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AUDITOR-GENERAL SPECIAL REPORT No.94

Election promise: five per cent price cap on electricity prices

November 2010

Presented to both Houses of Parliament in accordance with the provisions of Audit Act 2008

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30 November 2010

President
Legislative Council
HOBART

Speaker
House of Assembly
HOBART

Dear Madam President

Dear Mr Speaker

SPECIAL REPORT NO. 94

Election promise: five per cent price cap on electricity prices

This report has been prepared consequent to examinations conducted under section 23 of the *Audit Act 2008*. The objective of the audit was to form an opinion on whether the caretaker government knew, or should have known, about Aurora's financial position when the five per cent price cap election promise was announced.

Yours sincerely

H M Blake

AUDITOR-GENERAL

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Foreword

Any political party making election promises must ensure these can be funded. In this audit we found that the promise on 15 February 2010 of a five per cent cap on electricity prices was based on advice from the Department of Treasury and Finance that it could be funded and nothing in advice from Aurora Energy Pty Ltd (Aurora) prior to that date explicitly suggested otherwise.

We also found evidence showing Aurora had, prior to 15 February 2010, advised its shareholding Ministers that it was experiencing financial difficulties. This advice focussed on its growing levels of debt primarily caused by its acquisition of the Tamar Valley power station, the structure of its balance sheet, wholesale electricity market arrangements in Tasmania and losses in its energy business that were being subsidised by its distribution business. Importantly, however, at no stage prior to 15 February 2010 did Aurora indicate it would not meet its corporate plan objectives.

Therefore, taking into account information they were aware of on 15 February 2010, and up to and including the date of the election on 20 March 2010, neither the Treasurer nor the caretaker government misinformed the electorate when making the five per cent energy cap promise. In reaching this conclusion I note Aurora management briefed Treasury regarding its changed financial position as soon as was practicably possible but that was two days before Election Day. At that stage, there was not enough time for the caretaker government to be informed and to react.

While reporting by Aurora to its shareholder Ministers was adequate, the following two recent initiatives have the potential to further strengthen such reporting:

- A Position Paper titled Conversion of Government Business Enterprises to State-owned Companies released by Treasury on 18 November 2010 which, amongst other matters, includes aspects relating to reporting. We support the thrust of this paper including the continuation of the requirement that State-owned companies provide half-yearly reports to shareholding Ministers with the possibility such reports be made public.
- The resolution by the Legislative Council on 12 October 2010 when it resolved to establish two Government Administration Sessional Committees whose functions will be to inquire into and report on any matters relating to ‘the administration, processes, practices and conduct of any ... Government Business Enterprise, State-owned Company or other entity including entities established under the *Water and Sewerage Corporations Act 2008*’.

H M Blake

Auditor-General

30 November 2010

List of acronyms and abbreviations

Aurora	Aurora Energy Pty Ltd
AETV	Aurora Energy Tamar Valley Pty Ltd (a subsidiary company that owns the Tamar Valley Power Station assets and operates as a standalone business at arms length from Aurora)
GBE	Government Business Enterprise
LRMC	Long run marginal cost
Regulator	Office of the Tasmanian Economic Regulator
STED	Sum of tax equivalentents and dividend payments
Treasury	Department of Treasury and Finance
TVPS	Tamar Valley Power Station

Executive summary

Executive summary

Background

Late in 2009, it appeared likely that Tasmanian electricity consumers would be faced with substantial price hikes in the near future. In the lead up to the 2010 state election, the Labor Party promised to place a one-year price cap of five per cent on electricity prices for non-contestable (i.e. essentially domestic) customers. Dividends from Aurora Energy Pty Ltd (Aurora) to government would, largely, fund the price cap initiative.

In the meantime, it emerged that Aurora had serious financial problems and the government later abandoned the price cap, offering instead a one off \$100 electricity-related payment for concession cardholders. That policy shift led to heated debate in Parliament because the Liberal Opposition believed that the Government had known all along that Aurora's finances were troubled. The Liberals unsuccessfully attempted to refer the issue to a committee of the House of Assembly.

Later, the Treasurer wrote to the Auditor-General requesting an audit under section 24 of the *Audit Act 2008*. The objective of the audit was to form an opinion on whether the caretaker government knew, or should have known, about Aurora's financial position at the time of the price cap announcement.

Detailed audit conclusions

Was there a genuine intention to implement the five per cent electricity price cap?

In seeking a formal costing from Treasury, and the earlier provision of a similar cap on water and sewerage charges, the government's pre-election commitment to honour the five per cent price cap promise appears genuine.

From the point of view of affordability, information available in the public domain indicated that Aurora had experienced downturns in profitability in 2008–09. There were also 'rumblings' about debt and asset impairment of the Tamar Valley Power Station throughout 2009. However, at the time the election promise was made on 15 February 2010, the Government had sound reason to believe that the five per cent price cap could be afforded from payments to government anticipated to be made by Aurora.

