of raise FCAS to meet the Tasmanian local requirement**

24 May 2010

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## 1. Outline of submission

The Regulator has decided to declare certain electrical services provided by Hydro Tasmania, to be 'declared electrical services', for the purposes of the *Electricity Supply Industry (Price Control) Regulations 2003 (Regulations)*. AETV strongly supports that decision.

The Regulations now require the Regulator to conduct an inquiry into the pricing policies of Hydro Tasmania as they relate to the declared electrical services. The Regulator commenced his inquiry by providing notice to the Treasurer in March 2010 and has now published Terms of Reference for the inquiry.

The Regulator has also received:

- a submission from Hydro Tasmania, dated 30 April 2010; and
- a briefing from Hydro Tasmania on 11 May 2010.

The Regulator has now invited submissions on relevant matters contained in the notice of investigation, the Terms of Reference and Hydro Tasmania's submission.

AETV's submission covers three main areas. They are:

1. AETV's view concerning the main focus during this stage of the price control regulatory process;
2. AETV's response to the Regulator's Terms of Reference; and
3. AETV's initial response to Hydro Tasmania's proposals as regards appropriate price control mechanisms.

## **2. The regulatory process**

The Regulations prescribe the process which must be followed in order to make a 'declared electrical service price declaration'.

### **2.1 First stage – the declared electrical services declaration**

The Regulator has clearly fulfilled the regulatory requirements of the first stage of the process. That is:

- (a) the Regulator gave notice of his intention to declare raise contingency FCAS provided by Hydro Tasmania to be 'declared electrical services', by publishing a notice in a Tasmanian daily newspaper, and allowing Hydro Tasmania and others to make submissions; and
- (b) the Regulator formed the opinion that Hydro Tasmania has substantial market power in respect of raise contingency FCAS; and
- (c) the Regulator also formed the opinion that in order to:
  - (i) promote competition in the Tasmanian generation market,
  - (ii) promote efficiency in relation to the provision of raise contingency FCAS; and
  - (iii) protect the interests of consumers,a declared electrical services declaration should be made.

### **2.2 Second stage – investigation into Hydro Tasmania's current pricing policies**

The Regulator has also clearly fulfilled the notice requirements of the second stage of the process. That is, the Regulator has given notice that he will conduct an investigation into the pricing policies of Hydro Tasmania in respect of the declared electrical services.

AETV understands that at this stage the only publicly available information provided by Hydro Tasmania in response to the current investigation is its written submission dated 30 April 2010 and various 'non-confidential' portions of its power point presentation to the Regulator on 11 May 2010.

We understand that Hydro Tasmania also provided some additional confidential information to the Regulator during that presentation.

AETV accepts that:

- some information concerning Hydro Tasmania's current pricing policies will be commercial in confidence; and

- Hydro Tasmania may not wish to publically divulge that information.

However, AETV believes that all relevant commercial in confidence material must be provided to the Regulator for the purpose of the current investigation.

AETV encourages the Regulator to obtain all necessary information concerning Hydro Tasmania's pricing policies (both publically available and commercial in confidence) and critically analyse and assess that information.

This information (and the forecasts and assumptions which underlie this information) must be examined in detail during the investigation process and measured and assessed against appropriate benchmarks and historical information.

AETV also believes that the various forecasts and assumptions contained in Hydro Tasmania's current pricing policies need to be:

- benchmarked against the forecasts and assumptions used to determine prices for FCAS in other jurisdictions; and
- compared against actual historical costs and results, so as to determine:
  - the robustness, validity and accuracy of those forecasts and assumptions; and
  - whether those pricing policies and the related forecasts and assumptions are appropriate for inclusion within any future price control mechanism.

We note that Hydro Tasmania's submission appears to be more focused on the types of price control that the Regulator might impose in the future. However, it is clear from the Terms of Reference and the Regulations that the first stage of the investigation and determination process requires the Regulator to focus on Hydro Tasmania's current pricing policies. Any decision to carry forward aspects of Hydro Tasmania's current pricing policies into the new price controls will obviously depend upon the Regulator's findings concerning the appropriateness of those pricing policies.

The Regulator can only make a determination concerning the appropriateness of Hydro Tasmania's current pricing policies if it has access to and has critically examined all relevant information, assumptions and forecasts. In addition, given that a lot of this information is likely to be commercial in confidence, potential consumers of FCAS (like AETV) will be relying on the Regulator to test the validity of this information and these assumptions and forecasts.

AETV also submits that it is premature at this stage in the investigation process to consider, in any great detail, the potential price control measures that might be recommended by the consultants engaged by the Regulator. To do so could pre-empt the outcomes from the investigation stage and in particular, the work that will be undertaken by the consultants engaged by the Regulator to report on and recommend the new price control mechanisms which should be applied.

It follows that AETV has limited its comments to those aspects of Hydro Tasmania's submission regarding the new price control mechanism which AETV strongly disputes.

### **3. Terms of Reference**

#### **3.1 Regulatory context**

The Regulator has published Terms of Reference which are to govern the investigation stage.

The Terms of Reference properly set out:

- the matters that the Regulator must take into consideration (as prescribed by Regulation 33); and
- the types of permissible price control mechanisms that may be imposed by the Regulator (as prescribed by Regulation 18).

