13JP284163233

CANEGROWERS

190 Edward Street (GPO Box 1032)
BRISBANE QLD 4001
T: 07 3864 6444 F: 07 3864 6429
enquiry@canegrowers.com.au
www.canegrowers.com.au

11 October 2013

Mr Warwick Anderson
General Manager
Australian Energy Regulator

Sent via email: rateofreturn@aer.gov.au

CANEGROWERS submission to the AER *Better Regulation* program

Dear Mr Anderson,

Today I am writing to you to submit the CANEGROWERS submission on the Draft Rate of Return Guideline.

Irrigators are big users of electricity. Ensuring effective regulation for electricity networks is an important issue for irrigators all around Australia – particularly irrigators in the sugarcane industry. The price of retail electricity has doubled in the past seven years and without a fundamental change in approach by the AER, the price rises will only continue.

To ensure the long-run interest of consumers is protected, the AER needs to guarantee that the recent rapid price rises will not continue into the next regulatory control period. The CANEGROWERS submission outlines many policy options to achieve this goal.

I hope that you find the CANEGROWERS submission informative and constructive. Please do not hesitate to contact me if you have any further questions relating to our submission.

Yours faithfully

Brendan Stewart
CHIEF EXECUTIVE OFFICER

CANEGROWERS SUBMISSION

Australian Energy Regulator
Better Regulation

Rate of Return

October 2013

About CANEGROWERS

CANEGROWERS is the peak representative body for Australian sugarcane growers. Around 80% of Australian sugarcane growers are members of the highly successful lobby, representation and services group. Based in Queensland, the state that produces around 95% of Australia's raw sugar output, CANEGROWERS represents the interests of sugarcane growers Australia wide.

Government and business leaders recognise CANEGROWERS as the authoritative voice of sugarcane growers. Voluntary membership ensures that growers' needs are represented at the highest possible levels of industry and government decision-making. We safeguard growers' interests on all issues likely to affect their business.

The CANEGROWERS organisation exists to:

- Provide strong leadership for sugarcane growers within a viable sugar industry
- Deliver effective representation on behalf of Queensland sugarcane growers
- Ensure cane grower strength and influence at local, district and state/national/international levels through unity and common values.

Sugar is one of Australia's most important rural industries, worth around $1.8 - $2.5 billion to the Australian economy and the largest agricultural crop by volume and value in Queensland. Since 1970, world sugar production has undergone massive changes. As the global competition for sugar supply increases, so does the need to secure economic sustainability of primary producers. Australian sugarcane growers are 100% trade exposed and the price of sugar on the world market is highly volatile. Sugarcane growers are only profitable when on-farm productivity increases by 3% year-on-year and when cost of production can be appropriately maintained.

The sugarcane industry is one of the largest users of irrigation in Australia outside of the Murray Darling Basin – half of the sugar produced in Australia relies on permanent or supplementary irrigation. Most irrigation systems are reliant on electricity to power irrigation pumps. However, with the recent doubling of electricity prices, driven by increases in network charges, many irrigators can no-longer afford to turn on their pumps to water their crops. This situation is unsustainable.

CANEGROWERS aims to deliver short and long-term economic certainty to the sugarcane industry by containing the cost of production – as it is key to ensuring sugarcane growers are productive, efficient and profitable. Most importantly, we see sustainability as a basis for ensuring long term viability and the guarantee that future generations will continue to produce sugar - at a profit.

Contacts

Brendan Stewart	Chief Executive Officer
Jonathan Pavetto	Policy Officer
Phone	(07) 3864 6444
Street Address	190 Edward Street, Brisbane, Queensland, 4001
Email	enquiry@canegrowers.com.au
Web	www.canegrowers.com.au

11 October 2013

Mr Warwick Anderson
General Manager
Australian Energy Regulator

Sent via email: rateofreturn@aer.gov.au

Thank you for the opportunity to comment on the Rate of Return Guideline as a part of the AER's *Better Regulation* program.

