



**Review of
Electricity Arrangements
on the Bass Strait Islands**

Final Report

Working Group of Officials

February 2007

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Glossary of Terms

Aurora Energy	Aurora Energy Pty Ltd
BSI	King and Flinders Islands in Bass Strait ... also referred to as “the Islands”
CSO	Community Service Obligation
DED	Department of Economic Development
DIER	Department of Infrastructure, Energy and Resources
ESI Act	<i>Electricity Supply Industry Act 1995</i>
GBE Act	<i>Government Business Enterprises Act 1995</i>
GPOC	The Government Prices Oversight Commission
GPOC Regulations	<i>Government Prices Oversight Regulations 1998</i>
Hydro Tasmania	Hydro-Electric Corporation, trading as Hydro Tasmania
KWh	One kilowatt of electrical power used for one hour
NAC	Net Avoidable Cost
OEPC	The Office of Energy Planning and Conservation
OTTER	The Office of the Tasmanian Energy Regulator
Regulator	The Tasmanian Electricity Regulator
Service Provider	Hydro Tasmania
Treasury	The Department of Treasury and Finance

1 EXECUTIVE SUMMARY

1.1 Overview

This paper has been prepared by a Working Group of officials in response to a request for advice from the Treasurer and Minister for Energy in relation to electricity arrangements on King and Flinders Islands (the Bass Strait Islands).

The paper provides five recommendations for consideration by the Treasurer and Minister for Energy and details the process engaged by the Working Group to produce this Report.

In 2004, the King and Flinders Island Councils renewed calls for further reductions to the subsidised retail electricity tariff on the Bass Strait Islands (BSI). At the same time, favourable economic conditions were stimulating renewed interest in industrial development (and consequently electricity demand) on the BSI.

However, the cost of supplying electricity on the BSI had increased at a greater rate than the subsidised retail tariff, resulting in a large increase in the cost of the subsidy to the Government's Consolidated Fund. Lastly, questions had arisen about the consequences of a reduction in the Federal Government's excise on diesel fuel, as used for electricity generation on the BSI.

In response to these issues, in July 2005 the then Treasurer and the Minister for Infrastructure Energy and Resources, wrote to the Department of Infrastructure, Energy and Resources (DIER) requesting the formation of a Working Group to investigate and provide a set of recommendations regarding a number of BSI energy issues.

1.2 Terms of Reference

The Working Group's Terms of Reference are:

“The Working Group is to investigate and provide a set of recommendations to us regarding the following Bass Strait Islands (BSI) energy issues:

- 1. Recommending the tariff structure in relation to the BSI, including:
 - a) the principle as to how retail electricity prices are set on the BSI;***
 - b) the type of tariff structure that is implemented; and***
 - c) who has responsibility for approving annual tariff rates;******
- 2. Estimating the cost to Government of any new tariff structure introduced and recommending as to how this will be funded;***
- 3. Identifying how increased demand for electricity on the BSI above current generation capacity will be managed; and***
- 4. Identifying how cost savings to Government (through the BSI CSO) from a reduction in the Federal Government's diesel fuel excise will be applied; and if it is determined that these savings are to be passed on to the residents of the BSI, recommending an appropriate mechanism to do this”.***

1.3 Working Group Review

The Office of Energy Planning and Conservation (OEPC) within DIER convened and chaired a Working Group consisting of officials from OEPC and the Department of Treasury and Finance (Treasury), with assistance from the Office of the Tasmanian Energy Regulator (OTTER).

Additionally, OEPC sought the views of stakeholders including the Department of Economic Development (DED), the Department of Premier and Cabinet (DPAC), Hydro Tasmania, Aurora Energy (Aurora Energy Pty Ltd) and representatives of the King and Flinders Island Councils.

Meetings were held with Bass Strait Island Councils, Hydro Tasmania, Aurora Energy and relevant Government agencies.

The Working Group considered a wide range of matters including:

- a report presented to the Government by the BSI Councils and Region North in 2004,
- previous practices and policies,
- current related policies of the Tasmanian Government, and
- general objectives of economic efficiency, equity, social welfare and economic development.

The Working Group found little explicit existing policy to guide its deliberations, and that the matters put to it involved wider and more complex issues, such as the overall energy arrangements on the BSI. Accordingly, the Working Group developed and agreed a set of principles to guide its work, assessed the overall issues and considered and evaluated a range of options for each of the issues.

In the form of a Discussion Paper released by the Minister for Energy in September 2006 to all residents, business operators and local councils on the BSI, the Working Group offered a draft package of recommendations that addressed matters presented in the Terms of Reference. Twenty-four submissions were received in response to the Discussion Paper and these have been considered by the Working Group in delivering its final recommendations for consideration by the Treasurer and Minister for Energy.

2 SUMMARY OF RECOMMENDATIONS

1. “Recommending the tariff structure in relation to the BSI, including:
 - a) the principle as to how retail electricity prices are set on the BSI;
 - b) the type of tariff structure that is implemented; and
 - c) who has responsibility for approving annual tariff rates.”

a) - The principle as to how retail electricity prices are set on the BSI

The level of retail electricity prices on the BSI depends heavily upon the extent of Government subsidy through a Community Service Obligation (CSO).

It is recommended that this continue, but with better focus and clearer responsibilities.

To guide policies on this matter, the following principles/objectives are proposed:

Bass Strait Islands Electricity Pricing Principles/Objectives

- Principle 1:** The residents of the BSI will have access to affordable electricity consistent with a reasonable household standard of living.
- Principle 2:** The Government will continue to support electricity tariffs on the BSI at a level commensurate with the social policy objective of Principle 1.
- Principle 3:** The BSI electricity tariff will be consistent with other economic and environmental objectives.
- Principle 4:** The regulatory and/or contractual arrangements for supply of electricity on the BSI will promote ongoing efficiency gains and least-cost supply solutions.
- Principle 5:** The ongoing support for electricity tariffs on the BSI will be targeted to deliver the objectives in an efficient and sustainable manner, with costs balanced against other calls on public funds.

b) - The type of tariff structure that is implemented

The Working Group proposes that the tariff structure on the BSI should be changed in order to align the cost of basic electrical services on the BSI with that on mainland Tasmania, but at the same time to create appropriate incentives for efficient energy use and to limit the growth of the government subsidy over time.

The Working Group recommends that the current flat rate tariff is replaced with a stepped block tariff. Government would decide the rates for each block and the nature of the thresholds that should apply following advice from the Government Prices Oversight Commission (GPOC).

The Working Group recommends that the Minister for Energy request the Treasurer to issue Terms of Reference to GPOC under the *Government Prices Oversight Regulations 1998* (GPOC Regulations).

These Terms of Reference would include details of the Government's social objectives, as articulated in the policy principles, together with a range of potential funding levels for the CSO. GPOC would then recommend to Government a tariff that takes into consideration the Terms of Reference and the current cost structures.

The Working Group has included an example of a four block stepped tariff structure at Appendix A (without prejudice to the advice of GPOC or the decision by Government). In this example, block 1 targets household welfare and recognises the 'essential service' nature of electricity in household lighting and basic appliances.