Was the decision to abandon the five per cent electricity price cap reasonable?

What was new in the period following the 20 March 2010 election was the sharp decline in Aurora's projected financial performance and a bleak outlook for the business.

The decision to abandon the five per cent price cap was based on new information of sufficient weight. However, even if it had been delivered as originally promised, it would not shield Tasmanian electricity consumers from rising prices in the long term.

Audit Act 2008 section 30 — Submissions and comments received

Audit Act 2008 section 30 — Submissions and comments received

Introduction

In accordance with section 30(2) of the *Audit Act 2008*, a copy of this Report was provided to the Aurora Energy Pty Ltd, the Department of Treasury and Finance and the Department of Infrastructure, Energy and Resources with a request for comment. A summary of findings was also provided to the Treasurer and Minister for Energy with a request for comment or submissions.

The comments and submissions provided are not subject to the audit nor the evidentiary standards required in reaching an audit conclusion. Responsibility for the accuracy, fairness and balance of those comments rests solely with those who provided a response or comment.

Submissions and comments received

Aurora Energy Pty Ltd

Aurora has actively cooperated with the Auditor-General in undertaking this audit and has provided evidence to the Auditor-General to demonstrate that management and the Board were actively monitoring Aurora's financial performance and providing relevant and regular advice to the Government during the period in question, in accordance with State-owned Company reporting obligations.

As outlined in this Report, key issues raised by Aurora prior to the price cap announcement included debt and equity levels as well as concerns regarding the impact that the existing wholesale market arrangements could have on AETV and Aurora profitability.

However, at the time of the announcement, actual financial results for the year did not indicate that a significant drop in profitability would occur by the end of the financial year. As shown in Figure 2 in Section 1.3.4 of the Report, Aurora's year-to-date profit as at the end of December was well above budget and total earnings before interest and tax were also above budget.

In March 2010, Aurora identified and communicated detailed concerns regarding deteriorating financial performance for the current year and the potential for this to get worse in future financial years, including specific forecasts of potential losses for the Energy Business and the whole Aurora entity if the existing market arrangements remained unchanged.

The key factor in the change in Aurora's financial performance was that prior to the end of 2009, there was no operating history for the newly-completed TVPS. During 2010 it became clear that Aurora could not fully recover the costs of generating and procuring energy in the Tasmanian market. This resulted in the accumulation of losses for the Energy Business during 2010 and the projections for further losses in future years if there was no change to the market arrangements.

The removal of the electricity price cap by the Government, the new commercial agreement with Hydro Tasmania and the re-establishment of the independent Regulator's pricing determination process have enabled Aurora to return to a sustainable financial position, including a forecast for a return to profitability in 2010–11.

Department of Treasury and Finance

There are no matters that I wish to raise in response to the report.

Department of Infrastructure Energy and Resources

I write to confirm that DIER regards the audit as comprehensive and accurate and has nothing to add to the report or comment to make.

Introduction

Introduction

Background

In 1998, the former Hydro-Electric Commission was split into three entities: Hydro Tasmania which generates electricity; Transend Networks Pty Ltd (Transend) which transmits it across the state, and Aurora Energy Pty Ltd (Aurora), the retail and distribution arm, which sells and distributes it to customers.

Since the 1970s, the state has relied on alternative power sources to drought-proof the predominantly hydro-electric power grid. The existing Bell Bay power station that was commissioned in 1971, was reaching the end of its economic life. An opportunity arose for a private company to construct and operate a new gas-fired power station, the Tamar Valley Power Station (TVPS). In August 2008, the Government purchased the partially completed TVPS, as the private company faltered during the global financial crisis. Factors that influenced the government's decision to acquire TVPS included:

- At that time, hydro-electric water storages were at historic lows.
- Sale to another private-sector operator was unlikely without significant delays to completing construction.

Ownership of the new power station was vested in Aurora through a wholly-owned subsidiary company, Aurora Energy Tamar Valley — AETV. Based in part on the aim to reduce Hydro Tasmania's market power in generation, that decision meant that Aurora would no longer be just a retailer. In its new form as a 'gen-tailer', Aurora faced more aggressive pricing strategies (as evidenced by spikes in energy spot prices in June 2009). Also, TVPS was still under construction with \$260m of work needing to be completed which was financed by debt passed through Aurora

Later in 2009, it appeared likely that Tasmanian electricity consumers would be faced with substantial price hikes in the near future¹. On 15 February 2010, in the lead up to the 2010 state election, the Labor Party promised to place a one-year price cap of five per cent on electricity prices for non-contestable (i.e. essentially domestic) customers. Funds from Aurora to government (in the form of tax equivalents and dividends — STED) would, largely, pay

¹ For example, a decision by the Australian Electricity Regulator, a national entity, had meant that a \$20m charge that arose in Transend Networks would be passed on to Aurora and through to customers.

for the price cap initiative². Subsequently, it emerged that Aurora had serious financial problems and the government later abandoned the price cap. In its place, the government offered a one-off \$100 electricity-related payment to concession cardholders.