#### **3.2 Objectives**

The Terms of Reference also set out the Regulator's objectives in undertaking the investigation and making a price control determination. Those objectives are:

- to promote efficiency and competition in the Tasmanian electricity supply industry; and
- to protect Tasmanian consumers from the adverse effects of the exercise of substantial market power.

AETV agrees with these objectives.

#### **Promoting efficiency and competition in the Tasmanian electricity supply industry**

AETV notes that the issue of competition in the Tasmanian electricity industry has been the subject of previous investigations and processes, including:

- the review into the Tasmanian frequency operating standards conducted by the Reliability Panel of the AEMC; and
- the first stage of the current regulatory process (i.e. the declaration of raise contingency FCAS provided by Hydro Tasmania to meet the Tasmanian local requirement as a 'declared electrical service').

It has been acknowledged in both of those reviews<sup>1</sup> that:

- at times (for example, when Basslink is on import), the whole of the raise contingency FCAS required for the Tasmanian local region must be obtained 'on island';

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<sup>1</sup> See for example AEMC Reliability Panel *Tasmanian Frequency Operating Standard Review - Final Report*, 18 December 2008, section 2.3 for a discussion of the sources of FCAS available for the Tasmanian requirement; section 4.3 for a discussion of the benefit cost analysis of two proposed options as regards the Tasmanian frequency operating standards.. See also the Office of the Tasmanian Economic Regulator *Statement of Reasons*, December 2009 at page 3,

- raise contingency FCAS (particularly fast raise) is in short supply on island; and
- Hydro Tasmania is the only registered supplier of FCAS on island.

AETV submits that it would be unrealistic to expect this investigation, or any price controls imposed on Hydro Tasmania as a result of this investigation, to assist in enticing a new entrant into the Tasmanian electricity market merely to provide FCAS. This same possibility and conclusion has been canvassed in the other reviews referred to above.

However it is appropriate for the Regulator to consider whether imposing some form of price control mechanisms on Hydro Tasmania regarding raise contingency FCAS might promote competition between Tasmanian generators, and potentially greater efficiency in the Tasmanian electricity market as a whole.

### **Protecting consumers from the adverse effects of the exercise of substantial market power**

With regards to the second of the Regulator's objectives – protecting consumers from the adverse effects of the exercise of substantial market power – AETV submits that the first stage of the declared electrical service process clearly demonstrates that:

- Hydro Tasmania has substantial market power in relation to the supply of raise contingency FCAS; and
- consumers have been adversely affected by the exercise of that market power.

In particular, we note the Regulator's comments contained in his Statement of Reasons<sup>2</sup>, as follows:

"Regulation by price control is a focussed attempt to change the behaviour of the supplier of a declared electrical service, according to defined standards, in order to bring about a desired economic outcome. In this case, through price regulation of the declared electrical services, the Regulator seeks to prevent the misuse of substantial market power and promote competition in the markets for those services (and, as a consequence, the energy market and downstream markets) in Tasmania which should lead to more economically efficient prices paid by customers for their electricity."

AETV wholeheartedly agrees with this statement.

### **3.3 Principles**

The Terms of Reference also set out the principles that the Regulator will apply in order to achieve the Regulator's objectives.

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<sup>2</sup> Office of the Tasmanian Economic Regulator, *Declaration of Frequency Control Ancillary Services – Statement of Reasons*, December 2009, page 3

AETV generally agrees with and supports these principles. There are three principles that AETV would specifically like to comment on.

The first is the Regulator's reference to the fact that the price control mechanism should enable Hydro Tasmania to recover its costs for the efficient provision of the declared electrical services.

AETV considers that the use of the word 'efficient' here refers to 'efficient' in an economic sense.

For example, it reflects the fact that monopoly suppliers are, in economic terms, regarded as being inefficient suppliers. A more relevant comparison here is what the relevant prices would be, if the relevant market were a competitive one.

The prices for raise contingency FCAS which are charged in the Victorian region could provide an instructive benchmark, and throw some light on what the efficient costs might be (and perhaps, should be), if the market for raise contingency FCAS for the Tasmanian local requirement were a competitive market.

For example, the Regulator might consider the 'efficient' costs of supply to be the actual costs of supply, together with a reasonable return. AETV believes that this approach to determining the efficient cost of supply would be the method which best achieves the Regulator's stated objective.

The second principle that AETV would like to comment on is the principle that the price control mechanisms should provide market signals to promote efficiency and maximise incentives for other parties to supply raise contingency FCAS in the Tasmanian region. As we have already mentioned, AETV does not consider that it is realistic to expect that the imposition of price control mechanisms on Hydro Tasmania will, in and of itself, be sufficient to attract a new entrant to the Tasmanian market purely to provide FCAS. The regulation of the prices which Hydro can charge for raise contingency FCAS might however encourage other existing participants in the electricity industry in Tasmania to offer to provide FCAS

Most importantly, the regulation of the prices which Hydro can charge for raise contingency FCAS might also encourage competition between generators in the Tasmanian region, leading to greater efficiency in the Tasmanian electricity market as a whole.

The third principle that AETV would like to comment on is the principle that the price control mechanism should not impose significant regulatory costs on the Regulator or Hydro Tasmania.