The Terms of Reference could include a rate equivalent to Aurora Energy Tariff 31 on the initial 500kw block to deliver a block of energy at a comparable price to mainland Tasmania.

Block 2 could be set at a rate not dissimilar to the pre-existing tariff with allowances for general cost increases and inflation. Block 3 and 4 progress tariff rates towards the efficient cost of supply.

c) - who has responsibility for approving annual tariff rates

The Working Group recommends that the Minister for Energy should have responsibility for overall energy policy on the BSI, including approval of annual tariff rates.

Once the structure of the tariff is determined, the Minister for Energy, in consultation with the Treasurer, will seek advice from GPOC on the details of the tariff rates and thresholds to apply for the next period.

It is anticipated that a review of the tariff structure would occur at three yearly intervals in association with the terms of the CSO contract, or more often if special circumstances dictate (i.e. a material change in the generation or supply of electricity on the BSI).

For the years between the Commission's reviews, the BSI tariff structure would be escalated annually by the Australian Consumer Price Index.

2. *Estimating the cost to Government of any new tariff structure introduced and recommending as to how this will be funded.*

The Working Group proposes that the current arrangement, under which the CSO is funded from consolidated revenue to make up the shortfall from the contribution from electricity users on the BSI, should continue.

The cost to Government of the CSO will be the difference between the efficient cost of supply on the BSI and the revenue likely to be raised by the proposed tariff.

By issuing GPOC with Terms of Reference, which include the funding levels Government is prepared to contribute in order to meet its social objectives as articulated in the policy principles, GPOC will have clearer parameters for undertaking its review.

3. Identifying how increased demand for electricity on the BSI above current generation capacity will be managed.

The service provider (Hydro Tasmania) will be required to augment generation capacity on the BSI in an efficient manner to meet increases in demand caused by normal endogenous growth. Appropriate incentives to invest in new capacity are created by ensuring the service provider is entitled to a commercial return on efficient operations.

The Working Group recommends that new customers whose loads exceed more than 5% of installed system firm capacity be required to negotiate individual commercial power purchase arrangements and the supplier will be expected to offer them fair and reasonable terms. This ensures efficient pricing of electricity for new large loads.

It is possible that the supplier and prospective customer might be unable to reach a commercial agreement on supply for a very large new load. The customer is entitled to supply itself, or find another party willing to supply it, subject to satisfactory connection arrangements.

Concerns arising from the possible stranding risk if the new large loads leave the Islands are addressed by the requirement for customers with large new loads and the service provider to negotiate a commercial power purchase arrangement on fair and reasonable terms.

- 4. Identifying how cost savings to Government (through the BSI CSO) from a reduction in the Federal Government's diesel fuel excise will be applied. If it is determined that these savings are to be passed on to the residents of the BSI, recommending an appropriate mechanism to do this."**

Since the Federal Government announced the reduction in the diesel fuel excise, the savings arising from the reduction in excise have been offset by increases in the underlying diesel price and, as a result, such savings are unable to be passed directly to residents on the BSI.

3 BACKGROUND

Electricity on the BSI is supplied by Hydro Tasmania using a combination of wind and diesel generation, while Aurora Energy provides operational, distribution and retail services under contract to Hydro Tasmania. Due to the remote nature of the Islands and reliance on diesel generation, the cost of supplying electricity is significantly higher than on mainland Tasmania.

Historically, the Government has supported the BSI community by subsidising the retail electricity tariff significantly below the cost of production (the subsidised retail tariff).

Prior to 1995 the Government funded the subsidised tariff by accepting a reduced return from the Hydro-Electric Commission.

In 1998 the Hydro-Electric Commission was disaggregated and its generation, transmission, distribution and retail functions were corporatised into separate businesses under the *Government Business Enterprises Act 1995* (GBE Act) and the *Electricity Companies Act 1997*.

On the BSI, Hydro Tasmania retained an integrated generation, distribution and retail business. At that time (and in line with national competition policy) the Government used the CSO provisions under the GBE Act to make transparent non-commercial activities undertaken by Government owned businesses at the direction of the Government.

Since 1998, electricity on the BSI has been supplied by Hydro Tasmania under a CSO contract with Government. The subsidised component of the retail tariff is directly funded from the Consolidated Fund.

Currently the Government subsidises about two thirds of the cost of supplying electricity on the BSI. An amount of \$7.059 million has been included in the Budget for this purpose in the 2006-07 financial year, equating to an average subsidy of around \$2,615 for every resident of King and Flinders Island.

With most of the electricity used on the BSI being generated from diesel, the actual cost of generation is rising, with higher diesel prices offsetting the recent introduction of a rebate on the excise component of these costs.

Hydro Tasmania's operations on the BSI are not the subject of a licence issued by the Regulator with associated licence conditions under the ESI Act.

Nevertheless, the ESI Act does apply to Hydro Tasmania on the BSI but it is an incomplete application, with the tariffs effectively set through the CSO contract rather than by the Regulator and with no explicit Tasmanian Electricity Code requirements for performance targets and standards.

On the BSI, Hydro Tasmania operates under a deemed licence in accordance with the *Electricity Supply Industry (Transitional Provisions) Act 1995*. This allows it to continue to undertake those operations that it was lawfully undertaking prior to the licensing requirement under the ESI Act until such time as the deemed licence is replaced by a licence issued by the Regulator.

In recognition of the circumstances on the BSI, operations on the BSI have been kept separate from regulatory changes in the Tasmanian electricity market as it entered the National Electricity Market (NEM).

Under the current arrangements, there is no clear policy as to how the subsidised retail tariff is determined or who has responsibility for determining and approving tariff structure on the BSI.

The subsidised retail tariff structure on the BSI is traceable to government policy decisions prior to 1996. However it is not clear how the level of the subsidised retail tariff was determined or how this linked with the Government's social policy objectives. Historically, the Regulator assumed the pricing role by establishing maximum tariff charges for the BSI. However, since 2003, the BSI has been omitted from the Regulator's pricing determinations.

In the absence of legislation or other regulatory controls to determine the escalation principles to be applied to the BSI tariff, Hydro Tasmania has

continued to price electricity in accordance with the principles established by the Regulator in the 1999 Pricing Determination. Hydro Tasmania escalates the subsidised retail tariff resulting from the 1999 Pricing Determination and estimates the Net Avoidable Cost of supply on the BSI. The Government funds the difference through the CSO contract. The subsidised retail tariff passes on the impact of inflation to customers, while increases in costs, including the diesel fuel component, are funded through the CSO.

At the time of major electrification on the BSI, the principle for the connection of domestic consumers was for the provision of only “light and power” (consistent with the lack of a hot water/off peak tariff). The 1996 GPOC determination suggests that electrification did not contemplate that electricity would become a substitute for the alternative fuels used for space heating and also in many cases, for cooking and heating water.

In the past, additional loads were connected in accordance with Hydro’s historical connection practices. As the level of demand grew, additional increments of generation were added on the basis of case by case negotiations with Government.

The legislative framework around supply on the BSI is silent on both the issues of generation augmentation, obligation to supply and connection policy. Although the ESI Act allows such policy settings to be applied through licence conditions, Hydro continues to operate on the Islands under a deemed licence. The GBE Act, under which the CSO is declared, deals with the cost recovery aspects of the CSO in very broad terms only.

