



Statement of Reasons

on

**Changes to the Interim Price-regulated Retail
Service Price Determinations**

December 2013

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1 INTRODUCTION

1.1 Purpose

This Statement of Reasons addresses the issues raised in submissions received on the Regulator's proposed amendments to the 2013 Interim Price-regulated Retail Service Price Determinations.

Chapter 2 provides a summary of the changes to be made to the determinations as a result of the Regulator's consideration of issues raised in submissions.

Chapter 3 outlines, in detail, each of issues raised during the consultation process together with the Regulator's response to, and decision on, each issue.

Chapter 4 outlines, in detail, each of other issues raised during consultation.

Chapter 5 explains that the Regulator has also reviewed the amended determination and has made a number of changes to correct minor errors and to improve the amended determination's clarity.

1.2 Background

In July 2013 the Regulator made its 2013 Interim Price-regulated Electricity Retail Services Price Determinations (the 2013 Standing Offer Determinations) to apply for the interim pricing period from 1 January 2014 to 30 June 2016. Two determinations were required, reflecting the Government's intention at that time to sell Aurora Energy's existing customers in two separate bundles.

On 26 September 2013, the Tasmanian Government announced that it was deferring the sale of Aurora Energy's customer base and that retail competition would commence from 1 July 2014. Furthermore, from 1 July 2014, there will not be any restrictions on customer churn (customers switching between retailers) as was previously the case.

In response the Regulator reviewed the 2013 Standing Offer Determinations to assess the impact of the policy change on the NMR components and NMRs calculated in accordance with those determinations and to consider the application of the determinations under the Government's new policy.

As a result of this review, on 1 November 2013, the Economic Regulator released a draft determination incorporating its proposed amendments and accompanying Consultation Paper and invited public comment. The deadline for submissions was 22 November 2013.

This Statement of Reasons should be read in conjunction with the 2013 Standing Offer Determinations made on 29 July 2013 in respect of Retailer A and Retailer B, the Regulator's *Report on investigation of maximum prices for interim*

price-regulated electricity retail services for small customers on mainland Tasmania, July 2013 (the Final Report) and the Regulator's Consultation Paper issued on 1 November 2013.

1.3 Submissions

The Regulator received submissions from the following organisations:

- Aurora Energy Pty Ltd (Aurora Energy); and
- the Tasmanian Small Business Council (TSBC).

Both submissions have been published on the Regulator's website at: www.economicregulator.tas.gov.au.

1.4 Next Steps

The Regulator has finalised the amendments to the determination after considering the issues raised in relation to the amendments it proposed in its Consultation Paper released on 1 November 2013.

Following publication of the amended determination and this Statement of Reasons, Aurora Energy will be required to submit its standing offer pricing proposal for the period 1 January 2014 to 30 June 2014 for the Regulator's approval. Once approved, the prices will apply from 1 January 2014.

2 SUMMARY OF CHANGES

The following table summarises the changes to be made to the 2013 Standing Offer Determinations in response to issues raised in the public submissions.

Consultation Paper section reference	Amendments to the determination
4.2.4	Amend Retailer A's 2013 determination so that: <ul style="list-style-type: none"> ▪ the cost to serve is \$58.12 per customer and \$152.00 per customer for Period 1 and Period 2 respectively; and ▪ the retail margin is 4.85 per cent and 5.70 per cent for Period 1 and Period 2 respectively.
5.2.1	Amend Retailer A's 2013 determination so that: <ul style="list-style-type: none"> ▪ the amended determination applies to Aurora Energy Pty Ltd; ▪ the Notional Tariff Base (NTB) reflects Aurora Energy's proposal as outlined in Table 4.2 and Appendix 1 (as amended in respect of Demand Step 1 for Tariffs 82, 83 and 86 in each of Schedules 2(b) and 2(c)) of its submission on the Regulator's Consultation Paper.
5.2.1	Revoke Retailer B's 2013 determination.
5.2.2	Amend Retailer A's 2013 determination as follows: <ol style="list-style-type: none"> (a) amend the definition of 'Wholesale Contract Regulatory Instrument' in PART 1 – PRELIMINARY, Interpretation (Clause 2(b)): to reflect the fact that the Minister for Finance signed the instrument on 29 July 2013 and that the Instrument may be amended from time to time; and (b) further amend the definition of 'Wholesale Contract Regulatory Instrument' in PART 1 – PRELIMINARY, Interpretation (Clause 2(b)): to reflect the fact that the Regulator may amend the Instrument from time to time.