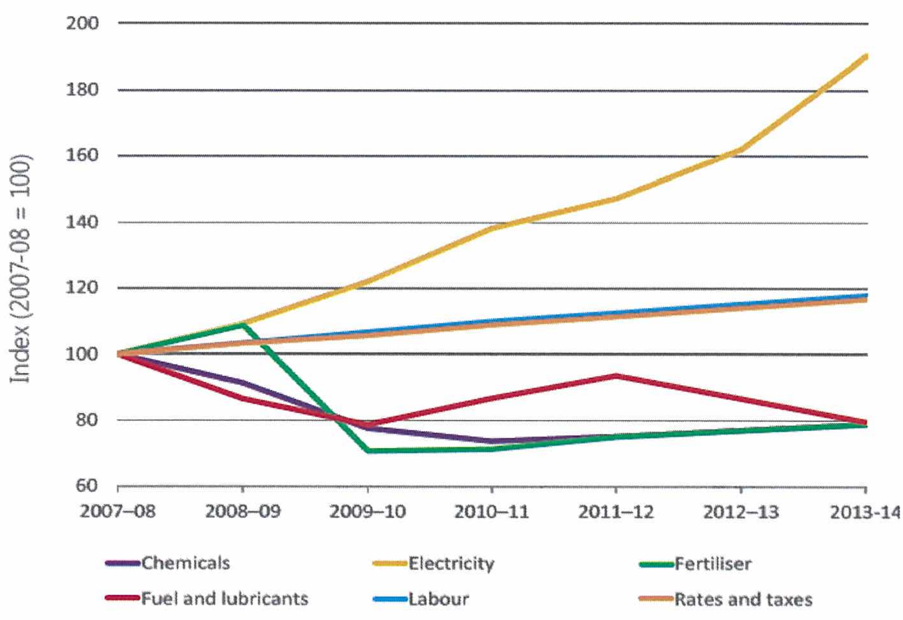
At present, the sugarcane industry is struggling to grapple with the rapidly rising cost of electricity. The growing sugar deficit in the East Asia Region should be providing a large economic gain to sugarcane growers in Australia and the industry should be in an expansion phase. However, high cost of production (primarily driven by increases in electricity network charges) is eroding the profitability of the farming sector and is prohibiting future on-farm investment. Irrigated agriculture in Australia is becoming economically unviable due to high electricity network prices.

The objective of the Electricity and Gas Laws (NEO) is to promote efficient investment in, and efficient operation and use of, energy services for the long term interests of consumers of energy with respect to—

(a) price, quality, safety, reliability and security of supply of energy; and
(b) the reliability, safety and security of the national energy systems.

CANEGROWERS is firmly of the view that the regulatory framework governing electricity networks, particularly the incentive framework when applied to state-owned NSPs, is broken. Over the past seven years, the retail price of electricity has effectively doubled, with the majority of price increases coming from network cost increases in the current 2010-15 QLD DNSP regulatory control period. As figure 1 shows, all competitively priced farm-inputs have decreased in price over the same period. The cost of electricity is a notable exception.

Figure 1: Farm input prices



Source: QCA, ABARES

Considering average year-on-year network price increases of five times above CPI have not been in the short- or long-term interests of consumers, the AER must acknowledge that it has failed in its role as a regulator. The AER must fundamentally change the way it regulates Australia's electricity networks if it is to meet its regulatory obligations under the NEO.

In the absence of a competitive market, the AER must best attempt to mirror what would be expected of NSPs under competitive market conditions. The current design of the Rate of Return Guideline will not stop the network price increases consumers are currently experiencing in the 2010-15 QLD DNSP regulatory control period. More must be done to bring the regulatory pendulum back to the sensible centre, away from providing large wind-fall gains to NSPs at the constant expense of consumers – particularly trade exposed irrigators.

In summary, CANEGROWERS calls on the AER to:

- Set separate benchmark efficient firms for state- and privately-owned NSPs;
- Ensure that state-owned NSPs are only able to only recover the <u>real</u> efficient financing costs (for QLD NSPs, this is at the AA+ 10-year bond rate) – this can be done using a revealed cost approach;
- Provide no compensation to NSPs for risks faced by all other businesses in a competitive environment; and
- Set a separate reasonableness test for state-owned NSPs to stop the overall rate of return providing windfall gains to NSPs at the expense of consumers.

This submission will outline the case for reform for the Rate of Return Guideline as well identify the shortcomings of the Draft Guideline and suggestions for improvement.