In the absence of an explicit policy with regard to funding of additional generation, Hydro’s historical connection practice, together with the CSO funding process, have acted as de facto framework for expansion of supply on the BSI, and indeed de facto eligibility criteria for subsidised supply on the BSI.

Although this approach has supported investment to date, the absence of formal policy guidance in this area creates significant uncertainty both for the

supplier (Hydro) and consumers, resulting in arguably unnecessary challenges in efficiently developing the system.

In this environment, Hydro appears to have sought to align its connection practice on the BSI with that on mainland Tasmania. This would seem practical for domestic and relatively small commercial connections. However, due to the small size of the electrical systems on the BSI, this approach is not sufficiently robust for the connection of larger customers who can significantly influence the requirement for both network and generation capacity.

4 OPTIONS, DISCUSSION AND RECOMMENDATIONS

The Working Group's Terms of Reference are:

“The Working Group is to investigate and provide a set of recommendations to us regarding the following Bass Strait Islands (BSI) energy issues:

- 1. Recommending the tariff structure in relation to the BSI, including:***
 - a) the principle as to how retail electricity prices are set on the BSI;***
 - b) the type of tariff structure that is implemented; and***
 - c) who has responsibility for approving annual tariff rates;***
- 2. Estimating the cost to Government of any new tariff structure introduced and recommending as to how this will be funded;***
- 3. Identifying how increased demand for electricity on the BSI above current generation capacity will be managed; and***
- 4. Identifying how cost savings to Government (through the BSI CSO) from a reduction in the Federal Government's diesel fuel excise will be applied; and if it is determined that these savings are to be passed on to the residents of the BSI, recommending an appropriate mechanism to do this”.***

This sections presents the options related to each Term of Reference.

4.1 The principle as to how retail electricity prices are set on the BSI

- 1. Recommending the tariff structure in relation to the BSI, including:***
 - a) the principle as to how retail electricity prices are set on the BSI;***
-

The Working Group considered the social policy objectives Government is seeking to progress by funding the subsidised retail tariff on the BSI, such as household welfare, industry support and industry development. Progression of these objectives was further considered in terms of the range of

Government assistance measures available including the subsidised retail tariff.

There is a need to more clearly define the scope of subsidised electricity on the BSI.

New entrants to the BSI, particularly large industrial concerns, are entitled to know what the policies are in regards to connection and whether or not they will be able to get supply, and on what basis.

Under the terms of the CSO contract, an eligible customer for the subsidised retail tariff must be a resident of the BSI. This suggests that the intended social policy outcome of the subsidised retail tariff is that it contributes to the social welfare of the residents of the BSI rather than the progression of industry support and/or development activities. (Furthermore, the establishment of the Department of Economic Development suggests that the Government believes that economic and regional development should be explicitly progressed).

In light of these considerations and the broader policy objectives of Government, the Working Group developed the following guiding principles for the electricity tariff on the BSI.

Principle 1: The residents of the BSI will have access to affordable electricity consistent with a reasonable household standard of living.

Principle 2: The Government will continue to support electricity tariffs on the BSI at a level commensurate with the social policy objectives of Principles 1.

Principle 3: The BSI electricity tariff will be consistent with other economic sustainability and environmental objectives.

Principle 4: The regulatory and/or contractual arrangements for supply of electricity on the BSI will promote ongoing efficiency gains and least-cost supply solutions.

Principle 5: The ongoing support for electricity tariffs on the BSI will be targeted to deliver the objectives in an efficient and sustainable manner, with costs balanced against other calls on public funds.

The Working Group recommends that there be a clear delineation of the processes that determine:

- (i) the subsidised retail tariff on the BSI, and
- (ii) the basis of remuneration to the service provider(s).

This will provide a practical framework by which the subsidised retail tariff can be set with due consideration of Government's social objectives, the impact on the Consolidated Fund and efficiency considerations.

Keeping the responsibility for determination of the subsidised retail tariff separate from negotiations on the remuneration of the supplier of electricity on the BSI ensures that the Government has the option to enhance the arrangements for either of these aspects in isolation, avoiding the practical difficulties of complex linkages.

Within the constraints of the current legislative and contractual arrangements, the basis of remuneration for supply of electricity is dictated by the prevailing CSO declaration and subsequent contract. Under this framework, the

Treasurer can seek advice as to the tariff structure by issuing Terms of Reference provided to GPOC under Regulation 20 of the GPOC Regulations. The Working Group recommends that these Terms of Reference include the details of Government's social objectives and tariffing principles, together with a range of funding levels. Separately, but within the same Terms of Reference, advice should be sought as to the efficient cost of supplying electricity on the BSI. This advice would then assist the Treasurer in the administration of the CSO contract.

This approach is generally consistent with previous arrangements with GPOC and the 1999 Determination, which was undertaken in accordance with a set of terms of reference provided by the Government.

It is intended that this mechanism will ensure that Hydro Tasmania is entitled to a commercial return on efficient operation in the same manner as a commercial entity operating under an incentive based economic regulation regime.

4.2 Type of tariff structure

- 1. *Recommending the tariff structure in relation to the BSI, including:***
 - b) the type of tariff structure that is implemented; and***
-

4.2.1 Option 1 – Apply the mainland Tasmania tariff structure to the BSI – NOT RECOMMENDED

The King and Flinders Island Councils are seeking to have funding for the CSO increased to further reduce the price of electricity on the BSI. A submission from the Councils dated July 2004 requests the extension of the mainland Tasmania tariff structure to the BSI, including business peak and off-peak tariffs to encourage new investment on the Islands. This raises the issue of whether the tariff structures (as distinct from tariff levels) on mainland Tasmania are suitable for the BSI.

Tariffs on mainland Tasmania are structured (to the extent practical) so as to reflect the costs of supplying electricity on mainland Tasmania. The economics of supply on the BSI, being a combination of remote area diesel generation

and wind, differ significantly from those on mainland Tasmania. This suggests that the structure of tariffs on mainland Tasmania is not suitable for structuring the tariff(s) on the BSI.

As the cost of diesel generation is constant regardless of time of day on the BSI, operational costs are likely to increase if tariffs on the BSI are offered at the full mainland range. Furthermore, Hydro Tasmania has indicated that reductions in unit price are likely to lead to an increase in electricity demand that is above Hydro Tasmania's current capacity to generate, thus requiring further investment in generation capacity.

It follows that the application of the mainland Tasmania tariffing principles to the BSI would result in a very different tariff structure to that on mainland Tasmania.

Furthermore, the tariff structure on the BSI should have regard to the Government's social objectives on the BSI as one of its principle considerations.

The Working Group considered the option that the subsidised retail tariff be reduced to the charge for the first 500KWh per quarter in the Aurora Energy 'Residential Light and Power – Tariff 31' (15.307 cents per KWh). Based on energy consumption on the BSI for the 2004 calendar year, preliminary calculations indicate an additional cost to the CSO of between \$1 million and \$2 million if the price per KWh on the BSI were reduced from 20.89 cents to 15.307 cents.

