



24 May 2010

Mr Glenn Appleyard
Office of the Tasmanian Economic Regulator
GPO Box 770
HOBART TAS 7001

Dear Mr Appleyard

FCAS DECLARED SERVICE INVESTIGATION TERMS OF REFERENCE

Aurora Energy (Aurora) welcomes the opportunity to comment on The Office of the Tasmanian Economic Regulator's (Regulator) Terms of Reference for its 2010 Frequency Controlled Ancillary Services Investigation ("the Investigation".)

Aurora previously provided a submission to the July 2009 Issues Paper from OTTER that outlined an intention to declare the supply of raise contingency frequency control ancillary services (FCAS) by Hydro Tasmania (Hydro). In its submission Aurora expressed its concerns in relation to the April 2009 raise FCAS bidding behaviour by Hydro. Accordingly, Aurora welcomed the Regulator's decision to proceed with its declaration of the provision of raise FCAS by Hydro as a declared electrical service.

Aurora has prepared this submission to highlight its concerns on aspects of the Investigation as well as the Investigation's Terms of Reference. In addition, Aurora also provides a response to the 30 April 2010 Hydro submission on matters raised in the Terms of Reference.

While Aurora is the parent company of Aurora Energy (Tamar Valley) Pty Ltd (AETV), Market Participant which has been directly impacted by Hydro's raise FCAS bidding behaviour, this submission focuses on the impacts of the April 2009 FCAS bidding events on energy retailers and consumers. AETV will be providing a separate submission that focuses on the impacts specific to its generation interests.

Summary of key concerns

Aurora retains its two key concerns from its August 2009 submission addressing Hydro's April 2009 raise FCAS bidding behaviour. Firstly, that the behaviour directly and negatively impacted the generation asset held by Aurora, namely AETV. Secondly, that by presenting a challenging barrier to entry for new forms of energy generation, the development of competition for wholesale and retail prices in Tasmania will be hindered.

In terms of impacts specifically on energy retailers and customers, Aurora maintains that the absence of a declaration, final determination and effective price control mechanism would result in:

- direct increases in FCAS prices being passed through the supply chain to energy retailers and thereby to consumers, at a time of considerable price pressures from other sources;
- the retention of existing market power and barriers to entry to the wholesale market and a reduction in the prospect of new entrant generators providing competitive pressure on energy prices paid by retailers and consumers; and,
- barriers to entry for new generators imposing a longer term impact on Tasmanian energy security and economic development that is not in the interests of consumers.

Hence, in taking the first step to mitigate this situation through the initial declaration it is essential that the Regulator complement this action with a determination and an effective price control mechanism that is commensurate with the acknowledged level of market power held by Hydro. This will be critical to keeping downward pressure on energy prices and on energy costs for retailers and consumers.

Investigation Terms of Reference

Aurora considers that the Terms of Reference provide a suitable framework for conducting the Investigation. However, there are some comments on the Terms of Reference and Hydro's response to the matters raised in the Terms of Reference that Aurora presents for further consideration.

Aurora notes that the period for the determination is open for consultation, although the July 2009 Issues Paper proposed a three-year period. Aurora's original response was that a limited three-year declaration would be insufficient for providing appropriate market

signals to prospective new entrant generators. Aurora's view on this is unchanged.

In considering entry to the Tasmanian generation market, a potential new entrant generator would be seeking greater certainty that the mechanisms in place to mitigate identified points of weakness in the wholesale market were locked in and assured.

However, Aurora understands that the *Price Control Regulations* require a fixed end date to be specified in any declared electrical service price declaration. Accordingly Aurora would advocate the maximum period of time possible being specified in the declaration, together with a mechanism for review of the FCAS market and whether conditions have altered substantially, so as to determine whether the declaration should be extended or revoked.

Comments on Hydro submission to Investigation Terms of Reference

In conducting the Investigation, Aurora strongly encourages the Regulator to focus on the factors and the environment surrounding the provision of raise FCAS that specifically relate to all matters outlined in Regulation 33(2) of the Price Control Regulations. As per those Regulations, these matters must be considered and Aurora believes this approach is essential to ensuring the Regulator's objectives in undertaking the Investigation can be met in a fair and appropriate manner.

Aurora challenges Hydro's interpretation of the public interest (A.14, p.41) being the promotion of the efficiency and competition in order to protect the interests of consumers, realised in the form of FCAS market co-optimisation. While both competition and efficiency are at times important in facilitating positive consumer related outcomes, restricting the interpretation of public interest to just these characteristics disregards other key factors such as prices and supply security, which may be affected independently of competition or efficiency, or simply require consideration as factors in themselves.