That policy reversal led to heated debate in Parliament; the Liberal Opposition claiming that the government had known all along that Aurora's finances were troubled. An Opposition attempt to refer the issue to a parliamentary committee was unsuccessful. Instead, the Treasurer wrote to the Auditor-General in July 2010 requesting an audit under section 24 of the *Audit Act 2008*.

Governance mechanisms

Although Aurora is a state-owned company it operates similarly to privately owned companies in Australia. Its chief governing body is the Board of Directors, which is currently comprised of non-executive directors, except for the Chief Executive Officer. Its only shareholders are the Treasurer and the Minister for Energy who hold these shares on behalf of the State of Tasmania.

Treasury's role with government businesses is to manage the State's shareholding relationship and advise the Treasurer on the structure and operations, including financial performance. More broadly, Treasury also provides expert advice on developments in economic policy. For the electricity supply industry, that takes account of Tasmania's participation in the national electricity market.

Treasury monitors the performance of government businesses by receiving and analysing regular reports from them and reporting to the Treasurer. It also receives and reviews corporate plans again advising the Treasurer about these. Treasury also prepares routine quarterly performance reports for the Treasurer

Audit objective

The objective of the audit was to form an opinion on whether the caretaker government knew, or should have known, about Aurora's financial position at the time of the price cap announcement.

Audit scope

The scope for this audit was limited to:

² Tax equivalents are payments made by government businesses to the Department of Treasury and Finance. These payments equate with income tax that private companies must pay and are factored into government businesses to ensure competitive neutrality.

- Aurora Energy Pty Ltd (including its subsidiary AETV Pty Ltd)
- Department of Treasury and Finance
- Department of Infrastructure, Energy and Resources
- Offices of the Minister for Energy and of the Treasurer.

Audit criteria

With regard to Aurora's financial position, we broke the audit objective down to the following audit criteria:

- Was there evidence of a genuine intention by the caretaker Government to provide a price cap on energy for 12 months?
- Was the decision to abandon the price cap based on new information that was of sufficient weight to reasonably support the reversal?

Audit approach

The audit involved two main sources of information:

- review of relevant correspondence, documents and reports
- consultation with staff (including some Board members) from Aurora, Treasury, Department of Infrastructure, Energy and Resources, ministerial advisors and the Treasurer.

Timing

Planning for this audit began in July 2010. Fieldwork was completed in November 2010 and the report was finalised in November 2010.

Resources

The total cost of the audit excluding production costs was \$72 000.

1 A genuine intention to implement?

1 A genuine intention to implement?

In this Chapter, we reviewed the events in the lead up to the price cap announcement and sought to determine whether or not there was evidence of a genuine intention by the caretaker Government to provide a five per cent price cap on energy in 2010–11.

1.1 *Was there a precedent?*

In this Subsection, we consider whether the commitment to cap energy prices was in the nature of normal government business or whether it is more reasonably regarded as being made for mainly electoral reasons.

In its 2008–09 Annual Report, Aurora showed a significant downward movement in its financial position. While the downturn was not catastrophic, both the Chairman and the Chief Executive Officer (CEO) drew attention in their respective reports for the need to communicate to consumers the reasons why electricity prices had to rise.

Subsequently, in House of Assembly GBE Scrutiny Committee hearings, the then Minister for Energy, David Llewellyn, demonstrated an awareness of the public sensitivity to energy price rises. Accordingly, he promised to continue ‘robust, independent price regulation’ and to insulate concession holders from future price rises.

Given the Government’s sensitivity to utility prices and Aurora’s foreshadowing of future price rises, it would seem probable that the Government would consider some form of subsidy or price cap, regardless of whether or not an election was imminent.

It is also worth noting that capping prices was not without precedent for the Labour Government; it had previously demonstrated sensitivity to utility pricing by introducing a five per cent price cap on water and sewerage charges.

1.2 *Was the promise properly costed?*

We enquired as to whether the Government had obtained Treasury costings prior to promising to cap prices. Such actions would indicate that Government had a genuine intention to implement its promise.

The possibility for a price cap, similar to that in place for water and sewerage, arose during a regular meeting between the Treasurer and Treasury officials in November 2009. The Treasurer sought their advice about rolling 2009–10 electricity tariffs into the following

year with price increases restricted to consumer price index rises. Treasury advised that a significant loss of value to the government-owned electricity businesses would result if the retail energy prices were not based on the long run marginal cost (LRMC) of electricity generation³.