Disregarding that further generation capacity would most likely be required by Hydro Tasmania in the event that a mainland tariff structure was applied to the BSI, funding for this additional demand would be from the Consolidated Fund. Part of this additional funding could be initially offset by savings to the CSO resulting from the proposed rebates on the Federal Government excise on diesel fuel used for stationary energy production (38.142 cents per litre). However, since the Federal Government announced the reduction in the diesel fuel excise, any such savings to the Consolidated Fund have been absorbed by increases in the underlying diesel fuel price. Additionally, the

most recent three year CSO funding forecast provided to Treasury from Hydro Tasmania indicates that the reduction in the diesel excise will reduce CSO funding to \$6.5 million in 2006/07 (approximately \$1 million less than the revised 2005/06 forecast of \$7.5 million), but then increase back to current levels by 2008-09. In other words, any saving to the cost of the CSO accruing from the diesel fuel excise rebate are likely to be minimal if at all.

In addition, the submission from the Councils in 2004 suggests that the extension of the mainland Tasmania tariff policy to the BSI could be cross-subsidised through an increase in tariffs from mainland Tasmania. Such an approach would be inconsistent with national competition policy, and in any case would become untenable in the contestable retail framework of the National Electricity Market. Application of a mainland tariff structure to the BSI would not promote cost effective usage of electricity on the Islands, nor maximise social outcomes for any given level of funding. It would significantly increase the long term impacts on the Consolidated Fund. Introduction of off-peak tariffs would risk displacement of substantial volumes of LPG and biomass (mainly firewood) due to undercutting by subsidised electricity, leading to even greater costs to the Consolidated Fund.

4.2.2 Option 2 – Regulated Tariff determined in accordance with the provisions of the Electricity Supply Industry Act 1995 – NOT RECOMMENDED

The BSI CSO declaration is for ‘Tariff concession on electricity supplied to customers on King and Flinders Island in accordance with the *Government Prices and Oversight (Electricity Prices) Order 1996*, or subsequent orders’.

Since this declaration was made, the legislative arrangements for price control of electricity have been shifted from the *Government Prices Control and Oversight Act 1990* (GPOC Act) to the *Electricity Supply Industry Act 1995* (ESI Act). Under the new arrangements, there is no mechanism by which matters such as the amount and focus of a government subsidy such as the CSO can be taken into consideration in determining maximum prices.

The most recent determination on maximum prices (including the BSI) by the Regulator was undertaken in 1999 (effective 1 Jan 2000) and was made having regard to a three year determination period.

In the 1999 pricing determination, the Regulator proposed a maximum allowable tariff for the BSI of 46.10 cents per KWh as being reflective of the cost of supply on the BSI. For the 2000 calendar year the standard energy charge¹ (subsidised retail tariff) was 18.79 cents per KWh, resulting in a CSO subsidy of 27.31 cents per KWh based on the maximum allowable tariff.

The BSI has not been included in further determinations of maximum prices undertaken by the Regulator. The Regulator took the view that his determination was neither effective nor enforceable on the BSI as in reality the tariffs on the BSI were determined by the Government through the CSO contract.

This option shares a common weakness with the preceding option, in that it does not give a clear framework for focusing the CSO subsidy to maximise social policy outcomes for any given level of public funding. Further, neither option provides a mechanism by which the appropriate level of subsidy is determined in the broader context of the budgetary process. A practical mechanism to manage the cost of the CSO subsidy is considered critical in the light of significant escalation of these costs in recent times.

4.2.3 Option 3 – Targeted subsidy aligned with social objectives – RECOMMENDED

Option 3 involves a clear delineation of the processes that determine (i) the subsidised retail tariff on the BSI, and (ii) the basis of remuneration to the service provider(s). This provides a practical mechanism by which Government's policy objectives and broader budgetary considerations can be integrated into the Tariff setting process.

The Working Group recommends that the tariff structure on the BSI should be changed in order to align the cost of basic electrical services on the BSI with that on mainland Tasmania, but at the same time to create appropriate

¹ An energy charge of 17.90 cents per KWh applied to pensioner and health care cardholder customers.

incentives for efficient energy use and to limit the growth of the government subsidy over time.

The Working Group is proposing that the current flat rate tariff is replaced with a stepped block tariff structure. The Government would decide the rates for each block and the nature of the thresholds that should apply following advice from the GPOC.

The Working Group recommends that the Minister for Energy, request the Treasurer (as Purchasing Minister for the CSO contract) to seek advice as to the tariff structure by issuing a Terms of Reference provided to GPOC under Regulation 20 of the GPOC Regulations.

These Terms of Reference would include the details of Government's social objectives as articulated in the policy principles, general tariffing principles (including a stepped tariff), together with a range of possible funding levels. The Minister for Energy would then advise the Treasurer as to the BSI tariff to be applied, on the basis of advice provided by GPOC.

The Working Group has included an example of a four block stepped tariff structure at Appendix A (without prejudice to the advice of GPOC or the decision by Government). In this example, block 1 targets household welfare and recognises the 'essential service' nature of electricity in household lighting and basic appliances.

The Terms of Reference could include rate equivalent to Aurora Energy Tariff 31 on the initial 500kw block (or another pre determined block) to deliver a block of energy at a comparable price to mainland Tasmania. Block 2 is set at a rate not dissimilar to the pre-existing tariff with allowances for general cost increases and inflation. Blocks 3 and 4 progress tariff rates towards the efficient cost of supply.

4.3 Responsibility for approving annual tariff rates

- 1. *Recommending the tariff structure in relation to the BSI, including:***
 - c) who has responsibility for approving annual tariff rates;***
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4.3.1 Option 1 - Status quo – NOT RECOMMENDED

Currently, there is no clear responsibility for approving the annual subsidised retail electricity tariff as the tariff is not required to be approved under the same process that occurs on mainland Tasmania. In the absence of formal arrangements determining the escalation principles to be applied to BSI tariffs, Hydro Tasmania has continued the principles established by the Regulator in the 1999 Pricing Determination in calculating the maximum energy charge allowable. The maximum energy charge allowable each year includes adjustments for inflation, GST and diesel. The subsidised retail tariff passes on only the impact of inflation to customers.

The disadvantage of this option is that, in the absence of a person or body having responsibility to approve tariffs, the appropriateness or otherwise of the subsidised retail tariff proposed by Hydro Tasmania is not considered. Continuation of the status quo also places Hydro Tasmania in the position of determining the subsidised retail tariff with no guidance from the Government regarding the social policy objectives pursued through the subsidy, or the appropriateness of the tariff given the cost structure of supply.

4.3.2 Option 2 – Government approves the subsidised retail tariff level and separately negotiates the remuneration of the supplier – RECOMMENDED

The recommendation is that the Minister for Energy is to have responsibility for approving the subsidised retail tariff on the BSI, in consultation with the Treasurer (as the purchasing Minister for the CSO contract).

Regulation 20 of the GPOC Regulations provides that the Treasurer (as the Minister responsible for these Regulations) may direct GPOC to inquire into and report on, a matter relating to or affecting the pricing policies of a prescribed body. For the purposes of the Regulations, Hydro Tasmania is a prescribed body.