Consultation Paper section reference	Amendments to the determination
5.2.2 (continued)	<p>Amend Retailer A's 2013 determination as follows:</p> <p>(c) in Clause 7 (PART 2 – MAXIMUM PRICES, Notional Maximum Revenue) amend the references to:</p> <ul style="list-style-type: none"> ▪ Notional Tariff Base by inserting y after each of 'forecast small customer load' and 'forecast number of small customers' in the text above Table 1 and each of 'Small customer load' and 'Small customers' in Table 1; ▪ Wholesale Electricity Price (WEP) in Table 3 by adding another line and presenting the WEP in an additional c/kWh format; and ▪ unbolding the current 'WEP (\$/MWh)' figures and bolding the additional 'WEP (c/kWh)' figures.

3 PUBLIC SUBMISSIONS: ISSUES, RESPONSES AND DECISIONS

This chapter outlines the issues raised in the submissions on the Regulator's proposed amendments together with the Regulator's response and decision on each issue.

3.1 Regulator's proposals

3.1.1 Retail Margin and the CARC

The Regulator sought comments on its proposal not to amend the Retail Margin and the CARC (as part of the Cost to Serve) in Retailer A's 2013 Standing Offer Determination (Consultation Paper reference 4.2.4).

Submissions

Aurora Energy

In its submission, Aurora Energy contends that without further amendments to the determination, it would be materially adversely affected by the Government's change in policy and the benefits of amending the determination outweigh any detriment to it as retailer.

Specifically, Aurora considers that, in assessing whether a Regulated Offer Retailer (ROR) is materially adversely affected by an event outside its control (i.e. the Government's policy change), the Regulator has not utilised the appropriate timeframes and metrics to ascertain materiality. In assessing if the ROR is materially adversely affected by the Government's change in policy, Aurora considers that the Regulator must:

- a) consider the cumulative impact to the ROR only over the periods where an impact of the event is evident (i.e. Periods 1 & 2 of the determination); and
- b) consider the impact to the ROR's retail margin of the proposed position to not amend retail margin and CARC (i.e. the ROR will have to fund the change in NMR through retail margin).

With respect to the timeframe for assessing the impact, Aurora considers that any assessment of materiality should only consider the impact over the periods in which the NMR is impacted. That is, Aurora considers that by including in its analysis a period in which the Regulator is not proposing any changes to CARC or Retail Margin (Period 3), the Regulator has diluted the impact of the policy change on the ROR. In recalculating the impact, Aurora's submission suggests that the net impact on the ROR's controllable costs is 3.22 per cent over the two periods impacted by the Government's policy change compared to the Regulator's estimate of a 1.84 per cent impact over the entire interim pricing period. Aurora considers that

over Periods 1 and 2 both the quantum of the net change in the NMR of \$2.676 million and the net percentage change in controllable costs of 3.22 per cent¹ are material such that the materiality test in Regulation 17(2) of the *Electricity Supply Industry (Pricing and Related Matters) Regulations 2013* has been met.

With respect to the impact on the retail margin, Aurora considers that the Regulator must consider the effect on retail margin as the ROR will be required to directly fund the costs the Regulator has established that a ROR would incur under the new Government policy. In its submission, Aurora calculates the change in the ROR margin and controllable costs as a percentage of the retail margin adopted in the 2013 Standing Offer Determinations. Aurora estimates that the net impact over Periods 1 and 2 is 6.65 per cent. Aurora considers that this provides further evidence that the impact of not adjusting the retail margin and CARC would be material.

TSBC

In its submission, the TSBC notes that it has concerns about the potential development of competition in Tasmania following the change in the Government's policy and how the Regulator has considered this impact. The TSBC considers that the conditions for entry by new retailers have been materially affected by the failure to sell Aurora's retail based and that retailer interest in Tasmania is likely to have been weakened by this. Given this the TSBC is concerned about the Regulator's proposal to provide Aurora Energy with essentially the same retail margin and CARC as would have been provided to the two retailers had the sale of Aurora's customers proceeded as originally intended.