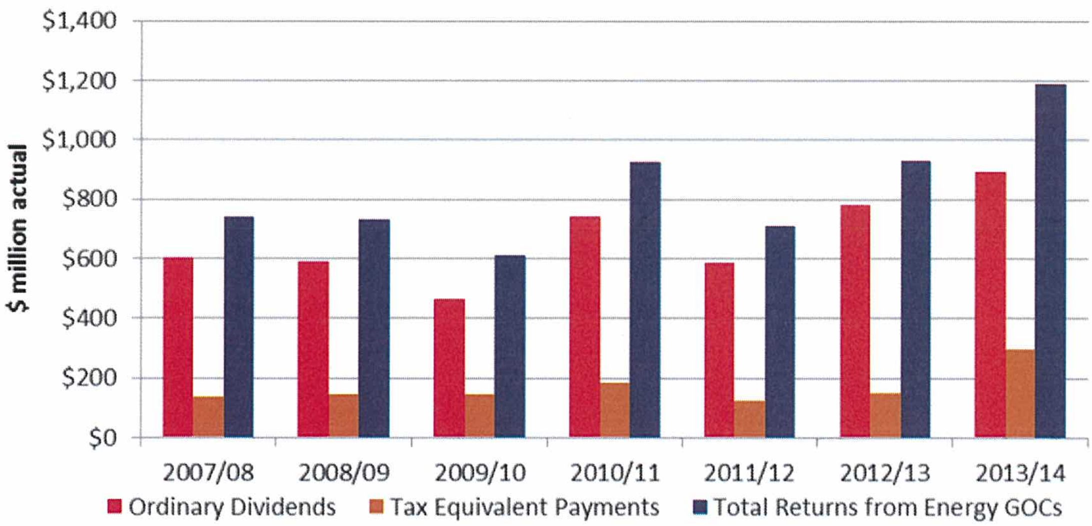
The case for reform

No recognition of ownership models

The AER's failure to recognise state ownership of NSPs is one of the main reasons for rapid network price increases in Queensland. Under the current regulatory framework, all of the benefits of state-ownership of a natural monopoly utility have been negated. The AER's current regulatory framework does not effectively regulate (or incentivise) state-owned NSPs or encourage efficiency in service delivery – it only artificially inflates the network charges paid by consumers, while providing large financial wind-fall gains to state governments.

The post-tax rate of return framework and calculation of commercial debt costs are not in the short- or long-term interests of consumers. As figure 2 shows, total receipts from the Queensland Government's energy GOCs has doubled from $610 million before the current 2010-15 QLD DNSP regulatory control period to a current Queensland Treasury forecast of $1.2 billion.

Figure 2: Receipts from QLD Energy GOCs



Source: Queensland Budget Papers, 2007/08 to 2013/14

Doubling of receipts for the Queensland Government comes at a direct cost to consumers. The increases have caused significant financial stress for consumers, which is evident in quickly falling demand. This has particularly been the case for trade-exposed irrigators, as irrigators are substantial users of electricity.

Over compensation for no-risk

Under the current regulatory framework, the AER does not account for regulated retail energy price controls or the protection NSPs receive from competitive environments provided by the regulated revenue cap. Under its delegation from the Queensland Minister for Energy and Water Supply, the Queensland Competition Authority (QCA) must treat the Network (N) component of their retail price build-up as a pass-through. This means that all revenues approved by the AER are not scrutinised and are accepted as reflecting the true cost of supply – this is a benefit not received by any business operating in a competitive environment and a cost that cannot be passed on by trade exposed irrigators.

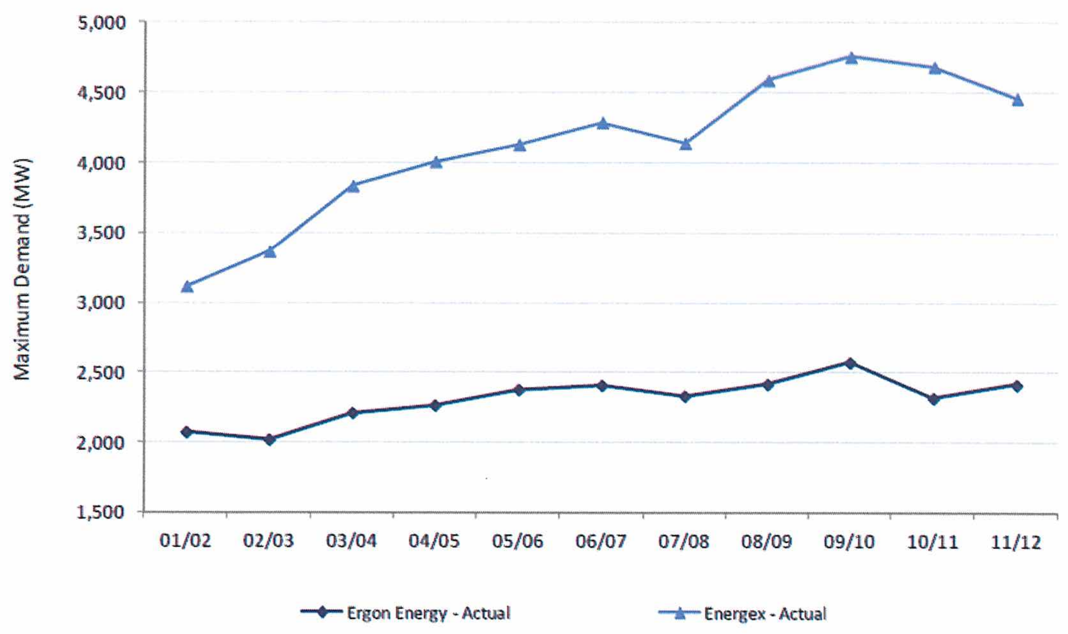
The network price pass-through and the revenue cap guarantees a risk-free return for NSPs, irrespective of network utilisation, efficiency of investment or NSP business performance. Due to this guaranteed return, it is unreasonable that the AER allowed an overall rate of return between 8.7 and 10% for all three QLD NSPs at the last regulatory reset, which assumed that the operating environment for NSPs were inherently "risky". These elevated rates of return for QLD NSPs have not been in the short- or long-term interests of consumers.