An inquiry undertaken under Regulation 20 is flexible in that GPOC may conduct the inquiry in such a manner as it considers appropriate. Similarly,

the final report is provided to the Treasurer, the Minister for Energy and the prescribed body (unless directed otherwise).

The Treasurer may make a direction at his own discretion or at the request of a Minister for Energy. Under the second scenario, the Minister for Energy would request the Treasurer to direct GPOC to investigate and report on an appropriate tariff structure that would apply to the BSI.

A direction is to be made in writing and contain the Terms of Reference for the enquiry, as described above. It is possible that the Terms of Reference could prescribe a link between the first tariff band and the Aurora Energy Tariff 31.

The Government would assess the recommendations returned by GPOC to ensure that the recommended tariff structure appropriately meets the policy principles. The Minister for Energy, in consultation with the Treasurer, would approve the tariffs to apply to the BSI and Hydro Tasmania subsequently publish and apply the tariffs.

It is anticipated that this process would occur at three yearly intervals in association with the terms of the CSO contract, or more often if special circumstances dictate (i.e. a material change in the generation or supply of electricity on the BSI). For the years between GPOC reviews, the BSI tariff structure would be escalated annually by the Australian Consumer Price Index.

The negotiation of the CSO contract is seen as a matter between the Government and the supplier. It is envisaged that this negotiation would be informed by an expert assessment of the efficient costs of supply. The Government could seek to obtain this advice from GPOC.

It should be noted that GPOC has no prescribed information requisition power to enable it to undertake the inquiry as specified in the Terms of Reference. However, this should not lead to difficulties as the Treasurer and Minister for Energy have information gathering powers in their capacity as shareholders of Hydro Tasmania and Aurora Energy, and under the *Energy Co-ordination and Planning Act 1995*.

A significant advantage of the process described above is that it aligns outcomes and funding responsibilities with the relevant portfolio responsibilities. This is particularly relevant as the BSI are excluded from the State's National Electricity Market regulation (being unconnected) and the Regulator does not have the same pricing responsibilities on the BSI as with the rest of the State.

4.4 Cost to Government of BSI retail tariff proposal

2. Estimating the cost to Government of any new tariff structure introduced and recommending as to how this will be funded;

The Working Group recommends that the current arrangement, under which the CSO is funded from consolidated revenue while the tariff makes up the shortfall from the contribution from electricity users on the BSI, should continue to apply.

The cost to Government of the CSO will be the difference between the efficient cost of supply on the BSI (as determined by GPOC under the Terms of Reference) and the revenue likely to be raised by the proposed tariff.

By issuing GPOC with Terms of Reference, which include the funding levels Government is prepared to contribute in order to meet its social objectives as articulated in the policy principles, GPOC will have clearer parameters for undertaking its review.

4.5 Managing increases in demand

3. Identifying how increased demand for electricity on the BSI above current generation capacity will be managed; and

4.5.1 Option 1 - An obligation to augment efficiently – RECOMMENDED

Managing increases in demand is complicated by uncertainties about the obligations on Hydro Tasmania to connect and supply new loads on the BSI.

On mainland Tasmania the retailer has an exclusive retail franchise for non-contestable customers, and this is formally recognised. Accompanying this status is an obligation to supply.

On the BSI, the obligation to supply is determined by Ministerial direction. This direction is not very specific in detail. Obligation to supply mechanisms may have worked well enough to date, but could be regarded as an issue that would benefit from greater clarity in future.

A question that needs to be answered is whether or not the supplier on the BSI has an exclusive retail franchise and, if so, what are the bounds on such a franchise and, if not, what are the detailed obligations on the supplier to connect and supply.

The recommendation is that the supplier will be required to efficiently augment generation capacity at tariff levels for normal endogenous growth (including all residential growth), and that new connections with provision to take capacity over 5% of installed system firm capacity will be expected to negotiate a power purchase agreement with the supplier.

The supplier (Hydro Tasmania) will be required to offer a commercial (cost reflective) power purchase contract to such new connections on fair and reasonable terms. This ensures efficient pricing of electricity for new large loads.

It is possible that the supplier and prospective customer might be unable to reach a commercial agreement on supply for a very large new load. The customer is entitled to supply itself, or find another party willing to supply it, subject to satisfactory connection arrangements.

Should the recommendations in regard to tariff structure be adopted, these risks would be explicitly allocated in an efficient manner.

Further, the requirement for new large loads to negotiate power purchase from the supplier on fair and reasonable 'commercial terms' allows the supply

to appropriately price and allocate the 'stranding risk' associated with generation investment to supply such loads.

4.5.2 Option 2 - Status quo – NOT RECOMMENDED

Under this option, the generation supplier connects new demand in accordance with the supplier's historical connection practice. Connections resulting in a significant increase in generation requirements are managed through case-by-case negotiation with Government under the CSO contract. Funding of new generation capacity is negotiated under the CSO contract on a case-by-case basis. This approach could be refined somewhat by explicitly setting criteria as to what represents a significant increase in supply.

Hydro Tasmania currently bears a stranding risk for large load connections and, as such, Hydro Tasmania's investment to meet these new large loads are without certainty of income. Therefore, the CSO would continue to fund Hydro's investment required to supply the electricity including a 'profit' element of Weighted Average Cost of Capital (WACC) on written down asset values.

4.5.3 Option 3 - Automatic funding of augmentation – NOT RECOMMENDED

Under this option, the generation supplier connects new demand in accordance with the supplier's historical connection practice. Additional generation required to meet additional load would be automatically funded under the CSO contract. As in 4.5.2 the additional load funding creates a stranding risk for Hydro in bearing large load connotations.

As a result of automatic funding through the CSO contract, this option would significantly increase the long term impacts on the Consolidated Fund

4.6 Reduction in diesel fuel excise

- 4. Identifying how cost savings to Government (through the BSI CSO) from a reduction in the Federal Government's diesel fuel excise will be applied; and if it is determined that these savings***

are to be passed on to the residents of the BSI, recommending an appropriate mechanism to do this”.

4.6.1 Option 1 – Offset rising CSO costs to the Consolidated Fund – RECOMMENDED

The Working Group was asked to recommend how cost savings to Government (through the BSI CSO) from a reduction in the Federal Government’s diesel fuel excise will be applied, and if it is determined that these savings are to be passed on to the residents of the BSI, recommending an appropriate mechanism to do this.

The Australian Government announced that from 1 July 2006 to 30 June 2021, there will be a reduction in excise of 38.142 cents per litre on diesel used in commercial power generation (this represents a reduction in the current price of diesel of approximately 35%).

Under the existing CSO contract arrangements, cost savings attributable to a reduction in the diesel excise will reduce the cost to the Consolidated Fund for the BSI CSO. These cost savings would not flow through to electricity prices as there is no mechanism under the current arrangements to do so.

Additionally, under the existing CSO arrangements, the Government has been bearing the diesel price risk because annual adjustments to the subsidised retail tariff on the BSI have been limited to movements in the Australian Consumer Price Index.

The cost of the diesel fuel excise to Government is approximately \$1.6 million per year, while the increased cost to Government arising from diesel fuel price rises over the past two years is around \$1.5 million per year. Since the Australian Government announced the reduction in the diesel fuel excise, the savings arising from the reduction in excise have been largely offset by increases in the underlying diesel price.

