



24 February 2014

Warwick Anderson
General Manager, Network Regulation
Australian Energy Regulator

By email: QLDelectricity2015@aer.gov.au

Dear Mr Anderson,

AER Framework & Approach: Energex and Ergon Energy

Thank you for the opportunity to make a submission on the AER's preliminary positions paper on the Framework and Approach for Energex and Ergon. As you are aware, the cost of electricity is a very important input cost for irrigators in the sugarcane industry. CANEGROWERS is committed to working with the AER and the Queensland distributors to ensure that the 2015-20 Regulatory Reset is in the interests of consumers in Queensland.

The current Framework and Approach does not provide confidence that the available regulatory mechanisms of the AER will be used in the short- or long-run interests of consumers in Queensland. More must be done to bring the regulatory pendulum back to the sensible centre, away from providing large wind-fall gains to distributors at the constant expense of consumers – particularly trade exposed irrigators.

The CANEGROWERS submission provides an overview of the most significant issues for the upcoming determination and how the AER's previous approach has resulted in unintended consequences for the current regulatory control period. The submission also outlines sensible solutions to avoid repeating previous mistakes in the application of the regulatory framework.

I hope that you consider the issues and solutions raised in the CANEGROWERS submission during your deliberations for the 2015-20 Queensland Regulatory Reset.

Once again, thank you for the opportunity to respond to your preliminary positions paper. If you have any further questions, do not hesitate to contact me on (07) 3864 6444.

Yours faithfully,

Brendan Stewart
CHIEF EXECUTIVE OFFICER

CANEGROWERS submission to AER *Framework and Approach for Energex and Ergon Energy*

Summary

For the 2015-20 regulatory control period, CANEGROWERS calls on the AER to:

- Better use the available regulatory structure to realign business and investment risks between distributors and consumers;
- Recognise the growing elasticity of demand in Queensland;
- Adopt a hybrid model for the regulatory control mechanism, comprising of both fixed revenues and price caps;
- Apply the CESS and EBSS in a way that better reflects a competitive environment;
- Not allow recovery of the costs of the Solar Bonus Scheme in the 2015-20 allowed revenues;
- Conduct a prudency review of distributors' past CAPEX; and
- Use the real cost of capital to distributors in the calculation of their allowed RoA.

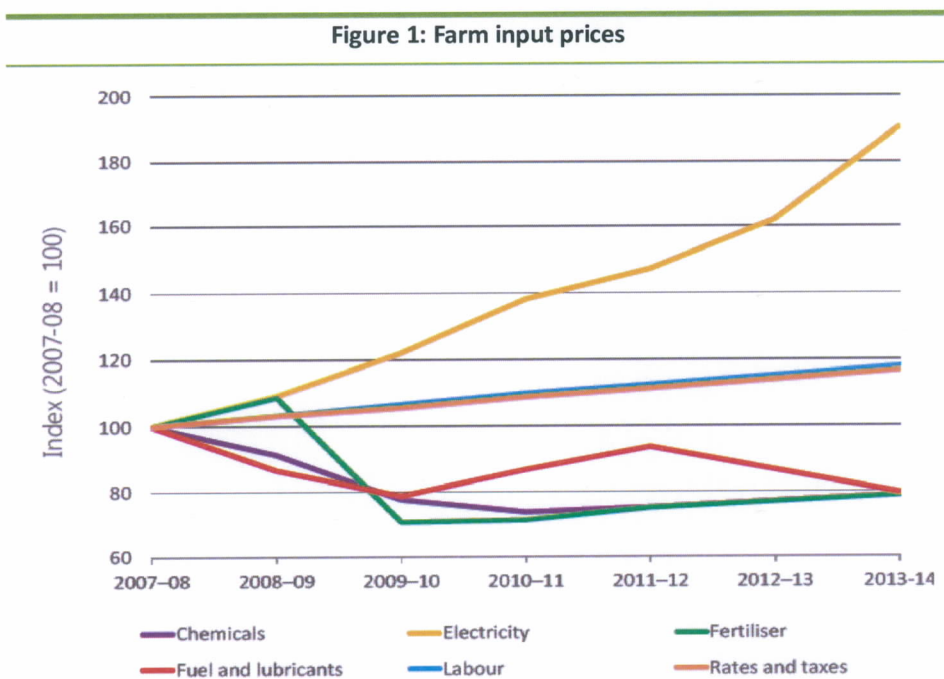
Preamble

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 costs of production (primarily driven by increases in electricity network charges) are eroding the profitability of the irrigated farming sector and is prohibiting future on-farm investment. Irrigated agriculture in Queensland is becoming economically unviable due to unnecessarily 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 the state-owned distributors in Queensland, is not in the short- or long-run interests of consumers. 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.