The Office of the Tasmania Economic Regulator (the Regulator) has responsibilities that include the regulation of electricity retail pricing. Hitherto, the Regulator had, for the period 1 January 2008 to 30 June 2010, used an assumed cost, set by government in price control regulations (based on LRMC). However, Treasury had then proposed using the LRMC more explicitly for setting the energy price component of regulated tariffs. Movement towards an explicit use of LRMC-based tariffs would inevitably see a rise in prices to customers due to rising costs. That change to energy pricing policy would also have the effect of mitigating the risk of potential impairment of the TVPS assets flagged by Aurora (see Section 1.3.1).

By the middle of December 2009, a number of developments, including the announced closure of the Wesley Vale and Burnie pulp mills (both major power consumers), had persuaded Treasury to put a number of alternate pricing options to the Treasurer again. Weighing the alternatives, the Treasurer directed Treasury to proceed with the preparation of a cabinet submission recommending adoption of the five per cent price cap.

Prior to the election, Treasury estimated that the five per cent price cap would cost about \$20m in a single year. Later, detailed costing raised that figure to \$23.5m.

1.3 *Was the promise affordable given the information available at that time?*

1.3.1 *Aurora's financial background*

As mentioned in the Introduction, the Government decided that Aurora would own TVPS by means of a subsidiary company. To fund completion of the power station, Aurora had to borrow \$260m. That amount was in addition to an existing debt of \$555m as at 30 June 2008. In order to ease concerns about the elevated debt

³ Long Run Marginal Cost: 'The LRMC of generation is defined as the most efficient available marginal generation cost to supply customer loads, based on a hypothetical optimal mix of generation assets.' Department of Treasury and Finance.

levels taken on by Aurora, the Treasurer was obliged to provide TASCORP with a Letter of Comfort⁴.

To be able to recoup its costs, Aurora needed an appropriately set tariff. Ideally, this should be established so as to cover actual total costs with a margin. As early as February 2009, financial modelling by Aurora indicated that the accounting valuation of the TVPS was below its acquisition and completion costs (a situation analogous with ‘over capitalising’). That was because estimated net revenues from generating in the Tasmanian market under the arrangements at the time were estimated to be below the overall acquisition and completion costs. As a result, the TVPS could have been impaired (i.e. had its book value written down) in the 2008–09 financial statements.

In the event of asset impairment, Aurora would almost certainly have its credit rating downgraded. One consequence of downgrading would be higher interest rates as the company would be viewed as a riskier proposition by lenders. In a spiralling situation, higher interest payments would further erode already decreasing profitability.

To mitigate the potential impairment Aurora undertook a structural re-organisation to form a new wholesale energy division within the company⁵. Having the wholesale energy division would allow Aurora to optimise its activities in energy generation. Another major advantage would be that Aurora could eliminate costly duplication within the company.

In 2008, the Energy Minister commissioned a consultant’s report examining possible restructures of the energy sector. A number of draft reports have been produced by the consultants, with the latest and final report released in July 2010. We note to date that no firm decisions have been taken in regards to those reports. However, the consultant’s report, which used financial information supplied by Aurora, showed continued profits going forward and future payments of STED.

1.3.2 Aurora’s corporate planning

Aurora undertakes its corporate planning on an annual basis, but that cycle is set within a longer term timeframe. During the early part of each year, Aurora prepares its corporate plan consisting of a budget

⁴ TASCORP is a statutory body that develops and implements borrowing and investment programmes for the benefit of Tasmanian State Authorities.

⁵ AETV, Retail and AEATM divisions were merged to form the one Energy Business division.

and plan for the next three to five years. This annual plan is normally available to Treasury and the shareholders by March.

2009–12 business plans

Originally, Aurora lodged its 2009–12 business plan in March 2009. As agreed with Treasury, a supplementary plan with consolidated financial information was provided in late April 2009 with a covering letter from Aurora to the Treasurer that stated:

While the Parent Entity will continue to deliver profitable results, consolidated profitability is expected to deteriorate over the three-year plan with debt levels, gearing and debt serviceability expected to move outside Aurora’s target range following the acquisition and construction of the TVPS.

The April 2009 supplementary business plan noted that for 2010–11:

- Payments to government (tax equivalents and dividend) were forecast to drop from \$32m to \$24m.
- Consolidated Net Profit Before Tax was projected to remain steady at \$42m.

We were persuaded that the 2009–12 corporate plan did not contain any information that would preclude the Government from pursuing a five per cent price cap.

Energy price

Treasury submissions to the Treasurer in late 2009 indicated that the then energy price of \$63 per megawatt hour (MWh), set in June 2009, would need to increase. At that time, Treasury estimated the LRMC cost to be \$71 MWh (later confirmed by the Regulator at \$73.50 MWh)⁶.