4.6.2 Option 2 - Reduction in the BSI subsidised retail tariff – NOT RECOMMENDED

It is understood that the King and Flinders Island Councils may believe that savings from the reduction in the diesel fuel excise can be applied to provide power price parity with mainland Tasmania at no extra cost to the State Government. The Working Group noted that there may be some expectation on the BSI that this is how the diesel excise reduction will be applied.

However, significant increases in diesel fuel prices have already eliminated the savings from the diesel fuel excise rebate.

Based on energy consumption on the BSI for the 2005 calendar year, preliminary calculations indicate an additional cost to the CSO of around \$1 million to \$2 million if the price per KWh on the BSI were reduced to the most common residential light and power tariff on mainland Tasmania. This is within the estimated savings of approximately \$1.6 million from the excise reduction.

However, as previously discussed, any flat rate reduction in the tariff is likely to lead to increased electricity demand, creating a volume effect that would increase the overall CSO cost and accelerate the requirement for additional generation capacity. The volume effect would come through normal price elasticity, stimulation of new sources of demand and displacement of other energy alternatives, such as LPG and biomass, even though these may actually be more cost effective in an overall sense.

4.6.3 Option 3 - Reinvestment in additional capacity and improved service standards – NOT RECOMMENDED

It would be possible in principle to use any cost savings from the removal of the diesel fuel excise to fund capital investment in the generation or distribution sector. However, apart from the fact that significant increases in diesel fuel prices have already eliminated the savings from the diesel fuel excise rebate, remunerating the supplier on an efficient cost basis will create the correct incentives to do this in any case.

It is noted that the interests of the BSI are best served if electricity on the BSI is viewed in the context of overall energy needs and opportunities on the BSI, including energy efficiency. A detailed consideration of this point is beyond the Terms of Reference of the Working Group.

5 SUBMISSION SUMMARY

5.1 Overview

Following the release of the Discussion Paper in September 2006, the Minister for Energy called for submissions from interested parties. The Discussion Paper was made available to all residents, business operators and local councils on the BSI.

There were twenty-four submissions to the Discussion Paper. Sixteen submissions were from residents and four submissions from business operators. The remaining four submissions were from Government and non-Government organisations. A full list of the submissions is available in *Appendix B – List of Submissions to the Discussion Paper*.

Comments were sought on draft recommendations proposed in the Discussion Paper and it was noted that following stakeholder scrutiny and comment, a final report and set of recommendations would be produced.

The Working Group has conducted an analysis of stakeholder comments in making its final recommendations.

The initial recommendations proposed by the Working Group were based around significant investigation and consideration of key issues identified in its deliberations. Throughout the submissions there was a trend for comments to address issues outside the scope of the Working Group's Terms of Reference as well as the proposed recommendations. The Working Group evaluated the submissions but did not consider that they included significant comments against the Terms of Reference that could provide a basis for large scale revision of the draft recommendations.

The lack of rigorous information to suggest and support alternatives to the proposed solutions belies the fact that many of the points made in submissions, although outside the scope of reference, are passionately made. For this reason the Working Group has addressed key points of concern raised by stakeholders in their submissions in the following section.

Based on the above the Working Group has determined to make only minor changes to the suite of recommendations proposed in the Discussion Paper.

5.2 Issues

The following is an allocation of the relevant points from the various submissions to the Terms of Reference (Issues 1-6). Following each Issue Summary is a confirmation of the Working Group's recommendation.

In addition, the summary below highlights the comments received on issues raised outside of the scope of the Terms of Reference (Issues 7-12). The Working Group has included its comments on these issues, specifically an elaboration on the reasons for their preclusion from the draft recommendations contained within the Discussion Paper.

5.2.1 ISSUE 1 - THE PRINCIPLE AS TO HOW RETAIL ELECTRICITY PRICES ARE SET ON THE BSI

A submission from the Energy Advisory Group (EAG), a public interest group, suggests that the pricing principles for the BSI's are neither clear nor are they transparent and that the pricing principles need to be included in the Terms of Reference to the GPOC. EAG believes a breakdown of the cost structure into the retail and energy costs and the Distribution Use of Charges for the BSI should have been provided. It further noted that it is reasonably clear that the cost structures of the BSI's may be higher than for the rest of Tasmania.

Other submissions noted the importance of viewing the real cost of energy on the Islands but like EAG further noted this was not forthcoming from the paper or any other source. One resident of King Island stated:

"If Bass Strait Islands are not entitled to the Tasmanian Electricity Grid Price Structure we are at least entitled to know how/why our costs are substantially higher than Tasmanian Mainland..."

The King and Flinders Island Councils ("the Councils") considers that:

“the Working Group’s interpretation of this item of its Terms of Reference has been inappropriately narrow as it has not considered the two core issues that were raised in the Councils’ 2004 submission to the Government, being:

- The extension of the uniform tariff policy that applies every where else in Tasmania to Tasmanian businesses and residents on King Island and Flinders Island; and
- The Government directing Aurora or Hydro to offer King Island and Flinders Island businesses peak and off-peak tariffs.”

Working Group Recommendation – *Targeted subsidy aligned with social objectives*

It is recognised that there is a need to more clearly define the entitlement to subsidised electricity on the BSI. Existing residents and enterprises are entitled to a confirmation of their expectations, if these are valid and reasonable.

Submissions to the Discussion Paper in part focussed on this issue noting concerns that the pricing principles lacked clarity and that a breakdown of the cost structure, by retail, distribution and generation cost, would assist stakeholders in determining the principle as to how prices are set on the BSI.

Further, the Government is entitled to be able to know what the arrangements are likely to cost. New entrants to the BSI, particularly large industrial concerns, are entitled to know what the policies are in regards to connection and whether or not they will be able to get supply, and on what basis.

In light of these considerations and the broader policy objectives of Government, the Working Group developed guiding principles as noted on p.6 *Section 2 - Recommendations*.

Following completion of the review of the efficient cost of supply by GPOC, information regarding the breakdown of prices will be more readily available.

5.2.2 ISSUE 2 - THE TYPE OF TARIFF STRUCTURE THAT IS TO BE IMPLEMENTED ON THE BSI

Overall the proposed tariff structure was welcomed but a consistent request was that the parameters or quantum of the consumption levels be adjusted to better suit the actual usage patterns of both residents and businesses of the Islands. A limited number of submissions wholly opposed the block tariff structure whilst one submission was simply grateful for mains power and happy to pay the attributed cost.

Submissions commented that the first two blocks for the tariff could be expanded. Specifically, it was suggested that block 1 is insufficient for a reasonable and efficient house standard and that it should be extended from 500KWh to 1000KWh. One resident suggested setting the first level in the tariff block at 1000KWh noting the excessive cost involved in using electricity alone as an energy source at residences that used electricity for all their major energy needs.

In terms of businesses/industry users, the Department of Economic Development (DED) requests that “in determining the consumption interval between tariff rates for existing industries, factors such as currently installed production capacity must be considered.” That historical data may not provide a reliable guide due to changeable weather and economic conditions. DED offered its assistance in helping the Government determine the consumption dimensions of tariff block 2.