With respect to the retail margin, the TSBC considers that the retail margin should be lower to reflect the perceived lower risk of competition under the Government's new policy settings. The TSBC considers the margin as proposed would provide Aurora with a form of monopoly rent, would be contrary to the objectives of reform in creating competition and would not be in the interests of consumers. Given this, the TSBC considers a retail margin of closer to 3.8 per cent, which was previously provided, as more appropriate at least until there is evidence that Aurora will face increased competition. The TSBC considers this could be reviewed and modified if necessary during the determination if circumstances change.

With respect to the CARC, the TSBC considers that the CARC should also be lower to reflect a market that may be characterised by reduced competition. The TSBC considers that the CARC as currently proposed is similar to that allowed by regulators in mature markets where competition already exists. The TSBC considers it is highly optimistic to consider that Tasmania will reach this state by 2015-16. The TSBC considers that the lack of the sale of Aurora's retailer customer base and the current wholesale market arrangements will be insufficient to encourage such competition unless Hydro Tasmania's market power is diluted. The TSBC therefore

¹ In Period 1 the policy change results in a reduction in the NMR and Retail Margin/Controllable Costs whilst, in Period 2, there is a greater increase in each of these items resulting in a net increase for Periods 1 and 2 combined.

considers the adoption of a mature market CARC will merely impose additional costs on small customers on regulated tariffs. Given this, the TSBC suggests that there shouldn't be any allowance be provided for CARC or, if the Regulator decides to allow CARC it should be close to the \$6.24 per customer proposed for Period 1 for the duration of the determination. The TSBC considers this could be reviewed and modified if necessary during the interim pricing period if circumstances change.

The TSBC considers that each of the above changes are material and warrant amendment to the determination. The TSBC's submission estimates that the combined impact of its suggested changes would result in a reduction in the NMR of \$37.52 million over the interim pricing period.

Regulator's Response

The Regulator notes that the retail margin and the CARC were set in the original determination based on the policy settings provided by the Government at that time having regard to the objectives under the ESI Act which include promoting efficiency and competition and protecting the interests of electricity consumers. In balancing these competing objectives the Regulator was mindful of ensuring that prices did not restrict competition but were set at an efficient level based on the amount of competition that could occur. This latter point involved adjusting the retail margin and CARC to levels commensurate with a market that reflected the Government's original restrictions on churn. The former point involved setting mature market levels of retail margin and CARC to ensure that pricing would not restrict the level of competition that may occur once the Government permitted retail competition to commence.

The TSBC's concerns appear to be focused on whether a sufficient level of competition will exist in Tasmania to justify the proposed retail margin and CARC once retail competition commences on 1 July 2014. Specifically, the TSBC refers to the failure to sell Aurora's customer base to two retailers and this, coupled with the doubts it holds that the wholesale regulatory framework will be sufficient to address Hydro Tasmania's market power, to support its views on this issue.

The Regulator understands that despite the failure to sell Aurora's customer base the wholesale regulatory framework has been designed in a way to replicate the outcomes that would be expected if operating in the National Electricity Market (NEM) on mainland Australia. Given this, the outcome of the wholesale regulatory framework is expected to replicate that of a competitive electricity generation market. New entrant retailers often compete with incumbent retailers under similar market outcomes on the mainland and the Regulator has no reason to believe, at this stage, that the wholesale regulatory framework will be an impediment to such competition in Tasmania. This means that Aurora is expected to be exposed to the same costs and risks retailers face in competitive retail markets within the NEM.

The Regulator also notes that the level of the retail margin and CARC set by the Regulator for the commencement of retail competition reflects the full costs and risks faced by retailers in competitive markets. One way a retailer can compete with other retailers is by undercutting the regulated price and taking on more risk. The Regulator considers that it would be inappropriate for it to set a lower retail margin

and lower CARC in a competitive retail environment because, if it did, it might contribute to the restriction of retail competition. In this light the Regulator considers its role is not to predict the future level of competition and set a retail margin and CARC accordingly, but to set these allowances independently of what may occur in the future and not to impede competition.