In contrast, an irrigated sugarcane grower (who faces perfect competition on the world market for sugar) receives an overall rate of return between -5 and 3% per year. This low rate of return for irrigators has been primarily caused by a falling world sugar price and rising input costs (such as electricity). Trade exposed irrigators receive no compensation for sugar price or input cost risks.

Inflated Regulated Asset Base (RAB)

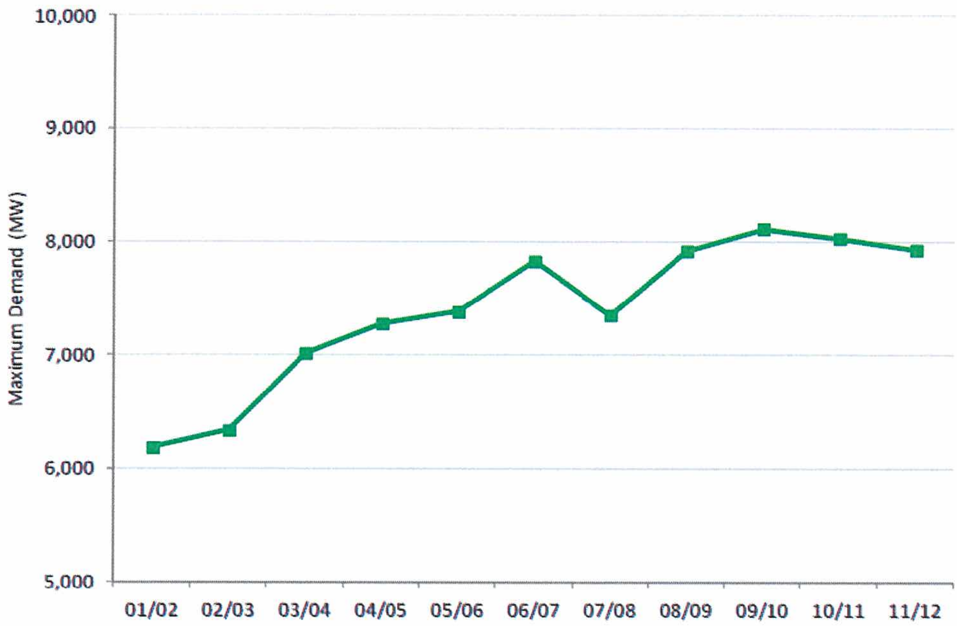
The RAB for QLD NSPs has grown rapidly, despite flat or falling demand growth across all of the QLD NSPs. Figure 3 shows the Maximum Network Demand (MND) for Ergon and Energex. Figure 4 shows the MND for Powerlink. Figure 5 shows the growth in regulated asset base across all QLD NSPs. All of these figures have been provided by the Queensland Government's Independent Review Panel on Network Costs and do not include the 2012/13 figures.