The Independent Grocers of Australia (IGA) also note the importance of providing price reductions to business as well as residential consumers. IGA suggest that businesses would most likely operate in Block 2 as costs would have been factored in and customers would be conscious of the consequences of high electricity costs.

Working Group Recommendation - *That the Minister issue terms of reference to GPOC under the Government Prices Oversight Regulations*

The explanation of the Working Group’s response to this issue is included in Section 4.2.

The Working Group further notes that the block structure in the Discussion Paper and in Appendix A of this Report is only included as an illustrative example. In line with the Working Group's recommendations, GPOC will recommend the block levels to Government for consideration. Terms of Reference will provide direction to GPOC to consider the structure and quantum of the block tariff.

5.2.3 ISSUE 3 - WHO HAS RESPONSIBILITY FOR APPROVING ANNUAL TARIFF RATES?

There were limited comments made on this section of the Paper.

Principal comments came from observations made on related sections of the Discussion Paper. For example, the Councils comment that whilst agreeing with the recommendation in Section 4.1 of the Discussion Paper that the issues of price setting and determining the CSO should be considered separately as that it is improper for the Minister to approve annual tariff rates. That the:

“Minister will clearly want to set prices having regard for the size of the CSO. By the Working Group's own reckoning this is inappropriate. Instead:

Prices should be independently set by GPOC quite separately of any consideration about the CSO – in the view of King Island and Flinders Island this should be at the uniform tariffs available elsewhere in Tasmania”

Working Group Recommendation – Government to approve the subsidised retail tariff level and separately negotiate the remuneration of the supplier

The explanation of the Working Group's response to this issue is included in Section 4.2.

5.2.4 ISSUE 4 - ESTIMATING THE COST TO GOVERNMENT OF ANY NEW TARIFF STRUCTURE INTRODUCED AND RECOMMENDING AS TO HOW THIS WILL BE FUNDED.

Submissions to the Discussion Paper made no observations on the Working Group's second Term of Reference.

Working Group Recommendation – *That the current arrangement, under which the CSO is funded from consolidated revenue, should continue.*

The explanation of the Working Group’s response to this issue is included in Section 4.4.

5.2.5 ISSUE 5 - IDENTIFYING HOW INCREASED DEMAND FOR ELECTRICITY ON THE BSI ABOVE CURRENT GENERATION CAPACITY WILL BE MANAGED.

Submissions perceived that there were options available on the BSI for introducing measures to meet demand on the Islands but did not specifically identify how this demand, or an increase in demand, would be managed.

Nexo Engineering identified four measures which it considers important:

- Increased wind generation on both Flinders and King Islands;
- Installation of high tension wires underground;
- Removal of diesel engines; and
- Installation of a cable across from mainland Tasmania to the BSI.

One resident suggested that an under water cable that connects both Islands to mainland Tasmania be considered.

Some submissions questioned whether wind power was being used to full potential on the Islands and sought a balance that was more in favour of wind over diesel generation.

Working Group Recommendation – *An obligation to augment efficiently*

The explanation of the Working Group’s response to this issue is included in Section 4.5.

The Working Group further notes that the measures proposed by Nexo Engineering are outside the Working Group’s Terms of Reference and that no suitable comment was provided as to how these measures would be funded and the costs recovered. It is also noted that wind profiles on the islands do not match industry use profiles, therefore a solution of more wind generation,

in the absence of efficient energy storage capabilities, is considered an incomplete option at this time

5.2.6 ISSUE 6 - IDENTIFYING HOW COST SAVINGS TO GOVERNMENT (THROUGH THE BSI CSO) FROM A REDUCTION IN THE FEDERAL GOVERNMENT'S DIESEL FUEL EXCISE WILL BE APPLIED.

Submissions to the Discussion Paper do not directly address this Terms of Reference. However, EAG makes the observation that:

“that diesel fuel is subject to the vagaries of the international oil prices and that a long term hedging contract would at least stabilise the price, making the fuel price budgeting easier. The EAG would recommend a whole of Tasmanian Government approach to diesel fuel purchasing to minimise the risks associated with volatile fuel prices.”

Further, one resident suggests that Hydro Tasmania should directly import fuel and that this approach would produce a saving of 40%. Further, that the King Island Ports Corporation (KIPC), a wholly owned subsidiary of Hobart Ports, is making a significant level of profit which should be passed onto the BSI.

Working Group Recommendation – *Offset rising CSO costs to the Consolidated Fund*

The explanation of the Working Group's response to this issue is included in Section 4.6.

5.2.7 ISSUE 7 – ASSESSMENT OF OPTIONS

There is a perception in some submissions that a full investigation of electricity issues on the BSI has not been conducted. Specifically, the Councils observe that:

“the Working Group should have conducted a full analysis of each of the feasible options and assess their relative merits against a set of objective criteria. This is the only way of knowing that the range of alternative views has been adequately considered and that the resultant recommendations are the best of the choices available.”

Working Group Response:

A range of issues relating to the supply of electricity to the Bass Strait Islands were considered by the Working Group during its deliberations and preparation of the Discussion Paper released for comment in September 2006. Numerous options were evaluated against the objective criteria provided by the guiding principles.

Through an in-depth review of these options the Working Group observed clear delineations between viable and non-viable draft recommendations to be proposed throughout the review of electricity arrangements on the BSI. Certain options reviewed by the Working Group or proposed by stakeholders would not be available for implementation due to factors such regulatory, environmental or other immovable impediments.

Many of these 'non-viable' options reviewed by the Working Group were raised as points for consideration through the submissions to the Discussion Paper. Some issues raised were clearly outside the Terms of Reference for the Working Group such as investigating further solar heating options or the construction of a cable from the BSI to mainland Tasmania. However some issues raised warrant addressing by the Working Group as they are included in scope of the Terms of Reference.

Specifically these issues can be listed as:

- That the Mainland Tasmanian tariff be applied to the BSI;
- That there be a cross-subsidy from Mainland Tasmania tariffs to BSI tariffs; and
- That there should be an off-peak tariff on the BSI.

Accordingly, the following is a discussion of three issues above considered by the Working Group but was not included in the Discussion Paper.

5.2.8 ISSUE 8 – APPLY THE MAINLAND TASMANIA TARIFF STRUCTURE TO THE BSI / CROSS-SUBSIDY FROM MAINLAND TASMANIA TARIFFS TO BSI TARIFFS

Most submissions from residents of the Islands indicate a perception that they are either not part of Tasmania or are regarded as Victorians. That the BSIs do contribute to the Tasmanian economy through taxes and charges. (The predominant suggestion from residential users is for the Government to introduce price parity for the BSI with mainland Tasmania.)

The Councils' submission also suggests one option to enable BSI residents access to mainland Tasmania tariffs is to have the "uniform tariff being increased by a very small amount across the whole of the State to cover the additional costs of Aurora servicing King Island and Flinders Island customers.

Regarding off-peak tariffs the Councils suggest that:

"The Government to direct Aurora or the Hydro to offer King Island and Flinders Island businesses peak and off-peak tariffs, to allow businesses to plan their load to best suit the Hydro and Aurora's system availability and lower overall costs"

Working Group Response:

The Working Group believes this issue has been addressed its discussions in Sections 4.1 and 4.2.