Given the above position, the Regulator considers that the position put forward by Aurora Energy is valid. Whilst there will not be two ROR's once FRC commences on 1 July 2014 the Regulator considers that Aurora will likely incur significant costs in attempting to retain its existing customer base. It is also likely that, given the opportunity, some customers will switch to a new retailer as soon as possible in line with the experience when other retail markets have been opened up to competition. From Period 2, when customers can switch to any retailer, Aurora will be exposed to the full costs and risks of the competitive market. The Regulator previously considered that the relatively higher retail margin and CARC in Period 1 (compared to the expected market conditions based on the Government's new policy setting) would be sufficient to compensate Aurora for the additional costs and risks it will face in Period 2 relative to current regulated prices. However, having considered Aurora's arguments, in conjunction with the Regulator's objective of not limiting competition, the Regulator considers that it is prudent and reasonable to set regulated prices similar to those applying in a mature market in Period 2 to:

- a) ensure competition is not discouraged through regulated prices (as discussed above); and
- b) to ensure Aurora is compensated for the full costs and risks it will be exposed to under the competitive market.

To not take this action may compromise the development of a competitive market and/or Aurora's financial position. This means that, for Period 2, the CARC increases to \$42 per customer and the cost to serve in the NMR to \$152 per customer.

Given the changes discussed for Period 2, the Regulator sees no reason to retain the higher CARC and retail margin for Period 1. As noted in the Regulator's Consultation Paper, the Regulator considers that some level of CARC should remain reflecting the likelihood of Aurora Retail's regulated customers transferring to market contracts and Aurora Energy preparing itself for the commencement of unrestricted retail competition. These costs and the associated risk would be expected to be minimal during Period 1 before retail competition commences. However, the Regulator considers a small allowance of \$6.24 per customer is reasonable as outlined in Table 4.3 of the Regulator's Consultation Paper. This means that for Period 1 (six months) the cost to serve in the NMR falls to \$58.12 compared to the proposed figure of \$60.80 per customer and retail margin falls to 4.85 per cent, compared to the proposed figure of 5.10 per cent.

Decision

Retailer A's 2013 Standing Offer Determination to be amended with respect to the cost to serve and retail margin as outlined in Table 3.1.

Table 3.1 Amendments to the cost to serve and retail margin

	Period 1	Period 2	Period 3
Cost to serve (\$ per customer)	58.12	152.00	152.00
Retail margin (per cent)	4.85	5.70	5.70

3.1.2 Application of the 2013 Standing Offer Determinations

In section 5.2.1 of its Consultation Paper, the Regulator sought comments on its proposal to:

- amend Retailer A's 2013 Standing Offer Determination so that the amended determination applies to Aurora Energy;
- amend the NTB in Retailer A's 2013 Standing Offer Determination so that it is now the sum of the customer numbers and forecast demand currently specified in Retailer A's 2013 Standing Offer Determination and Retailer B's Standing Offer Determination; and
- revoke Retailer B's 2013 Standing Offer Determination.

Submissions

Aurora Energy and the TSBC both agreed with the Regulator's proposed amendments to ensure that the determination applies to Aurora Energy. Furthermore, Aurora Energy supported the Regulator's proposal to revoke Retailer B's Standing Offer Determination, whilst the TSBC did not comment specifically on this proposal.

However, both Aurora Energy and TSBC had concerns about the Regulator's proposed approach with respect to determining the Notional Tariff Base (NTB). Both parties referred to the Regulator's concerns at the time of making the 2013 Standing Offer Determinations, with respect to the unexplained reduction in customer numbers of 15 800 (the Regulator sought an explanation of the reduction from Treasury but had not received a response at the time of making the determinations).

In its submission Aurora Energy, has provided an explanation for the difference in customer numbers. Specifically, Aurora notes that the values provided by Treasury were from the retail divestment customer bundle information which appear to have been based on the number of accounts within Aurora's billing system. However, Aurora's submission notes that some accounts relate to more than one customer. Aurora's submission also notes that the information provided by Treasury on customer load refers only to single period historical usage rather than a forward forecast developed from historical patterns that Aurora considers would be more representative of usage over the interim pricing period.

Table 3.2 and Table 3.3 present Aurora Energy's proposed adjustment to the NTB based on the above discussion and the variances from the NTB figures adopted in

the 2013 Standing Offer Determinations. Appendix 1 of Aurora Energy's submission provides more detailed information on its proposed load schedules.