Figure 3: Maximum Network Demand for Ergon and Energex



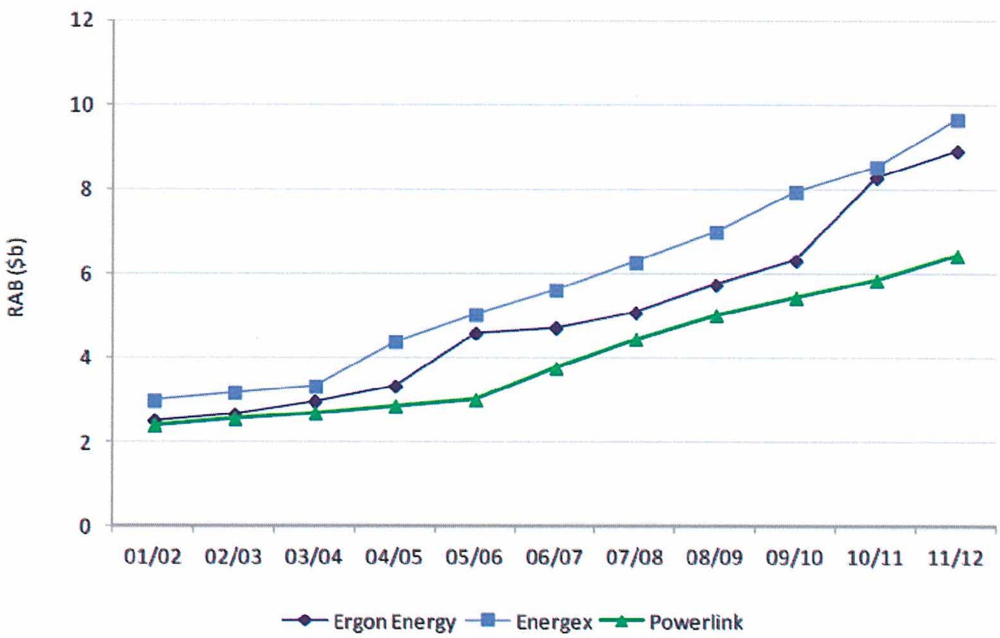
Source: Independent Review Panel on Network Costs

Figure 4: Maximum Network Demand for Powerlink



Source: Independent Review Panel on Network Costs

Figure 5: Regulated Asset Base



Source: Independent Review Panel on Network Costs

CANEGROWERS finds this growth in the RAB without growth in the maximum network demand concerning for two reasons. Primarily, it is concerning because it shows that the majority of the AER's approved expenditure is neither used nor useful. Secondly, it is concerning because an elevated RAB will increase the total allowable revenue (and total cost of supply for consumers) over the 2015-20 QLD DNSP regulatory control period.

The growth in the RAB is a result of a regulatory framework that does not correctly incentivise efficient expenditure. Due to low financing costs and a guaranteed rate of return from the revenue cap and retail price controls, NSPs in Queensland have increased CAPEX, gold-plating their networks to deliver enhanced profits to their shareholder, the Queensland Government. These increased profits have come at the expense of consumers, particularly trade exposed irrigators.

Currently, state-owned NSPs are being compensated for inefficient practices. Due to the rapid increases in network prices, it is clear to consumers that the current incentive regulation framework for state-owned NSPs doesn't work. For state-owned NSPs, it is easier to increase returns by increasing CAPEX and expanding the RAB, as opposed to selling a higher volume of electricity through a competitive pricing policy. The AER must acknowledge this failure in the regulatory framework and take steps to correct it as a matter of urgency.

Shortcomings and suggestions for improvement

CANEGROWERS remains particularly concerned that the AER does not propose to significantly depart from past practice following the Better Regulation work program. There are several issues that this Draft Guideline does not address, they will be examined throughout this submission.

Benchmark efficient entity

CANEGROWERS does not support the AER's proposal for a single benchmark efficient entity. The AEMC provided the possibility for more than one benchmark if there was not a similar degree of risk between the benchmark efficient entity and the network service providers. The AER should use this opportunity to set a separate benchmark efficient firm to reflect the differences in financing practices and risks to be compensated through the rate of return between private and state-owned NSPs.

In light of the issues identified in the case for reform of the AER's rate of return calculations, the AER cannot expect that setting an overall rate of return based on a privately owned (or benchmark) NSP will deliver efficient investment in and operation of state-owned electricity networks. Real-world experience has shown that it cannot contain non-market TOTEX and RAB expansion and will not be in the short- or long-term interests of consumers.

A single benchmark doesn't recognise differences in financing practices due to ownership

The AER's should set a rate of return which provides NSPs with a reasonable opportunity to recover at least efficient financing costs. Setting a single benchmark will lead to the AER approving an allowed rate of return in excess of state-owned NSPs efficient funding costs – incentivising further non-market investments. It is commonly known that state-owned NSPs have significantly lower efficient financing costs than privately owned NSPs. The AER must acknowledge this difference and regulate NSPs accordingly.