In addition to the Working Group's statements against introducing mainland Tasmanian tariffs to the BSI, a cross-subsidy approach would be inconsistent with national competition policy, and would become untenable in the contestable retail framework of the National Electricity Market.

Further, it is a principle of the National Competition Policy that cross subsidies be removed where at all possible. The regulatory framework that relates to energy in Tasmania reflects this and OTTER is required to set maximum prices based on efficient costs of supply. There is also no cross-subsidy between tariff customers and contract customers as the tariffs are set to recover the costs of supply to tariff customers.

Application of a mainland tariff structure to the BSI would not promote cost effective usage of electricity on the Islands, nor maximise social outcomes for any given level of funding. It would also significantly increase the long-term costs to the Consolidated Fund.

Introduction of off-peak tariffs would risk displacement of substantial volumes of LPG and biomass (mainly firewood) due to undercutting by subsidised electricity, leading to even greater costs to the Consolidated Fund.

It is clear that submissions to the Discussion Paper are aware of the benefits of off-peaks tariffs for those on mainland Tasmania. However, with diesel generation being the predominant source of power on the BSI, the opportunity for off-peak power is minimal. Added to this are the counter cycles of wind and industry usage. Residents should also be aware that if the generation framework for the Island changed significantly as to allow for off-peak power there would be significant metering costs involved.

Off peak tariffs are a means of providing an incentive for loads to shift away from peak periods, thus 'flattening the load curve' and reducing or delaying expenditure on infrastructure to meet peak demands. Off peak tariffs may also be a method for electricity providers to compete with other sources of energy for space and water heating, since the heat can be usefully stored and used later.

Unless these outcomes are achieved, the off peak tariff is merely a discount, and the need for additional circuits and meters adds to costs. The Working Group welcomes the suggestion and will consider suggesting that the service provider be encouraged to offer special terms to large industrial users on the BSI where a win-win outcome can be identified and achieved.

APPENDIX A: ILLUSTRATIVE EXAMPLE OF A STEPPED TARIFF

The Working Group is proposing that the current flat rate tariff be replaced with a stepped block tariff. Government would decide the rates for each block and the thresholds that would apply following advice from GPOC in accordance with Terms of Reference provided to it. For illustrative purposes, the Working Group includes the following example of a four block stepped tariff.

Fixed charges

Fixed and metering charges to be set following general tariffing principles.

Variable Charges

The energy component of the tariff would consist of four (increasing) blocks, as described below:

Block 1: Block 1 targets household welfare. This recognises the ‘essential service’ nature of electricity in household lighting and basic household appliances (as opposed to heating or cooling) and delivers a block of electricity at a comparable price to that on mainland Tasmania. For example, instead of paying 20.89c/KWh, customers on the BSI might pay a rate equivalent to Aurora Energy Tariff 31 on the initial 500 KWh block, saving up to \$28 per quarter.

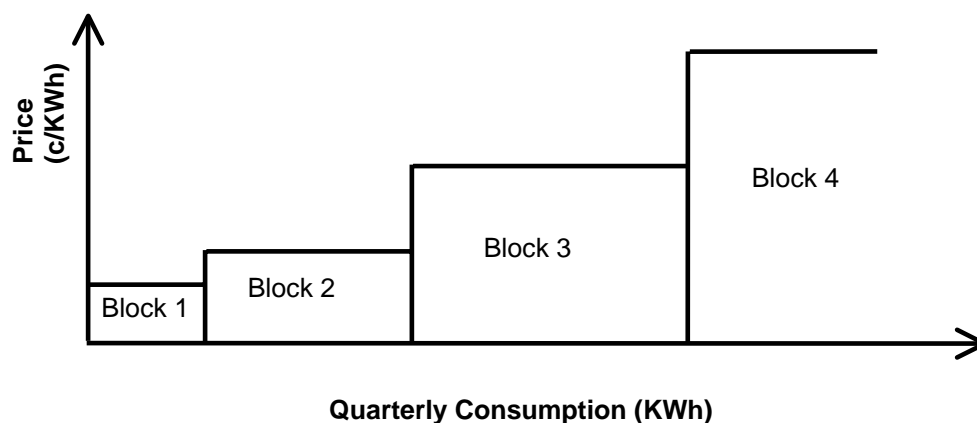
Block 2: Block 2 recognises the need to avoid price shocks for existing commercial and industrial activities on the BSI and would be set at a rate not dissimilar to pre-existing tariffs, with allowances for general cost increases and inflation.

Block 3: Block 3 provides limited price relief to support organic growth of existing enterprises and softens the step towards the full cost pricing in Block 4. To the extent that the pricing of this block is reflective of efficient cost, it is intended to avoid displacement of more efficient fuels and support efficient

arrangements for supply. Block 3 is a step closer to the true cost of supply, thereby increasing incentives on large users to consider cost efficient energy alternatives for incremental demand.

Block 4: This block is unsubsidised. It is only likely to be relevant for large users. The principle is that such large volumes of electricity should be related to the true costs of efficient supply. If Government assistance is warranted then it should be targeted, and delivered in an efficient way, and not cause a large distortion towards electricity at the expense of other fuels.

Example: Illustrative Tariff Structure



The tariff structure is based on the concept of blocks of energy at tariff rates that are stepped upwards towards the efficient cost of supply. The illustrated (conceptual) design gives an additional discount to all BSI customers for the first block of energy used each quarter, providing approximate equivalence to mainland Tasmania for basic light and power. The rates for each block, and the nature of the thresholds and block sizes, would be decided by Government following advice from the Government Prices Oversight Commission. For instance, it might be possible to have a different threshold for Block 1 for different classes of customers.

The need to define thresholds for block sizes is one of the matters on which feedback was sought. The Working Group is not opposed to specific

Government assistance for existing, new or expanding commercial and industrial developments on the BSI. However, it is considered that the blanket discounting of electricity gives little comfort that the social policy gains are commensurate with the level of subsidy provided. Support for existing industry, new industry or substantive expansion of existing industry is better progressed through regional development mechanisms in order to deliver support in the most efficient way.

APPENDIX B: LIST OF SUBMISSIONS TO DISCUSSION PAPER

Ansley, Tom, resident, King Island

Blundstone, Peter E, resident, Flinders Island

Cleeland, Roger J, resident, King Island

Cox, L.J., resident, Flinders Island

Department of Economic Development

Energy Action Group

Fanning, Daryl, resident, King Island

Food Works, Duncan McKenzie – proprietor

Gem Shop, Thelma Shaik – proprietor

Grassy Service Station, Kevin and Sharon Coates – proprietors

Harper, Peter and Monica, residents, King Island

Howard, Earl G, resident, King Island

Independent Grocers of Australia

King Island and Flinders Island Councils

Martin, E.S and D.M, resident, King Island

Nexo Engineering

Peddle, Kevin, resident, Flinders Island

Peddle, R.M, resident, Flinders Island

Ransley, S.M, resident, King Island

Richards, John B, resident, King Island

Robertson, W.I., resident, King Island

Roser, L.J., resident, King Island

Scott, Lyell, resident, King Island

Worsley, Ken, resident, Flinders Island