We suggest that the emphasis here should be on the word 'significant'. The principle would not necessarily lead to the conclusion that no costs should be imposed on the Regulator or Hydro Tasmania. The costs which may be incurred must of course be weighed against the benefits to be obtained.

## **Hydro Tasmania submission**

### **3.4 Information on pricing policies**

As noted above, AETV considers that the Regulator will need a great deal more information from Hydro Tasmania in order to:

- properly investigate Hydro Tasmania's current pricing policies; and
- determine whether any of those pricing policies are appropriate for inclusion within the new price control mechanism.

The need for the current regulatory process was brought into sharp relief by Hydro Tasmania's bidding behaviour in a three week period beginning on 1 April 2009, which saw Hydro Tasmania's bids for raise contingency FCAS skyrocket to \$5000 / MWh (where those prices were previously in the order of \$2 / MWh).

It is notable that Hydro Tasmania's submission does not shed any light as to the policies that might have underpinned this bidding behaviour.

AETV contends that the current investigation process must result in the Regulator gaining a thorough understanding concerning the pricing policies which led to these bids being made, so that in formulating any future price control mechanisms, the Regulator can ensure that this type of outcome is not repeated.

Further comment on Hydro Tasmania's pricing policies is contained in section 4.8 of this submission.

### **3.5 Hydro Tasmania 'key considerations'**

Hydro Tasmania's submission to the Regulator dated 30 April 2010 gives three 'key considerations' that Hydro Tasmania suggests ought to be accommodated for the regulatory process to be successful. These three key considerations are:

- the form of regulation should not impact the spot market or physical offer and dispatch process;
- the form of regulation should encourage new entrants in markets where there is a more efficient new entrant available; and
- Hydro Tasmania should not be restricted in recovering a reasonable return on its assets, nor subjected to excessive costs or unmanageable risks.

Hydro Tasmania's submission, and the considerations which it states to be key, must be considered in light of the current process. That is:

- (a) the Regulator has already formed the view that Hydro Tasmania has substantial market power in the provision of raise contingency FCAS in the Tasmanian region; and

- (b) the Regulator has also already formed the view that the promotion of competition, efficiency and the public interest requires the making of a declared electrical service declaration; and
- (c) the Regulator has stated that the objectives in undertaking this investigation are to promote efficiency and competition in the Tasmanian electricity supply industry and to protect Tasmanian consumers from the adverse effects of the exercise of substantial market power.

The Regulator's findings on these matters and the objectives contained in the Regulator's Terms of Reference must necessarily take priority over the 'key considerations'. In other words, the real test to determine whether this regulatory process is successful is whether a price control mechanism can be formulated so as to temper Hydro Tasmania's substantial market power, thereby benefiting and promoting efficiency and competition in the Tasmanian electricity industry and protecting Tasmanian consumers.

By way of example only, having conducted this investigation, the Regulator may form the view that the only effective way to promote competition and efficiency and to protect consumers is to impose a form of price regulation that impacts on Hydro Tasmania's bids into the spot market.

If this were to occur, then in AETV's view (subject to AETV's other comments on this issue), the Regulator should proceed to impose that form of price regulation, so that the objectives of promoting competition and efficiency and protecting consumers could be met.

AETV does not object to the notion that Hydro Tasmania ought to be able to recover a reasonable return. However AETV does not agree with Hydro Tasmania's view that its current returns are reasonable. We expand on this later in section 4 of this submission.

### **3.6 Hydro Tasmania suggested approach**

In principle, AETV does not object to Hydro Tasmania's suggestion that the Regulator impose a form of price control that regulates the price at which, and the terms and conditions on which, Hydro Tasmania offers hedge contracts to generators in Tasmania in respect of raise contingency FCAS.

However:

- AETV considers that it would be premature for the Regulator to restrict his consideration of potential price control mechanisms to only one form of mechanism, at this stage of the process;
- AETV suggests that any price control mechanism must be detailed, and prescriptive;
- if the Regulator were to consider regulating hedge prices as advocated by Hydro Tasmania, AETV strongly disagrees that this should be on the basis

that a disgruntled participant could seek a review if they are unhappy with the quoted price.

AETV does not agree with Hydro Tasmania's analysis (contained on pages 6 and 25 of its submission) as to whether the Regulator's objectives and principles could be met by the 'physical' market or the 'financial' market. AETV does not propose to canvass this in detail, because as previously mentioned in this submission, it is considered premature to consider in detail any one type of price control mechanism as opposed to another. AETV suggests that the better approach is to focus on the overarching factors, set out in paragraphs (a), (b) and (c) of paragraph 3.2 above.

We do make some further comments, however, on Hydro Tasmania's proposed price control methodology, in sections 3.11 and 3.12 of this submission.

### 3.7 'Efficient costs' of supply

Hydro Tasmania suggests in its written submission<sup>3</sup> that the 'efficient costs of (one) supplier' requires that 'the efficient costs of a new entrant are used'.

AETV submits that this is simply incorrect.

In relation to the provision of raise contingency FCAS on island, Hydro Tasmania is currently in a monopoly, or virtual monopoly, position. As mentioned earlier in this submission, monopoly suppliers are generally regarded as inefficient suppliers and accordingly markets can seek to ameliorate the effects of the monopoly by implementing some form of price regulation.