1.3.3 Payments to government: tax equivalents and dividends (STED)

At the time the promise was made, a precise mechanism by which the government would compensate Aurora for the price cap’s impact on revenue had not been fully determined. However, there had been a notional linking between:

- the sum of tax equivalents and dividend payments (STED) expected to be paid by Aurora to Treasury

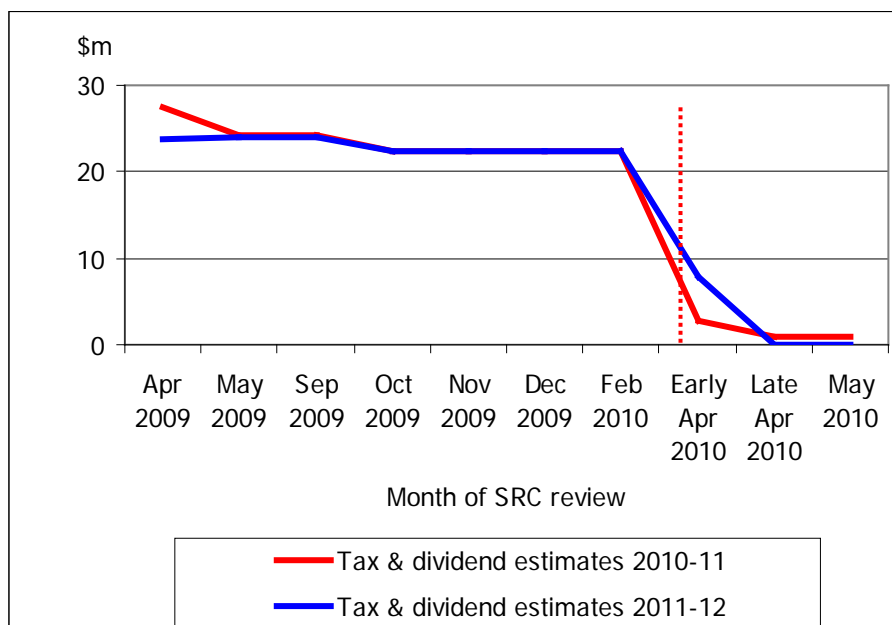
⁶ Intelligent Energy Systems, *Wholesale Energy Price for Period 2010–2013 — Final*, 7 May 2010.

- the revenue foregone because of the price cap⁷.

We also noted that STED estimates were regularly updated by Aurora and considered by Treasury’s State Revenue Committee (SRC). For those reasons, we considered the relationship between those payments and the estimated cost of the cap to provide a useful framework for our audit.

In the period from March 2009 to March 2010, Treasury’s SRC was provided with updates of the expected returns to the Government from all businesses, including Aurora. These expected returns remained steady up until April 2010, as shown in Figure 1.

Figure 1: Estimates for 2010–11 and 2011–12 STED



The dotted line indicates the date of the March 2010 election.

However, by April 2010, STED estimates for 2010–11 and 2011–12 had fallen sharply. Documents that we audited from SRC meetings prior to the election gave no indication that the projected STED was about to drastically decline.

It was reasonable to assume that during the election campaign, the five per cent price cap could be funded from Aurora’s payments to government.

1.3.4 2009–10 profitability

In addition to the projected STED for 2010–11, we would also expect actual 2009–10 profitability to be a factor for the government in determining the affordability of the five per cent price cap. As a state-owned company, Aurora provides half-yearly performance

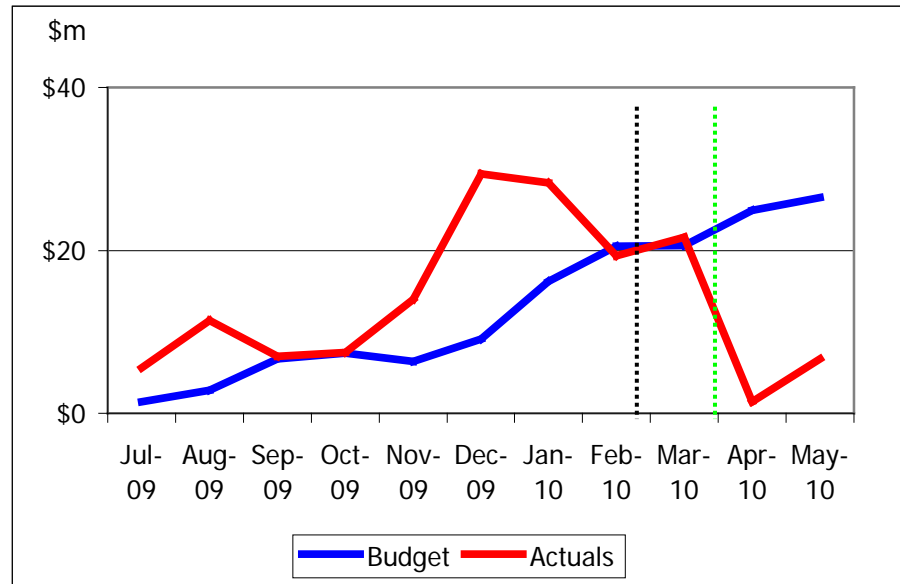
⁷ STED amounts do not include guarantee fees paid to Treasury.

reports for the shareholders. The report for the first half of 2009–10 stated:

Overall the Forecast Group likely end of year Profit Before Tax is \$13.3m higher than budget [originally \$38m] ... but the forecast is based upon a number of assumptions.