Source: QCA, ABARES

Electricity as a farm input is quickly becoming unaffordable for irrigators in Queensland. Irrigators are now no longer able to optimise yields due to the high costs of applying water, despite making significant investments in energy efficient technology, changed practices to focus consumption in off-peak times, or reduced the total area irrigated. Some irrigators have stopped irrigating their crops altogether.

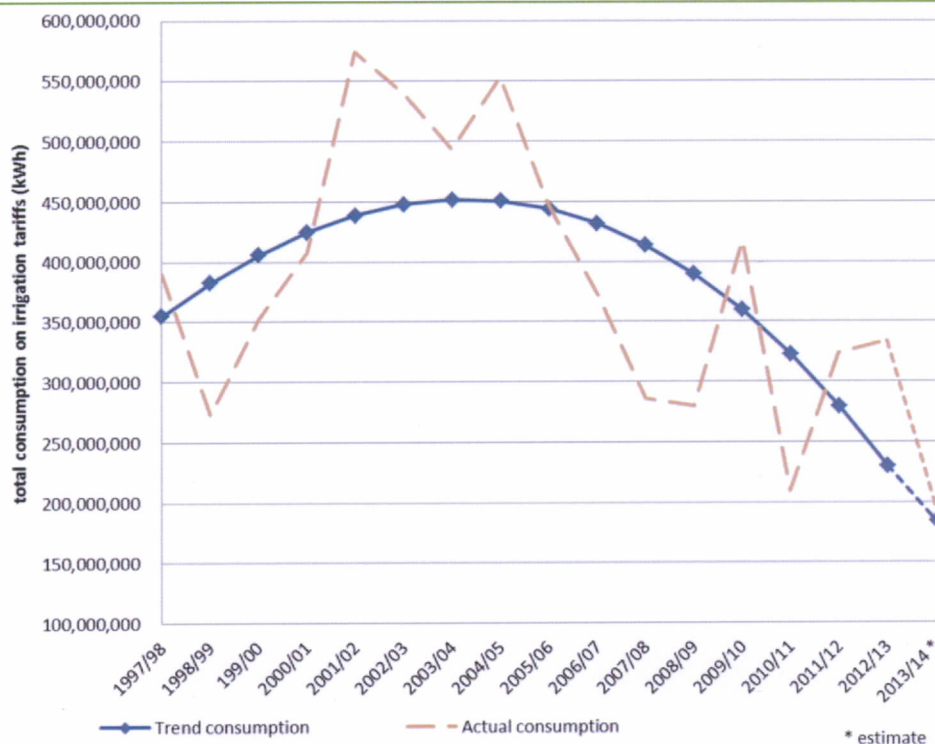
The impact of high electricity prices goes beyond irrigators. Large, in-scheme electricity costs to public irrigation schemes have increased the cost of irrigation water, which further increases the cost of applying irrigation water to crops and reduces the capacity for irrigators to irrigate their crops. In instances where sugarcane production is reduced, regional Queensland will receive much less export revenue from sugar, threatening the viability of food manufacturers (such as sugar mills and refineries) which will lead to significant job losses.

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 must fundamentally change the way it approaches network regulation in Queensland, if it is to meet its regulatory obligations under the NEO. The AER can meet the expectations of consumers under the current regulatory framework, if the rules are applied differently.

The AER must do more than what is outlined in the Framework and Approach to realign the allocation of risk between consumers and distributors. Through the regulatory control mechanism and incentive schemes, distributors are able to recover the full underlying cost of supply, which is currently over and above the prudently incurred cost of supply. Without a change in approach, the risks of poor investment decisions and poor governance of the networks will continue to be pushed back onto consumers, who are not best placed to wear these risks. To remove the perverse pricing impacts that have currently beset the existing regulatory control period, the allocation of risk must be reversed.