A good example of monopoly suppliers in the electricity industry are networks. Electricity networks are regarded as natural monopolies and there are sound efficiency reasons for allowing them to continue as monopolies (it would be economically inefficient to install duplicate networks in most, if not all, parts of Australia). However, to ensure that networks do not extract monopoly rents, the revenue of network operators is regulated.

In no case is a network operator permitted to earn revenue on the basis of 'the efficient costs of a new entrant'. To allow this as the basis of regulated revenue would involve a very substantial increase in the costs to consumers (given the many billions of dollars that would be required to replicate the networks). More importantly, this basis would represent a substantial windfall gain to the incumbent supplier, as revenue would be earned on the basis of ***theoretical or notional capital expenditure***, not the actual cost of capital incurred, or even capital which is planned to be expended.

Equally, AETV submits that 'the efficient costs of a new entrant' bear no relationship to Hydro Tasmania's actual costs of providing raise contingency FCAS, even after allowing for a reasonable return on those actual costs.

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<sup>3</sup> Hydro Tasmania's Submission on OTTER's Regulation of Raise FCAS in Tasmania, 30 April 2010, page 9

Hydro Tasmania has admitted that the direct cost of enablement to provide raise contingency FCAS is 'relatively low'. The balance of the cost, according to Hydro Tasmania, is the economic cost<sup>4</sup>.

At the time of the review into the Tasmanian frequency operating standards by the Reliability Panel of the AEMC, and subsequent to that review being completed, it has been acknowledged that there are three factors which would affect the requirement for raise contingency FCAS in the Tasmanian region. They are:

- the commissioning of AETV's combined cycle generators;
- the change in the frequency operating standard itself; and
- the change in the manner in which AEMO calculated the raise contingency FCAS requirement for the Tasmanian local requirement.

All of these factors are now in operation. Accordingly it is difficult to envisage there being any additional requirement for raise contingency FCAS for the Tasmanian region in the foreseeable future.

It is also difficult to see how Hydro Tasmania could justify including any allowance for new capital, in any of its cost structures aimed at determining an 'efficient cost' for Hydro Tasmania supplying raise contingency FCAS.

In other words, Hydro Tasmania's current plant and equipment would appear to be both adequate and sufficient to supply the majority of the current and anticipated future requirements for raise contingency FCAS. Any substantial allowance for additional capital costs would appear to be a windfall gain for Hydro Tasmania and certainly would not represent the 'efficient costs' of supply.

Instead of Hydro Tasmania's proposal as to what constitutes an 'efficient cost' or 'reasonable cost', AETV submits that any price control mechanism ought to allow Hydro Tasmania to recover;

- the actual costs of providing raise contingency FCAS; plus
- a reasonable return.

AETV suggests that one possible approach would be to allow Hydro Tasmania to seek a redetermination of the applicable price control mechanisms, should Hydro Tasmania determine to make additional capital investments to enable it to increase its raise contingency FCAS capabilities in future.

### **3.8 Options available to generators**

In its submission, Hydro Tasmania suggests that there are five options available to generators to mitigate their exposure to FCAS costs. They are:

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<sup>4</sup> Office of the Tasmanian Economic Regulator, *Statement of Reasons*, December 2009 at page 14 (quoting from Hydro Tasmania's submission to the Regulator's Issues Paper)

- reducing output when FCAS prices are high;
- registration as a non market participant;
- hedge with another participant;
- source their own FCAS; and
- negotiate with a major load.

In response, AETV notes:

- the suggestion that generators can simply limit their generation capacity to avoid high FCAS costs (which are of course being caused by one competitor generator) is not an option which will assist in promoting efficiency or competition in the Tasmanian electricity market, nor will it assist in protecting consumers in Tasmania from the exercise of substantial market power;
- registration as a non market participant is only available to generators with a very low (less than 5MW) name plate rating;
- the only participant in the Tasmanian region with which a generator can hedge, is Hydro Tasmania (which, as has been noted, is the participant that has caused the high FCAS prices in the first place);
- as has been noted, FCAS is in short supply on island and it would simply not be economically efficient to build new generation capacity simply to provide FCAS; and
- as has been noted in another review,<sup>5</sup> there are unlikely to be any substantial loads in Tasmania which are available to participate in a load shedding scheme (in other words, the majority of those loads in Tasmania are already committed).

In short, Hydro Tasmania's suggestions as to how a generator can manage their exposure to FCAS prices ignores the reality of the situation in Tasmania – one which Hydro Tasmania has been instrumental in creating.

### **3.9 Economic purpose of price regulation**

Hydro Tasmania's written submission<sup>6</sup> gives as the 'economic purpose of price regulation', the following:

- eliminate any potential for pricing of FCAS well above the efficient cost of supplying the service;
- encourage investment in additional sources of supply of fast raise contingency FCAS within Tasmania to the extent that this is economically efficient.

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<sup>5</sup> Office of the Tasmanian Economic Regulator, *Statement of Reasons*, December 2009, page 29

<sup>6</sup> at page 12

As noted earlier in this submission, the current regulatory process starts with the finding that Hydro Tasmania has substantial market power in the provision of raise contingency FCAS, and that consumers in Tasmania have been adversely affected by Hydro Tasmania's use of that market power.

Accordingly AETV submits that the real purpose of price regulation in this instance is to ensure that the electricity market in Tasmania is protected from an inappropriate use by Hydro Tasmania of its substantial market power, in future, together with the promotion of competition and efficiency in the Tasmanian electricity market.