Further, this interpretation is a blending of two characteristics that were required to be examined in order to ascertain the existence of substantial market power and which subsequently formed the basis for the declaration of the raise FCAS as a declared electrical service. Given the findings of the Regulator in the declaration, it appears incongruous to claim competition and efficiency are the factors that underpin the public interest when the declaration essentially proposed

that deficiencies of such qualities were contributing factors to presence of substantial market power. As such, the claim that co-optimisation serves the public interest due to its resulting least cost dispatch solution is questionable if there is insufficient competition in determining the co-optimised price.

In this context Aurora disagrees with Hydro's view that interstate benchmarks are not relevant and have no bearing to the market in Tasmania. The presence and references by Hydro to the co-optimisation process shows that interstate factors are relevant. Further, to disregard other jurisdictional instances would be to discount a potentially useful source of comparative data. Aurora acknowledges that while there are differences across NEM regions the application of the NEM to the Tasmania framework is a key contextual point and related instances and/or events cannot be ignored.

At the core of the Hydro submission is the suggestion that the form of regulation or the eventual price control mechanism be enabled as regulatory approval of pricing policies for Hydro raise contingency FCAS hedge products. Aurora is concerned this proposal will not fully ameliorate the market characteristics that prompted the initial declaration. Moreover, this arrangement is overly similar to the current practice whereby participants can choose to request a contract offer from the only current supplier of FCAS raise services, Hydro Tasmania, with the only point of difference being the ability for reference of the Hydro offer to a pricing policy or potentially, by appeal to the Regulator in circumstances where the principles have been deemed not to have been met.

A price control mechanism would only be effective if it were to exist in a regulatory framework that resulted in downward pressure on prices to ensure the substantial market power of Hydro in the Tasmanian FCAS market could be mitigated and not perpetuated. The Terms of Reference for the Investigation provide objectives and principles that, while seeking to facilitate incentives for additional FCAS providers as well as introducing fairness, do not explicitly focus on a resolution to the factors which supported the initial declaration. In this context it is important that the Terms of Reference maintain a pathway towards removal of the need for the declaration. Additionally, the Regulator should not disregard key inputs such as referencing to interstate benchmarks for the provision of raise FCAS services that would affect the ability to set a price control mechanism that delivers on that goal.

Aurora suggests that any price control mechanism which seeks to affect the hedge price would need to be structured so that the various

cost-based components could be separately justified, and validated by the Regulator. Aurora would refer to a similar process to that is undertaken for retail and distribution pricing determinations. A suitably rigorous and transparent process is more likely to ensure that market power is not inefficiently exercised.

In Aurora's view, the Regulator should examine all possible price control mechanisms and not be limited, during this investigation phase, only to a consideration of the mechanism proposed by Hydro Tasmania.

Regarding the determination duration, Hydro's vision that the requirement for regulation would cease in a time less than three years based on attraction of a new entrant is optimistic. It is difficult to predict the successful addition and retention of adequate competition in Tasmania for the supply raise contingency FCAS in such quantities and qualities that the requirement for the declaration could be removed within that time frame. As previously discussed Aurora favours the longest possible duration for the declared electrical services price declaration, with a process for review to determine whether the declaration should be revoked (if indeed the Market has evolved sufficiently to provide effective competition) or continued (if it has not).

Conclusion

Aurora reiterates its support for the Regulator's declaration of raise FCAS as a declared electrical service. In the main, the proposed Terms of Reference appropriately support the Investigation in its attempt to ensure the delivery of a price control mechanism that adequately addresses the findings that underpin the initial declaration. However, further guidance on a pathway to removal of the declaration should be considered.

In terms of producing a determination and price control mechanism, Aurora considers it critical that the outcome of the Investigation does not enable replication of recent market practices. Moreover, while regulation of financial products may prove to be an adequate response to the declaration, this action can only be considered effective if it is based on efficient pricing and removes the potential for market power to be exercised.

In further support of the concerns highlighted in this submission, Aurora requests that its previous submission be reviewed by the

Regulator and/or any consultants assisting the Regulator in preparation of the Draft Determination.

Finally, Aurora believes it is important that the Terms of Reference for the Investigation do not preclude the Regulator's consultant from undertaking discussions with affected parties other than Hydro Tasmania. Aurora believes that there may be more effective alternatives to those presented in Hydro Tasmania's response to the Terms of Reference.

If you would like to discuss further any of the issues raised in the submission please contact Giles Whitehouse, Aurora's Market Policy Manager (03) 6208 7809, in the first instance.

Yours sincerely



Mr Martin Wallace

General Manager Strategy & Corporate Affairs