Table 3.2 Aurora Energy's proposed change to the NTB – customer numbers

Period	2013 Standing Offer determinations	Aurora submission	Variance
1	214 861	231 786	16 925
2	212 834	229 626	16 972
3	211 135	227 815	16 680

Source: Aurora Energy submission.

Table 3.3 Aurora Energy's proposed change to the NTB – load (GWh)

Period	2013 Standing Offer determinations	Aurora submission	Variance
1	1 008	930	(78)
2	2 232	2 082	(150)
3	2 204	2 061	(143)

Source: Aurora Energy submission.

Regulator's Response

The Regulator sought further details from Aurora in respect to its proposed changes to the NTB and, after analysing those further details, is satisfied with the explanation of the reason for the anomaly in customer numbers originally submitted by Treasury.

The Regulator is also satisfied with the revised Demand Step 1 figures provided by Aurora in response to the Regulator's queries about demand for Tariffs 82, 83 and 86 in Schedules 2(b) and 2(c) of Appendix 1 in Aurora Energy's submission.

The Regulator therefore considers this issue resolved.

Decision

Retailer A's 2013 Standing Offer Determination to be amended as proposed so as the determination applies to Aurora Energy and the NTB in the determination reflects Aurora Energy's proposal as outlined in Table 4.2 and Appendix 1 (as amended in respect of Demand Step 1 for Tariffs 82, 83 and 86 in each of Schedules 2(b) and 2(c)) of its submission on the Regulator's Consultation Paper.

Retailer B's 2013 Standing Offer Determination to be revoked.

3.1.3 Additional amendments to Retail A's 2013 Standing Offer Determination

In section 5.2.2 of its Consultation Paper the Regulator proposed the following additional amendments be made to Retailer A's 2013 Standing Offer Determination:

- PART 1 – PRELIMINARY, Interpretation (Clause 2(b): amend the definition of **‘Wholesale Contract Regulatory Instrument’** to reflect the fact that the Minister for Finance signed the instrument on 29 July 2013 (i.e. the same day that the Regulator made its determinations);
- PART 2 – MAXIMUM PRICES, Notional Maximum Revenue (Clause 7):
 - Notional Tariff Base: insert y after each of ‘forecast small customer load’ and ‘forecast number of small customers’ in the text above Table 1 and each of ‘Small customer load’ and ‘Small customers’ in Table 1; and
 - Wholesale Electricity Price (WEP): in Table 3, add another line and present the WEP in an additional c/kWh format. Consistent with the presentation of the other NMR components the current ‘WEP (\$/MWh)’ figures are to be unbolded and the additional ‘WEP (c/kWh)’ figures are to be in bold.

Submissions

Both Aurora Energy and the TSBC agreed with the Regulator’s proposed additional amendments to PART 1 and PART 2 of Retailer A’s determination.

Decision

PART 1 and PART 2 of Retailer A’s 2013 Standing Offer Determination to be amended as proposed.

The Regulator will also amend the definition of Wholesale Contract Regulatory Instrument to reflect the fact that, since the release of the Regulator’s Consultation Paper, the Minister for Finance has made a number of amendments and signed a revised version of the Instrument on 6 November 2013.

The Regulator will further amend the definition of Wholesale Contract Regulatory Instrument to reflect the fact that the Regulator may amend the Instrument from time to time.

4 OTHER ISSUES RAISED IN SUBMISSIONS

A number of submissions on the Regulator's Consultation Paper raised matters that were additional to the specific issues the Regulator sought comment on (as detailed in Chapter 3 of this document).

4.1 Concerns about previous determinations

Section 3.2 of the TSBC's submission (and to a more specific sense in relation to customer numbers and load, section 4.2 of Aurora's submission) raises a number of concerns about the determinations made by the Regulator in July 2013 (the previous determinations). These concerns relate to the time constraints that the Regulator was operating under, the insufficient time allowed for the Regulator to be able to consult with customers and the impact this may have had on individual parameters in the NMR calculation.

In particular, the TSBC notes that the Regulator commented in several areas of its Final Report that it did not have time to establish the robustness of certain information and therefore accepted what was provided by the Government in respect to:

- a) load;
- b) customer numbers;
- c) Wholesale Electricity Price (WEP);
- d) Wholesale Electricity Cost (WEC); and
- e) AEMO Budget Unit Costs.