### **3.10 Regulation of the spot price – vs – Regulation of hedge price**

Hydro Tasmania has argued that the form of price control mechanism imposed by the Regulator should not control the bids that Hydro Tasmania makes into the FCAS spot market. It gives its reasons for this on page 13 of its submission.

As mentioned earlier in this submission, AETV considers that it is too early in the investigation process for the Regulator to definitively rule in, or definitively rule out, any potential form of price control mechanism.

AETV would be very interested to hear the views of the AEMC and AER, as to whether a price control mechanism which affects Hydro Tasmania's bids into the spot market would (or may) have unintended impacts on the spot price for energy, or the spot price for FCAS outside of the Tasmanian region.

A real question here, we think, is whether the spot market in Tasmania for raise contingency FCAS is actually competitive or efficient at the moment. We would suggest that it is only where a market is currently operating in a competitive and efficient fashion that regulators should be wary of introducing regulation.

AETV takes issue with Hydro Tasmania's assertion that 'there is no means by which Hydro Tasmania can distinguish its bids for the supply of FCAS across the NEM as opposed to solely in the Tasmanian region'.

Whilst this might strictly be true, it is possible for Hydro Tasmania to structure its bids into both the energy and one or more of the FCAS markets so as to ensure that it becomes the sole supplier of FCAS in the Tasmanian region and thereby the price setter for FCAS.

Hydro Tasmania demonstrated the potential for it to do exactly this in April 2009. By bidding both FCAS and two thirds of its energy capacity into the market at \$5,000 / MWh (or slightly under that amount, in the case of energy), Hydro Tasmania ensured that Basslink would be importing cheaper energy from the mainland (i.e. cheaper than \$5000 / MWh). When Basslink is on import, the local FCAS requirement must be sourced on island. As Hydro Tasmania is the only registered provider of FCAS on the island, it was absolutely assured that its bids of \$5,000 / MWh for FCAS would be dispatched, thus causing the significant price hike.

Hydro Tasmania's submission specifically makes mention of outages of Basslink or the Gordon Power Station.

It would appear that, of all participants in the Tasmanian energy market, Hydro Tasmania is best able to manage the risks associated with these outages, by determining or agreeing when any planned outages may occur. Because of this, it would seem to us to be highly inappropriate to exclude these contingencies from any hedge arrangement, in any pricing methodology or price control mechanism that may apply to the supply of raise contingency FCAS by Hydro Tasmania.

The diagram contained in Attachment 1 to our submission compares FCAS prices for Tasmania and Victoria over the period from December 2008 to April 2010 and indicates significant events which were occurring at relevant times. The diagram demonstrates that an outage at the Gordon Power Station and a prolonged outage of Basslink were not events which had the most significant effect on FCAS prices.

If the Regulator does consider imposing a price control mechanism that operates on the hedge price, AETV suggests that the hedge should operate as a 'floor' rather than a 'ceiling' on prices (i.e. a standard hedge price fixed with reference to average costs and probable market conditions that can only be increased if Hydro Tasmania is able to justify this increase to the Regulator). The responsibility should rest with Hydro Tasmania to apply for any variation to or increase in the allowed hedge price, instead of requiring other participants to dispute an amount quoted by Hydro Tasmania. This is particularly so given the information asymmetry.

AETV suggests that the Regulator might explore:

- whether it is appropriate to implement the same forms of price control for each form of raise contingency FCAS (fast, slow and delayed) or whether different price control mechanisms might be indicated for each<sup>7</sup>;
- whether some control might be imposed in respect of 70 MW of fast raise contingency FCAS (which will always be required to be sourced on island, to cover the contingency of a Basslink outage) and some different form of control might be imposed in respect of other bands of FCAS; and
- whether some or all of these might best be implemented by way of control on Hydro Tasmania's bidding behaviour into the spot market, or by way of the prices and terms and conditions it might offer via hedge contracts, or both (or potentially, neither of these – and by some other mechanism instead).

In summary, AETV considers that it is premature to suggest that regulating the price at which Hydro Tasmania can bid into the spot market 'does not achieve the objectives of price regulation' and also considers that it is too sweeping a generalisation to suggest that such a form of price control 'is contrary to the public interest'.

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<sup>7</sup> AETV does note, however, that in April 2009, the prices for slow raise and delayed raise contingency FCAS bid by Hydro Tasmania were actually higher than the fast raise contingency FCAS. AETV would therefore advocate equally strong price control mechanisms for all types of the declared electrical services. See the diagram contained in Attachment 2, which demonstrates the increasing differential in prices between the three types of raise contingency FCAS.

Whether the Regulator ultimately determines to regulate the hedge price or the spot price (or determines some other form of price control), AETV submits that any form of price control mechanisms or pricing principles should:

- provide more certain outcomes for market participants in Tasmania;
- insulate market participants and Tasmanian consumers from the effects of potential price hikes of the type experienced in April last year;
- have some regard to the price for (and, in particular, the cost of) raise contingency FCAS historically paid on the mainland;
- have regard to the price for raise contingency FCAS paid in the Tasmanian region:
  - prior to April 2009; and
  - post October 2009 (i.e. after the new Tasmanian frequency operating standards were implemented);
- have regard to Hydro Tasmania's actual costs of providing raise contingency FCAS; and
- ensure that the full exposure of other generators in the Tasmanian region is protected.