CANEGROWERS rejects the AER's assessment that government finance would be no different to that of private investors. State governments are able to raise debt in ways not possible for private owners. Primarily, state governments can:

- realise scale economies in issuing debt;
- gain access to financial markets, where the issuance size would be prohibitive for private owners;
- increase the regularity of debt raisings which can reduce transaction costs and improve investor appetite for debt issuances; and
- guarantee debt offerings through the taxing powers of the state.

State-owned NSPs to recover only real efficient financing costs

The proposed vanilla WACC formula to be used by the AER incorrectly assumes 40% of total financing will be derived form equity sources. CANEGROWERS does not support the application of this formula to state-owned NSPs, as they are almost entirely funded by debt.

CANEGROWERS calls on the AER to develop a separate benchmark efficient firm for state-owned NSPs to ensure that state-owned NSPs recover only real efficient financing costs. In Queensland, this means that the total rate of return for Ergon, Energex and Powerlink should be set at the AA+ 10-year bond rate. This could be conducted using a revealed-cost approach.

Any other alternative approach would result in artificially inflated financing costs, leading to higher returns to NSP owners and higher prices for consumers. This outcome is not in the short- or long-term interests of consumers.

Overly generous risk compensation

The AER exists as a regulator because NSPs are natural monopolies that do not operate in a competitive environment. Therefore, the role of the AER should be to replicate pressures faced by businesses in a perfectly competitive environment and apply them to NSPs to deliver efficient market-orientated outcomes.

The Draft Guideline assumes that there are risks that are unavoidable and unmanageable and that these risks need to be compensated through an elevated rate of return or through cash flows. If consumers' interests are to be protected, the AER's approach to compensating NSPs for risks through the rate of return needs to change.

If the AER is to set the rate of return to reflect a competitive environment, NSPs would receive no additional allowances for risk. Providing no allowance for systematic, systemic risks in the rate of return and no allowance for asymmetrical risks through cash flows will incentivise NSPs to innovate and operate their networks in a more efficient way, to avoid (or minimise) the loss of profits.

CANEGROWERS recommends the AER provide no allowance for NSPs to compensate for risks faced in a competitive environment. In doing this, the AER will ensure that risks are managed by those best placed to do so, the individual NSPs. Consumers are not best placed and should not be required to pay for them. NSPs' rate of return or cash flows should not be compensating NSPs for risks that are not fairly compensated to any other business operating in a purely competitive environment.

Trade-exposed irrigators and all other companies operating in a competitive market must innovate to manage risk, why shouldn't NSPs? Further, no business operating in a competitive market can receive guaranteed regulated revenues, regardless of business practice or operational efficiency, so why should the risk profile of NSPs be compared to a competitive market? The level of revenue protections built into the current rate of return guideline provide a risk-free return to investors – the overall allowed rate of return needs to reflect this reality.

Reasonableness test

CANEGROWERS supports the inclusion of a reasonableness test for the overall rate of return. However, the failings of the current rate of return guideline are replicated in the proposed reasonableness test. The proposed reasonableness test would not have prevented the current inflated rate of return for state-owned QLD NSPs, leading to significant investment in infrastructure that is not used nor useful because of falling demand due to very high prices. The proposed reasonableness test will fail to prevent future inflations in the rate of return that lead to non-market CAPEX resulting in RAB inflation and even higher prices in the future.

Using RAB acquisition and trading multipliers may provide a broader indication of whether the AER's overall rate of return estimates are above or below those required by investors, but they fail to account for the non-market investment priorities (such as security and reliability standards and the Solar Bonus Scheme) of state-owned NSPs that have driven "gold-plating" and RAB inflation. The current model of the reasonableness test also relies on a fair return on equity – a funding mechanism that isn't effectively used by state-owned NSPs.

CANEGROWERS calls on the AER to remodel the reasonableness test to ensure that rate of return (in the context of the revenue cap) reflects the operations of an efficient business, delivering returns of a low risk investment. The reasonableness test needs to have factors such as retail cost and network utilisation (demand impacts) feeding back into setting of rate of return. If the proposed rate of return cannot deliver efficient outcomes in retail pricing or utilisation, either the RAB needs to be discounted or rate of return lowered to reflect a point of efficient operation.

Benchmarking should also be undertaken against similar businesses in the UK and USA to determine what is a reasonable rate of return for monopoly energy NSPs in an international context.