In the 2015-20 Regulatory Reset, the AER also needs to consider the real prospect of increasing elasticity of demand in Queensland. The current Framework and Approach assumes demand is inelastic and will perpetually increase. As figure 2 shows, this is not the case in Queensland, particularly for trade-exposed irrigators.

Figure 2: Reduction in consumption of all irrigation tariffs in Queensland



Source: Independent Review Panel on Network Costs

Failure to recognise the growing elastic nature of demand in Queensland will result in another regulatory control period with ruinous pricing ramifications for both distributors and customers. In the next control period, distributors must not be allowed to operate in an inelastic supply environment where they are not required to pay regard to the demand side of the electricity market – primarily, consumers' capacity to pay.

Regulation to replicate market conditions

Revenue cap as a control mechanism

Issue:

CANEGROWERS does not agree with the AER that the revenue cap best meets the factors set out in clause 6.2.5(c) of the National Electricity Rules. Primarily, the use of a revenue cap as the control mechanism for direct control services does not result in efficient tariff structures and it is not in the short- or long-run interests of consumers.

Despite the range of evidence provided by CANEGROWERS and other representative groups, the AER has produced no solid evidence to show that the revenue cap is the most efficient control mechanism for Queensland's distributors.

In the current regulatory control period, the revenue cap has been highly problematic for all participants in the electricity market in Queensland. Under the revenue cap, exceedingly generous revenue allowances have been made for distributors. These allowances have been based on overly optimistic demand forecasts which have in turn caused the highest increases in tariffs within period pricing in Queensland's history.

Weak pricing incentives for Ergon and Energex inherent in the pricing cap mechanism have resulted in further distortions in the Queensland energy market. The pricing of network services is not efficient with a revenue cap as Energex and Ergon have a high reliance on energy demand forecasts to maintain price stability. Throughout the current regulatory control period, consumers have been responding to the large increases in price of network services by reducing or substituting consumption. The reduction and substitution of demand below the forecast level has caused a negative price spiral that has caused further price increases and subsequent reduction and substitution of demand.

The recovery of allowed revenue has not been efficient. Energex and Ergon have not been adequately incentivised to engage in demand-side management as their revenue is guaranteed irrespective of demand-side movements in the energy market. Energex's tariff off-peak differential is insignificant and Ergon does not have a ToU tariff.

For price sensitive consumers, distributors currently face a perverse incentive under the revenue cap to increase prices above marginal costs, thereby reducing demand for those services. Further, the revenue cap encourages Energex and Ergon to increase the size of the RAB (to meet peak demand) as the primary means of increasing total revenues. Neither of these outcomes would have occurred if a more appropriate control mechanism was used for the 2010-15 regulatory control period.

The only successes of the revenue cap in Queensland are limited to a wholesale transfer of risk from distributors (and their shareholders) to consumers, shielding distributors from competitive market forces and providing large, guaranteed returns to distributors' shareholders. The limited

administrative cost saving for the AER of implementing the revenue cap (compared to an alternate control mechanism) is not worth the perverse outcome for the Queensland electricity market.

Proposed solution:

A hybrid control mechanism, as outlined in the preliminary positions paper for the Framework and Approach, will result in better outcomes for all participants in the Queensland electricity market. The hybrid mechanism can include a proportion of controlled revenue to provide income certainty to distributors (to reduce equity risk) with a set of price cap constraints to remove within period pricing instability that occurs under the revenue cap.

Efficient prices require market exposure, for distributors market exposure will force consideration of demand-side response to network prices. The AER needs to introduce incentives (that currently do not exist in the revenue cap) for distributors to set efficient tariffs and price their services that reflect both the underlying costs of supply and consumers' willingness to pay. The incentives could be either the risk of loss of revenue for poor business practices or the capacity to generate more revenue through efficient business operation.

Distributors' exposure to loss or gain of revenue will improve currently weak pricing incentives. All electricity consumers must face these incentives, distributors should face them too. Improvements in the pricing incentives would encourage networks to actively engage with consumers to increase revenues by pricing flexibility – additional profits could be raised by reducing prices for under utilised assets (particularly at off-peak times) or by engaging with consumers in demand-side management or critical peak pricing (particularly in capacity constrained areas of the network).