### **3.11 Hydro Tasmania current pricing policies**

AETV reiterates the point it made in section 2 of this submission.

That is, Hydro Tasmania does not appear to have provided sufficient information in its publicly available submission for the Regulator to properly investigate its pricing policies.

AETV suggests that Hydro Tasmania should be requested to provide, at least, the following additional information:

- evidence of its calculations of both short run marginal cost and long run marginal cost of supplying raise contingency FCAS for the local Tasmanian requirement;
- if not included in the above, its actual input costs for each of its plant, and explanations of how and why they are different;
- what amount of raise contingency FCAS Hydro Tasmania reserves for its own requirements and the cost attributed to this;
- how Hydro Tasmania does, in fact, 'reserve' an amount of raise contingency FCAS for its own requirements;
- what the cost of inertia in FCAS supply is, and the basis upon which that cost is allocated to Tasmanian generators;

- what other assumptions are included in Hydro Tasmania's calculations;
- how those assumptions become less accurate over time, and why;
- what sensitivity analysis is provided for;
- how the expected energy dispatch affects the supply cost curve for FCAS;
- what forecasts Hydro Tasmania has used in its pricing policies; and
- how actual historical results have compared with the assumptions and forecasts Hydro Tasmania has applied.

Given the overarching objectives of this investigation, and the declared electrical services process as a whole, AETV suggests that a more appropriate basis for pricing these services is actual costs plus a reasonable profit margin.

### **3.12 Further specific comments on Hydro Tasmania's proposal**

Set out below are some additional comments concerning particular aspects of Hydro Tasmania's price regulation proposal.

#### **Risks if not fully hedged and impact on average hedge cost**

If a generator operating in Tasmania is not fully hedged, it will continue to be exposed to:

- the FCAS spot market (particularly for the local service requirement); and
- the exercise by Hydro Tasmania of its substantial market power in that market.

Under the current arrangements, Hydro Tasmania knows the level of hedge cover and probable exposure of each of its competitors because:

- it is the only FCAS hedge contract provider in Tasmania; and
- it can control the spot price via its bidding behaviour.

It follows that a generator operating in Tasmania will need to fully hedge its fast contingency FCAS exposure because the risk of being exposed to the spot price is too high.

Whilst this level of hedge coverage is rarely needed, the inclusion of this type of additional hedge coverage appears to significantly increase the cost of the hedge. It follows that Hydro Tasmania is receiving significant additional revenue for providing hedging in relation to a potential exposure which Hydro Tasmania will rarely ever have to actually cover. However, competing generators have little choice but to take out this level of hedge coverage and pay the additional cost.

In a competitive FCAS market, a generator will usually hedge its normal exposure and deal with this residual exposure through the FCAS market knowing that competition will ensure that the price in the FCAS market represents the efficient cost of supply in this particular circumstance.

Under the current arrangements in Tasmania, Hydro Tasmania is recovering more revenue than is associated with the efficient supply of the service.

### **Efficient cost**

As noted above, AETV believes that the starting point for any pricing policy must be the determination of the efficient cost of providing the relevant service.

Hydro Tasmania has stated that in formulating its hedge costs it assumes that the least cost sources of FCAS are used first to supply Hydro Tasmania's requirements.

It appears to follow that the FCAS hedge prices offered by Hydro Tasmania to its competitors do not reflect the average cost of providing the required level of FCAS. Rather, the hedge prices are based on the highest cost sources of FCAS after the lower cost sources are removed from the equation.

This is the case even though Hydro Tasmania will recover the FCAS spot price (i.e. the price determined by reference to the highest bid price for the FCAS needed to meet the local requirement in Tasmania) in relation to all FCAS provided by Hydro Tasmania. In other words Hydro Tasmania is receiving the same spot price for both low cost and high cost sources of FCAS.

### **Cost of new entrant supplies**

Hydro Tasmania is proposing that:

- incremental pricing should be used to determine the next cheapest sources of FCAS up its supply curve; and
- in times of FCAS scarcity incremental pricing can be associated with new entrant supplies.

However, fixing the hedge price with reference to the cost to a new entrant means that Hydro Tasmania will recover significantly more than its efficient cost of supply.

In other words, Hydro Tasmania is receiving a cost which is fixed with reference to a level of anticipated capital expenditure it is not in fact incurring and does not need to incur in order to provide the current FCAS services.

### **The opportunity cost of energy effectively lost by being reserved for raise contingency FCAS**

Hydro Tasmania has suggested that the opportunity cost of the energy which is effectively lost when water is reserved for contingency FCAS, is the cost that is associated with potential for future spill of water over the dams because Hydro Tasmania could not use that water when it wanted to. (i.e. Hydro Tasmania was forced to reduce its output so as to supply fast raise FCAS).

We believe that this approach involves calculating a probability of a quantum of water spilling into the future and then applying a lost opportunity value on the quantum that may be spilled.

AETV questions whether these costs should be taken into account in determining the regulated efficient cost of fast raise contingency FCAS. In particular, AETV raises the following questions.

First, the reduction in generation use as an outcome of the NEM dispatch process can be for a number of reasons (i.e. reduction in generation use is not only to provide fast raise contingency FCAS).