The TSBC considers each of these items to be important inputs into, or components of, the building blocks which the TER uses to set regulated retail tariffs. The TSBC observed that it is not clear from the Consultation Paper whether the Regulator has been able to verify the data in the meantime and considered that if this has not occurred, it should be done to clarify the status of these matters and, if necessary, take steps to remove any remaining doubts or uncertainty.

Regulator's Response

The Regulator concedes that the time constraints it encountered with respect to its investigation for the standing offer determinations were unfortunate. As quoted by the TSBC from the Regulator's Final Report, the Regulator noted that it did not have time to consult on its draft investigation findings as would normally occur and as it strongly prefers to do.

The primary concern of the Regulator, as noted by the TSBC, was the issue of load and customer numbers. In particular, the Regulator noted that total customer

numbers had reduced by 15 800 between the making of the 2013 Determination² and the making of the 2013 Standing Offer Determinations and the Regulator had not received an explanation from Treasury as to the reason for the decline. The Regulator notes that this has been rectified as explained in section 3.1.2 above.

With respect to AEMO Budget Unit Costs the Regulator notes that it had limited time to analyse this item and accepted the estimates proposed by Treasury. However, the Regulator notes that having compared the quantum of this component to the figures adopted in previous determinations, it had no concerns about the accuracy of these figures.

With respect to the WEP and WEC, the Regulator notes that these estimates are based on forward estimates of a regulated load following swap (LFS) to apply in Tasmania from 1 January 2014. The methodology used to determine this estimate is now specified in the Wholesale Contract Regulatory Instrument. Hydro Tasmania is required to develop a model to set the price for wholesale contracts consistent with this Instrument. Given that financial contracts will be regulated under this methodology from 1 January 2014, the Regulator considers it prudent to set retail prices consistent with the methodologies used to regulated wholesale financial contracts and the WEP (and in turn the calculated WEC). The Regulator understands that the model used by Treasury to estimate the LFS for the purpose of estimating the WEP in the 2013 Standing Offer Determinations complies with the principles outlined in the Wholesale Contract Regulatory Instrument.

The Regulator also notes that each of the WEP, WEC and AEMO Budget Unit Costs will be reviewed and reset each year as part of the annual standing offer price approval process. The first review will occur in May 2014 for the 2014-15 financial year.

Decision

The Regulator has decided to amend the NTB as discussed in section 3.1.2.

The Regulator has decided not to amend the WEP, WEC and AEMO Budget Unit Costs.

4.2 Policy issues

Section 2.3 of the TSBC's submission raises a number of policy issues which are directed to the Tasmanian Government:

- a) the Government should review its reform strategy as a matter of urgency, particularly to publicly assess the reasons for the failure to sell Aurora's retail customer base and take steps to overcome these with the intention of again placing Aurora's retail operations for sale but this time with pre-conditions that will ensure success;

² Tasmanian Economic Regulator, *Aurora Energy Pty Ltd Pricing Policies, 2013 Determination* (issued 28 March 2013)

- b) it should also consider more fundamental reforms to the wholesale market that would promote greater competition and help to secure a successful sale of Aurora's retail operations. The minimum requirement would be adopting the Expert Panel's recommendation to separate Hydro Tasmania's hydro power assets into three trading entities, preferably privately owned, and the sale of the TVPS;
- c) the Government should bring forward Full Retail Competition (FRC) to 1 January 2014. As part of this, the Government should retain its existing stance of no restrictions on the number of customers that can transfer to another retailer; and
- d) the Government should review the need for continuing regulation of electricity retail prices with a view to announcing a decision on this before 1 July 2015.

Decision

With respect to the introduction of retail competition, the Regulator notes that the change in the Government's policy means that unrestricted FRC will commence from 1 July 2014, as opposed to the previous commencement date of 1 July 2015 (with restricted churn leading up to that date).

With respect to the other matters raised by the TSBC, these are properly matters for the Government and the Regulator will forward these issues to the Government for its consideration.

5 ADDITIONAL CHANGES

In addition to the changes discussed in this document, a limited number of other changes have been made to the amended determination to correct minor errors and to improve the amended determination's clarity.