Further, a set of price caps (by using a tariff basket price control or some other method) could be used to limit network price increases to a yet to be determined rate, possibly CPI-X. The value of X could be representative of the broader productivity of the Australian economy. The use of price caps in this way would remove the within period price volatility experienced in the current regulatory control period under the revenue cap. Distributors would still be able to generate extra revenue by selling higher volumes of electricity and increasing the total utilisation of their assets.

In summary, CANEGROWERS calls on the AER to adopt a hybrid control mechanism that consists of a proportion of guaranteed revenue with price caps. The hybrid model would improve pricing flexibility and stability, incentivise demand-side management and allow stable revenue recovery.

Incentive schemes

Issue:

CANEGROWERS firmly believes that the incentive schemes are not designed in accordance with the National Electricity Objective, as they are not in the long-run interests of consumers. CANEGROWERS has never supported the current design of the current incentive schemes and does not support the wholesale application of the incentive schemes to the Queensland DNSP Regulatory Reset.

Under the current EBSS and CESS, distributors are only required to pay 30c for every \$1 overspend – consumers are required to pay 70c of the \$1 overinvestment. This outcome would not occur in a competitive environment. In a competitive environment, the distributor and its shareholders would wear the risk for these investments, not the consumer.

The primary issue with the current design of the incentives schemes is that they shield distributors from a competitive environment. For example distributors are not required to write-down assets that are neither used nor useful or re-organise their business when the underlying costs of providing a service are above what customers are willing to pay.

Other reasons detailing CANEGROWERS' lack of support for the current form of CESS and EBSS have been raised in previous submissions throughout the Better Regulation process.

Proposed solution:

To realign incentives for the 2015-20 regulatory reset, the power of the incentive schemes (particularly the EBSS and CESS) should be changed to 100% for distributors and 0% for consumers. Consumers should not be expected to pay for any imprudently incurred costs. Similarly, distributors should be rewarded for and allowed to keep any increase in efficiency of their operations, beyond what the AER considers is an efficient expenditure benchmark.

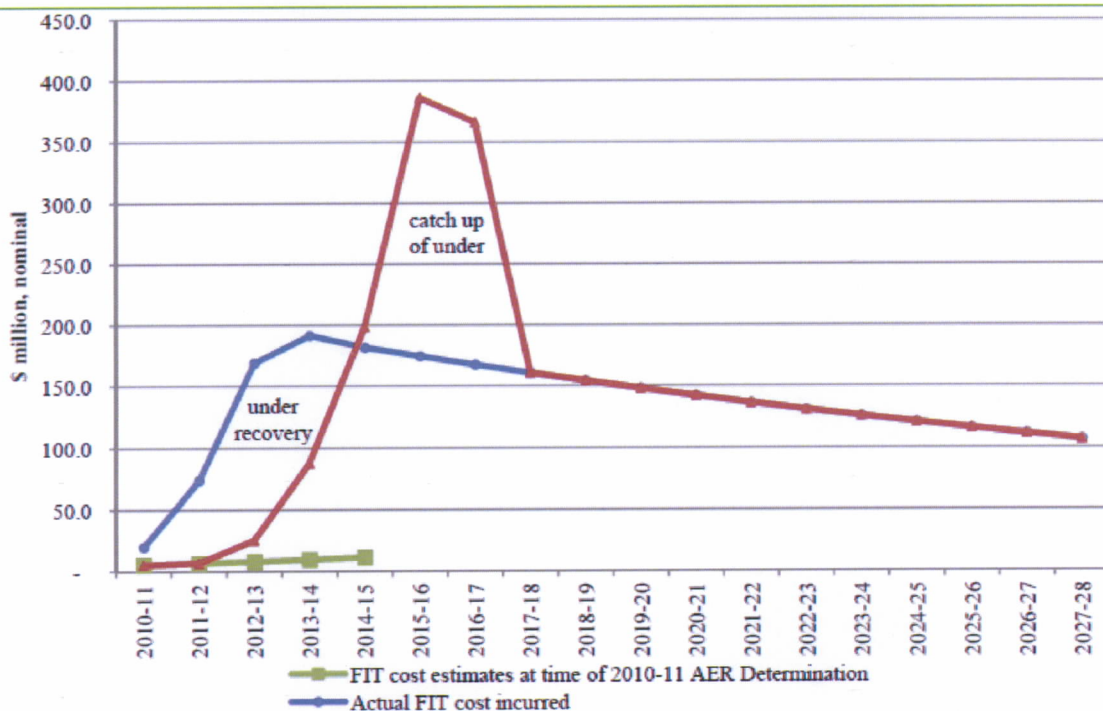
Treatment of solar feed-in tariffs

Issue:

The costs associated with the Solar Bonus Scheme (SBS) are not prudently incurred and do not relate to the cost of supplying network services. The impact of the SBS on consumers in Queensland is significant. Irrigators in Queensland currently pay a disproportionately large share of the SBS in comparison to households due to larger annual energy consumption.

Analysis by the Queensland Competition Authority (QCA) has found that the take-up of 44c/kWh feed-in tariff under the SBS was largely under-estimated by distributors. Failure (on behalf of the distributors) to effectively forecast uptake of the scheme has resulted in under-recovery of revenue that requires future catch-up. As figure 3 shows, the total cost of the scheme will peak in 2015/16 and will add an additional \$400 million revenue requirement on Energex to recover in higher network charges. The impact of the SBS on Ergon is of a similar magnitude.

Figure 3: Energex feed-in tariff payments and impacts on network revenue



Source: QCA/Energex analysis

Proposed solution:

The total cost of the SBS will peak in 2015-16 and is expected to account for 29.5% of total DNSP charges, after accounting for the feed-in tariff payments, infrastructure augmentation and admin costs. These are charges that should not be spread across users of the shared network and do not relate to the cost of supplying network services.

CANEGROWERS asks that the AER not include allowances to recover solar feed-in tariffs over the 2015-20 regulatory control period. The intent of the SBS is non-commercial and should be paid for by the shareholder.

Prudence of the costs to supply distribution services

Adoption of prudence review with the AER's CAM for Ergon and Energex

Issue:

For the 2015-20 regulatory control period, distributors will be required to allocate asset costs to service types according to an approved Cost Allocation Methodology (CAM). Currently, distributors are allowed to charge consumers for a range of imprudently incurred costs that do not relate to the actual cost of supplying network services.

The AER must recognise that the current cost of supply is significantly higher than what would be the prudently incurred cost of supply. For example, investment by Queensland distributors in their HV network to meet the N-1 security standard was not a prudent investment (as it was not a commercial investment) and is not used by consumers, even in some of the most stressed moments on the network. Also, significant network augmentation has been undertaken to moderate the impact of embedded generation (particularly domestic solar panels). However, consumers are still required to pay for these investments, as they have been automatically rolled into the RAB.

Proposed solution:

For the current transition from the QCA's CAM to the AER approved CAM should be used as an opportunity to examine the prudent costs of supply for different service types. The CAM process should be used by the AER to understand the real cost of supplying network services in Queensland, particularly network services to price sensitive customers, such as irrigators. In cases where the assets have not been prudently incurred and cannot be reasonably prescribed to a distribution service, the AER should remove these assets from the RAB.

CANEGROWERS would appreciate the opportunity to be involved in the development and approval of the CAM to be used by Ergon and Energex. CANEGROWERS would also appreciate the opportunity to assist the AER in challenging the prudence of investments that have been allocated to costs prescribed with providing distribution services to certain consumers, particularly in areas with a high proportion of supply to irrigators.

If the AER is not able to reduce the size of the RAB from a prudence review due to existing transitional arrangements, the AER should publish what it believes the impact of non-prudent investments have on the price of distribution services. Publishing this information is important to removing information asymmetry in the market for network services. This means consumers and distributors will be better able to make efficient investment decisions.