Second, there exists a number of questions which need to be answered before these costs can be included. For example:

- How would the amount of energy not used be calculated?
- How can OTTER and competitors to Hydro Tasmania be assured that the amount of energy effectively lost by being reserved for raise contingency FCAS is appropriate?
- How is the part of that amount associated with the local fast raise contingency FCAS dealt with under this regulation to be determined?

Third, the calculation of the probability of spill can only be done by Hydro Tasmania. Any pricing policy which includes an allowance for this type of cost will also need to include a mechanism for checking whether the calculation is reasonable in the circumstances taking into account the concept of efficient cost of supply.

Fourth, the opportunity value of the water is an amount established by Hydro Tasmania on an unknown basis. Once again, any pricing policy which includes an allowance for this type of cost will also need to include a mechanism for checking whether the method used to calculate this value is reasonable in the circumstances. For example, this opportunity cost could potentially be affected by the inclusion of an allowance for future high cost investments that are unlikely to occur.

These concerns are symptomatic of the broader lack of transparency in relation to the types of costs and methods used to determine the level of costs under Hydro Tasmania's current pricing policy. It is imperative that these issues are critically examined during the current investigation.

Consumer's of FCAS services in the Tasmanian market need to feel confident that only appropriate costs have been included within the hedge price for FCAS services.

### **The costs associated with inefficient operation and costs associated with out of merit generation**

Hydro Tasmania is claiming that the costs associated with inefficient operation should be included in the cost of providing regulated fast contingency raise FCAS. AETV understands this to mean that:

- A Generator is bid into the NEM energy market with the hope of dispatch at its efficient output. That is, at the output close to its maximum efficiency point.
- The Generator is backed off to provide fast contingency raise FCAS by the operation of the NEM market.
- This new operating level is at a lower efficiency point on the Generator efficiency curve and thus takes more water per unit of energy to produce.
- Compensation is requested for higher water use per unit of energy as compared to the efficient operating point.
- This compensation is based on an opportunity water value which is the present value of the future revenue that could have been earned from the increment of water (presumably if it had been used at maximum efficiency).

AETV has a number of concerns with including compensation for this impact in the 'efficient cost' for regulated fast contingency raise FCAS.

The NEM dispatch engine does not guarantee that dispatch will occur at the maximum efficiency point. Dispatch at lower levels can occur as a result of factors other than the provision of fast contingency raise FCAS. For example as the result of the operation of a constraint equation.

AETV is also concerned with the transparency of calculations of this amount and the ability of a reasonable third party to determine that the calculations are appropriate. Once again it is imperative that these issues are critically examined during the current investigation.

For example, we believe it is difficult to determine how much a particular generator has been backed-off to meet the local requirement for fast contingency raise FCAS as distinct from meeting the total requirement.

We are also of the opinion that when the Generator in question backs off for whatever reason, a more expensive Generator (with bids above the price that would have been set if the Generator had not been backed off) has to be dispatched through the energy market to meet the energy requirements. This results in an increased energy price which all dispatched generators receive. An entity with a portfolio of generating systems (such as Hydro Tasmania) receives increased revenue from the energy market for all dispatched generating units including the backed-off generator as a result of this operation. It is even possible for a portfolio generator to price the incremental generating unit to ensure that the incremental generating unit sets a price such that the total revenue the portfolio generator exceeds any assumed costs associated with the inefficient generation dispatch. In other words, some level of compensation for this type of cost is already received from the energy market. It is possible, that this additional revenue from the spot market could actually equal the incremental cost of the backed-off generating unit.

### **Increased maintenance costs**

AETV believe that it is reasonable to recover any increased maintenance costs associated with supplying the local fast raise contingency FCAS. The difficulty we have is in how these costs are determined and shown to be just those incremental costs associated with the delivery of the regulated service. We believe that the majority of maintenance costs will be incurred to meet the performance standards established during the connection agreement process.

The challenge for OTTER is how it can get assurance that only the appropriate level of maintenance costs is included in the regulated efficient cost base. Transparency is likely to be a problem.

#### **4. Period of declaration**

AETV repeats the submission it made in response to the Issues Paper on this point, that the three year period proposed by the Regulator should be the trigger point for a further review, but should not necessarily or automatically lead to the revocation of the proposed declaration. AETV submits that any declared electrical service price declaration in respect of raise contingency FCAS for the Tasmanian region provided by Hydro Tasmania should only be revoked once the conditions as stated in the Regulation 19(2) of the Regulations have been met, that is:

- a) Hydro Tasmania no longer has substantial market powering respect of the declared electrical service; or
- b) That the declaration is no longer required for the promotion of competition, efficiency or the public interest.

AETV suggests that the Regulator institute a review process, say 12 months prior to the proposed expiry of the declared electrical services price declaration, in order to ascertain whether the conditions in Regulation 19(2) have been met.

The price control mechanism can incorporate sufficient flexibility to enable Hydro Tasmania to apply for a redetermination, should circumstances change over the period of the determination.