Figure 2 shows Aurora's 2009–10 financial performance on a monthly basis of actuals to budget⁸.

Figure 2: 2009–10 Profit Before Tax — actual to budget



The dotted green line indicates the date of the March 2010 election. The dotted black line shows the date the five per cent price cap was announced.

Towards the end of 2009, a large increase in actual profit was recognised due to a rise in the book value of some of Aurora's hedge contracts. However, that rise was more than offset by poor profitability in the early part of 2010. In February 2010, a combination of unfavourable energy spot prices and reduced customer consumption resulted in an operating loss. A worse result was experienced in April, due to lower wholesale prices from TVPS and lower than normal load demand because of unseasonably warm weather.

Despite a spike in profits caused by accounting movements, the dip in early 2010 corrected and performance was restored to budgeted levels. While profits fell further after March that was not immediately apparent due to lag time in producing financial reports.

1.3.5 Chairman's concerns

⁸ Actuals to budget financial performance were extracted from Aurora Board papers. Results presented to Board reflected previous months' results.

In December 2009, Aurora's Chairman wrote to the shareholder ministers outlining his concerns that:

- Debt levels for AETV were unsustainable from a commercial perspective.
- The company's borrowing capacity needed to be increased prior to 30 June 2010.
- Wholesale energy pricing policies prevented the Energy Division from generating enough revenue to cover operating costs (see Section 1.2).

The Chairman's letter requested the government to take urgent action, including an increase of Aurora's borrowing limit by a further \$30m and extending the government's letter of comfort to TASCORP until the end of 2010. These actions were suggested as temporary fixes only, because fundamental issues remained with Aurora's capital structure. The Chairman also believed the company needed an equity injection of between \$150m–\$200m, accompanied by improved electricity market arrangements.

In mid-January 2010, a Board sub-committee instigated briefings with the shareholder ministers. The Board was concerned that the company's overall profitability was now being impacted by large losses starting to appear in its Energy Division. The presentations focussed on the current financial year (i.e. 2009–10) but were in summary format with few hard numbers. However, earnings were reportedly below budget and unless input costs could be passed on to retail customers, Aurora's financial position would worsen. The presentations also highlighted that regulated wholesale price arrangements needed to be urgently reviewed. Despite the difficulties outlined, there was no suggestion in the briefing of a downgrade in anticipated STED.

At that stage, the next five-year corporate plan had not been completed and, as a result, a clear picture of Aurora's forward performance was not available. The February 2010 SRC meeting, relying on information supplied by Aurora, did not see a need to change its 2010–11 projections. Thus, it is hard to conclude that the Government could have anticipated the subsequent fall in profitability and its impact on affordability of the five per cent price cap.

1.4 Did the Government receive information after the promise but before the election likely to impact on its capacity to cap energy prices?

In February and March 2010, work undertaken by Aurora on its 2010–15 Corporate Plan had revealed a fundamental downward shift

in profitability. As an example, for Profit Before Tax in the Energy Division, the likely 2009–10 result of -\$23m was projected to balloon out to -\$55m in 2014-15⁹. Concerned by this likelihood, Aurora’s management (with knowledge of the Board) arranged a briefing for Treasury officials on 18 March — two days before the state election. The intent of the briefing, so far as Treasury officials saw it, was for Aurora to preview a briefing that would be made to an incoming government.

The Treasurer, his advisors and senior Treasury officers all confirmed that the contents of the briefing had not been relayed to the Treasurer or discussed with him.

Three factors were instrumental in understanding why Treasury did not advise the Treasurer’s Office:

- The briefing did not have the same weight as a formal document that had been signed off by the Board. Without the underlying draft plan, Treasury officers were not in a position to evaluate the significance of items covered in the briefing.
- Under the caretaker convention, contact between government departments and their Ministers is quite restricted because of the need for the bureaucracy to maintain its apolitical stance.
- With the state election just two days away, there was insufficient time to act even if more detailed information had been available.

On 30 March, ten days after the election, Aurora sent its draft five-year corporate plan to the Treasurer and the Minister for Energy, through Treasury and the Department of Infrastructure, Energy and Resources. However, the departments retained all copies of the draft corporate plan as it was not known which party would form Government. Later, Aurora provided a briefing to the shareholders in April 2010. The plan showed a large deterioration in expected financial performance for 2010–11 that made it clear that the energy cap could no longer be funded by payments to government.

1.5 *Conclusion*

In seeking a formal costing from Treasury, and the earlier provision of a similar cap on water and sewerage charges, the government’s pre-election commitment to honour the five per cent price cap promise appears genuine.

⁹ Excluding mark to market gains on derivatives.