Maximum Allowed Revenues

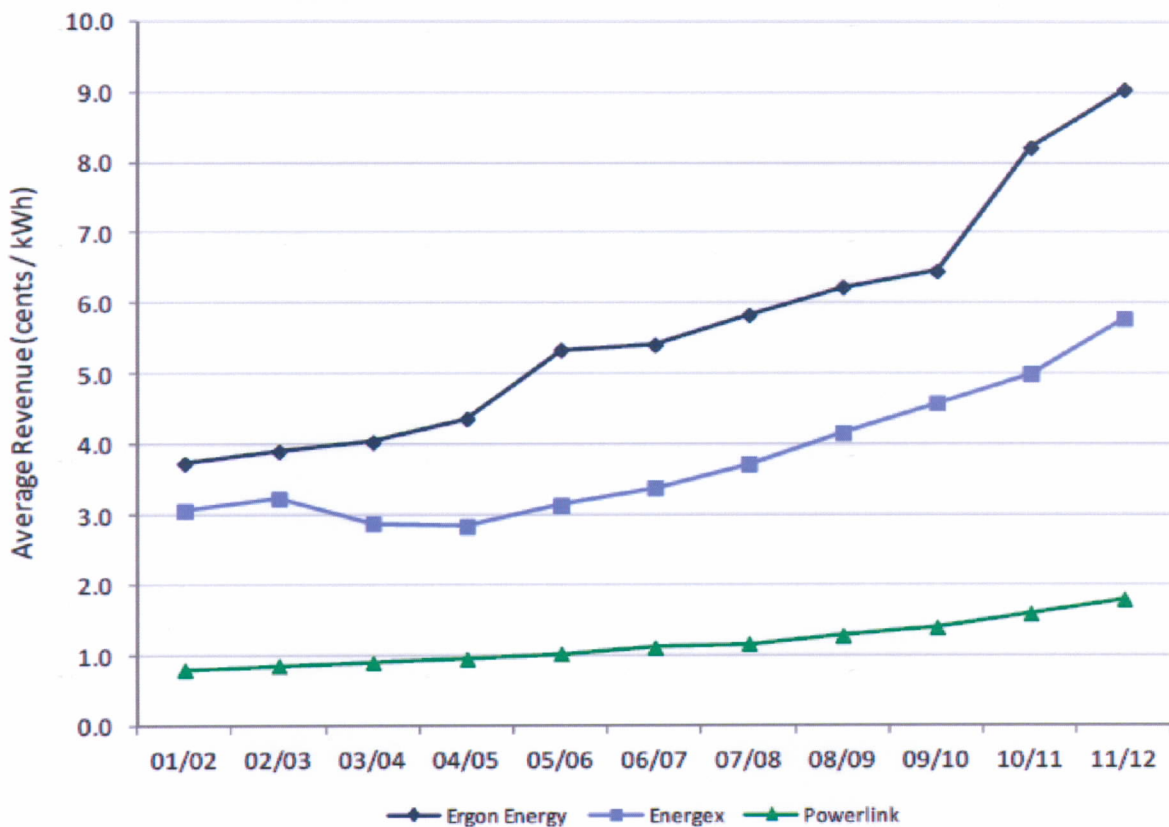
Return on Assets

Issue:

The Return on Assets (RoA) is the single largest cost item in the building block of network tariffs, accounting for 68% of Ergon and 69% of Energex's Maximum Allowed Revenue (MAR) in 2014-15. The Framework and Approach does not detail how the AER will regulate distributors MAR, particularly with regards to different costs of debt and equity in Queensland compared to other jurisdictions.

In the current regulatory period, the use of the private debt and an equity beta that resembles a high risk investment has caused unnecessary price increases for consumers. As the Queensland Government's Independent Review Panel on Network Costs (IRP) has identified, average revenues have been increasing at an alarming rate. As figure 4 shows, average revenue for Ergon (the main supplier to irrigators) has more than doubled over the IRP's sample period.

Figure 4: increase in network revenues 2001-02 to 2011-12



Source: Independent Review Panel on Network Costs

Proposed solution:

Inflating the return on assets does not reflect the cost of supplying distribution services and is contrary to the NEO and is not in the short- or long-run interests of consumers.

For the 2015-20 Regulatory Reset, CANEGROWERS requests that the real cost of debt and equity be used to calculate Ergon and Energex's ROA, so prices can reflect the real cost of supply. CANEGROWERS analysis (previously provided to the AER) has shown that using the real cost of capital to Queensland's NSPs, total network charges could have fallen by up to 30% in the current regulatory period.

Alternatively, CANEGROWERS would also be willing to consider the use of a "split cost of capital" approach to delivering a return on Queensland distributors' RAB. However, this option would require due research before it is applied to the 2015-20 regulatory reset.

CANEGROWERS Queensland
ABN: 94 089 992 969

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