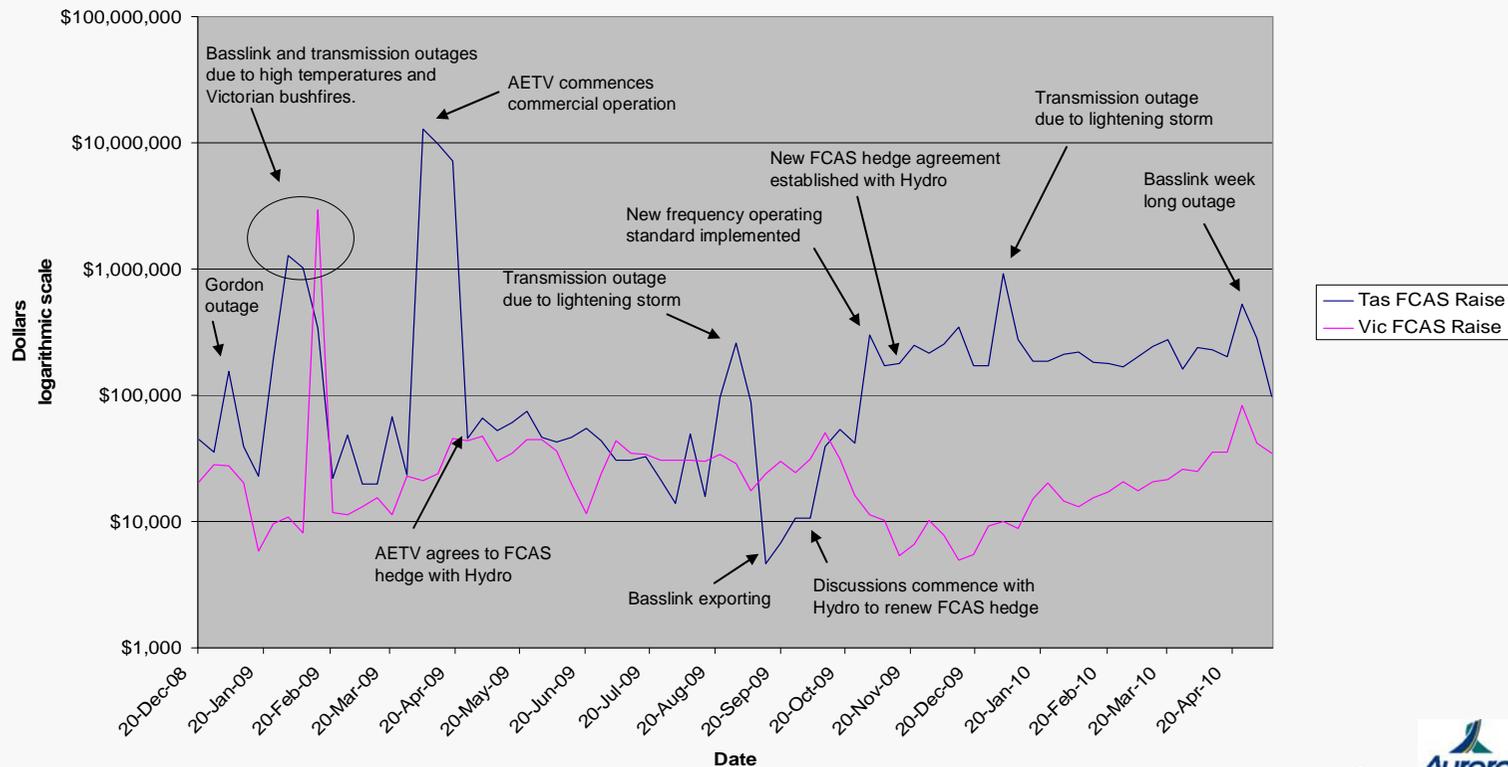
## 5. Conclusion

In conclusion, AETV:

- a) suggests that the Regulator will require more detailed information from Hydro Tasmania in order to properly conduct an investigation into Hydro Tasmania's pricing policies;
- b) considers that the Regulator should focus on efficiency and competition with regards to existing participants in the Tasmanian electricity market, and the protection of Tasmanian consumers, rather than using this process as an attempt to encourage new market entrants;
- c) considers that the Regulator ought to consider all permissible means of price control mechanisms at this stage; and
- d) without limiting (c), suggests that the Regulator might explore:
  - I. whether it is appropriate to implement the same forms of price control for each form of raise contingency FCAS (fast, slow and delayed) or whether different price control mechanisms might be indicated for each;
  - II. whether some control might be imposed in respect of 70 MW of fast raise contingency FCAS (which will always be required to be sourced on island, to cover the contingency of a Basslink outage) and some different form of control might be imposed in respect of other bands of FCAS; and
  - III. whether some or all of these measures may best be implemented by way of control on Hydro Tasmania's bidding behaviour into the spot market, or by way of the prices and terms and conditions it might offer via hedge contracts, or both (or potentially neither, and by some other mechanism instead);
- e) suggests that if the Regulator considers imposing a price control mechanism which impacts Hydro Tasmania's hedge price, the Regulator ought to consider setting a 'floor' price, from which Hydro Tasmania could seek to depart by application to the Regulator, rather than a 'ceiling' price which a hedge party would be required to dispute;
- f) supports the Regulator in proposing to review the need for the proposed declaration after a three year period

# FCAS Cost Comparison - Victoria & Tasmania

Weekly FCAS Contingency Raise Costs



# FCAS Cost Comparison - by service

## Weekly FCAS Contingency Costs