From the point of view of affordability, information available in the public domain indicated that Aurora had experienced downturns in profitability in 2008–09. There were also ‘rumblings’ about debt and asset impairment of the TVPS throughout 2009. At the time the election promise was made, though, the Government had sound reason to believe that the five per cent price cap could be afforded from payments to government anticipated to be made by Aurora.

2 A reasonable decision to abandon?

2 A reasonable decision to abandon?

On 9 June 2010, the government announced that it could no longer afford to maintain its policy of capping electricity price increases at five per cent for 2010–11. Instead, as a compromise that would compensate vulnerable consumers, a \$100 reduction for concession holders was developed. That discount equated with a five per cent reduction for that group of energy users.

In considering whether the government’s decision to drop the five per cent price cap commitment was reasonable, it should be remembered that, prior to the election, the caretaker government was already aware that Aurora:

- had significant balance sheet issues, with its debt levels acknowledged to be too high (see Section 1.3.2)
- faced the risk of asset impairment of the TVPS (see Section 1.3.1)
- was underperforming with three of the four key performance indicators reported by Treasury below target and displaying ‘red traffic signals’
- had been described by its Board as ‘unsustainable’ (see Section 1.3.5).

This Chapter deals with the question of whether that decision was based on information that was not available prior to the election and whether that new information was of sufficient weight to reasonably support the abandonment of the election commitment. We were looking for information other than that already covered above.

2.1 *Was there new information?*

Aurora’s March 2010 Board meeting papers included, for the first time, a draft copy of the 2010–15 corporate plan. The environment in which Aurora produced that new plan was extremely fluid and substantially changed from the context in which the 2009 corporate plan was developed. Uncertainties for Aurora with its new plan included energy pricing, operating costs of the TVPS and price determinations of the Regulator.

On that basis, detailed profit projections and debt levels indicated a drastically changed business outlook. The 2010–11 forecast now showed a projected drop in:

- Consolidated Net Profit Before Tax of \$43.8m
- Dividend and tax equivalent payments of \$21.3m.

So, while the underlying cost and price factors had not substantially changed, other contextual factors led to Aurora markedly revising its projections downwards subsequent to the election.

2.2 *Were changes of sufficient magnitude to justify abandoning the commitment?*

There are two potential changes to consider in this Section; cost of the promise and availability of funds to pay for it. As noted in Section 1.2, Treasury had costed the five per cent price cap at \$23.5m. We were advised that cost estimate had not been revised at the time the commitment was abandoned in June 2010.

On the other hand, STED (the funds notionally to be used to cover the commitment) had dropped by approximately \$21.3m. Whereas Treasury had advised the Government that Aurora would provide sufficient STED to pay for the promise, that funding was no longer available. On that basis, the Government believed it could no longer afford to deliver the promised price cap.

The Government could have still proceeded if it had chosen to allocate money from other sources. To put that in context, we reviewed that potential funding commitment against other election commitments for 2011–12. We found that the additional funds allocated would have:

- exceeded all of the individual commitments
- equated to the 22 cheapest promises
- represented 16 per cent of total commitments.

We also note that the Government was facing other potential costs related to Aurora's possibly unsustainable position. In other words, rather than receiving money from Aurora, the Government may have been obliged to pump money in. Accordingly, we consider the reduction in STED to be of sufficient weight to justify abandoning the election promise since the impact on other commitments would have been substantial.

2.3 *Later developments*

In late June 2010, Aurora and Hydro entered into a hedge contract for wholesale energy purchases for the period from 1 July 2010 to 30 June 2013. Subsequently, the Regulator made a draft determination in relation to energy pricing that signalled a move towards the LRMC model, as required under recently made regulations under the *Electricity Supply Industry Act 1995*. Based on the new arrangements, Treasury revised the cost of the five per cent price cap to \$54.2m.

At that time, the Regulator's preliminary assessment was to recommend an overall increase of 16 per cent in retail energy prices over the next three years. That increase occurs against a backdrop of increasing electricity prices across Australia. For example, in the three-year period 2011–2013, price rises of 20–42 per cent will come into effect across the three New South Wales retail companies¹⁰.

In that light, a cap on energy prices can only be seen as a short-term measure that would ultimately lead to sharper price rises for consumers because, ultimately, energy prices cannot escape market pressures. Further, maintaining capped prices beyond 2011–12 would be ever more costly to the Tasmanian government.

2.4 Conclusion

What was new in the period following the 20 March 2010 election was the sharp decline in Aurora's projected financial performance and a bleak outlook for the business.

The decision to abandon the five per cent price cap was based on new information of sufficient weight. However, even if it had been delivered as originally promised, it would not shield Tasmanian electricity consumers from rising prices in the long term.

¹⁰ Sydney Morning Herald, *NSW electricity bills to soar*. 18 March 2010

Independent auditor's conclusion

Independent auditor's conclusion

This independent conclusion is addressed to the President of the Legislative Council and to the Speaker of the House of Assembly. It relates to my audit as to whether the caretaker government knew, or should have known, about Aurora's financial position at the time of the price cap announcement. My work was based on the objective, audit scope and audit criteria detailed in the Introduction to this Report.

In developing the scope of this audit and completing my work, the parties interviewed provided me with all of the information that I requested. There was no effort by any party to the audit to limit the scope of my work. This Report is a public document and its use is not restricted in any way by me or by any other person or party.

Responsibility of the Treasurer, and the care-taker government, in announcing the five per cent energy price cap

The Treasurer, and the Labor Party, when making the five per cent energy price cap announcement, were responsible for ensuring that this election promise could be funded. Once, following the election, it was elected to government, the Treasurer, and the Labor Party, were responsible for ensuring steps were taken to implement their election promises and, where this could not be done, the electorate was well informed as to why they could not.

Auditor-General's responsibility

In the context of this audit, my responsibility was to form an opinion on whether the caretaker government knew, or should have known, about Aurora Energy Pty Ltd's financial position at the time of the price cap announcement.

I conducted my audit in accordance with Australian Auditing Standard ASAE 3100 *Compliance Engagements*, which required me to comply with relevant ethical requirements relating to audit engagements. I planned and performed the audit to obtain reasonable assurance of:

1. the state of Aurora Energy Pty Ltd's financial situation prior to, at and after 12 February 2010 which was the date the State's 2010 election was announced
2. the information available to the Treasurer regarding #1.

In this circumstance, my work involved performing procedures to obtain evidence about the state of Aurora Energy Pty Ltd's financial

situation, the Treasurer's knowledge about this and when he became informed. My procedures were based on objectives and criteria outlined in the Introduction to this Report. The criteria were established by me without influence. The audit procedures depended on my judgement, based on the criteria and the assessment of the risks of material misstatement of the information obtained by me as part of this audit.

In making this risk assessment, I considered the nature, accuracy and timeliness of the financial information provided to the Treasurer, the Labor Party and the government. I believe the evidence I have obtained was sufficient and appropriate to provide a basis for my conclusion.

Auditor-General's conclusion

Based on the audit objectives and scope, and for reasons outlined in the remainder of this Report, I conclude that, at the time of making the five per cent energy price cap announcement on 15 February 2010:

- It was reasonable for the Treasurer to have concluded that this could be funded.
- Financial information provided to the Treasurer by Aurora Energy Pty Ltd had not indicated a decline in anticipated dividends and tax equivalent payments.

I also concluded that information that led to the Treasurer, and the elected government, withdrawing the five per cent energy price cap election promise was based on new information provided by Aurora Energy Pty Ltd and this information differed significantly from that available on 15 February 2010.

H M Blake
Auditor-General
30 November 2010

Recent reports

Recent reports

	Tabled	Special Report No.	Title
Oct	2007	69	Public building security
Nov	2007	70	Procurement in government departments Payment of accounts by government departments
Nov	2007	71	Property in police possession Control of assets: Portable and attractive items
Apr	2008	72	Public sector performance information
Jun	2008	73	Timeliness in the Magistrates Court
Jun	2008	74	Follow up of performance audits April–October 2005
Sep	2008	75	Executive termination payments
Nov	2008	76	Complaint handling in local government
Nov	2008	77	Food safety: safe as eggs?
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May	2009	79	Follow up of performance audits April–August 2006
May	2009	80	Hydro hedges
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Oct	2009	83	Communications by Government and The Tasmanian Brand project
Oct	2009	84	Funding the Tasmanian Education Foundation
Nov	2009	85	Speed-detection devices
Nov	2009	86	Major works procurement: Nation Building projects, Treasurer's Instructions 1299 and 1214
Jun	2010	87	Employment of staff to support MPs
Jun	2010	88	Public Trustee — management of deceased estates
Jun	2010	89	Post-Year 10 enrolments
Jul	2010	90	Science education in public high schools
Sep	2010	91	Follow of special reports: 62–65 and 70
Oct	2010	92	Public sector productivity: a ten-year comparison
Nov	2010	93	Investigations 2004–2010

Current projects

Current projects

Performance and compliance audits that the Auditor-General is currently conducting:

Title	Subject
Profitability, and economic benefits to Tasmania, of Forestry Tasmania	Evaluates Forestry Tasmania's long-term financial and economic performance.
Fraud control	Assesses the effectiveness of fraud controls in government entities.
Follow up of special reports	Ascertain the extent to which recommendations from Special Reports 69–73 (tabled from October 2007 to June 2008) have been implemented.
Fire management	Examines whether respective government entities have implemented the recommendations from the COAG 2004 report titled <i>National inquiry on bushfire mitigation and management</i> .
Tourism Tasmania — Value for money?	Examines the effectiveness of Tourism Tasmania with respect to: promotions and advertisements; websites and implementation of planned strategies and initiatives.
Out-of-home care	Assesses the effectiveness of some aspects of the efficiency of out-of-home care as an element of child protection.