the
Australian
Sugar
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Alliance

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Ms Christine McDonald
Committee Secretary
Senate Standing Committees on Environment and Communications
PO Box 6100
Parliament House
Canberra ACT 2600

18 December 2014

Emailed To: ec.sen@aph.gov.au

Dear Ms McDonald

Re: Senate Inquiry in the Performance and Management of Electricity Network Companies.

Thank you for the opportunity to make a submission to the Senate Inquiry into the performance and management of electricity network companies.

ASA was formed in 2007 to bring together supply chain participants on whole of industry matters. Founding members CANEGROWERS, representing some 80 per cent of the 4,000 Australian sugarcane farmers, and Australian Sugar Milling Council (ASMC), representing 95 per cent of raw sugar production and 100 per cent of Australian raw sugar exports, recognised the need for collaborative efforts in research, development and extension (RD&E), trade liberalisation, environmental and resource management programs, and community engagement. Sugarcane production and processing is the lifeblood of many regional towns and communities along the east coast of Australia from Grafton in northern New South Wales to Mossman in Far North Queensland.

The current electricity pricing framework, unnecessarily distorting Australia's electricity market, is failing electricity consumers and is directly and adversely affecting the international competitiveness of Australia's traded goods sector. Nowhere is this more evident than in the sharp electricity price increases faced by irrigated agriculture and food and fibre producers more generally. Since the framework was first introduced, electricity prices in Australia have been increasing at a faster rate than anywhere else in the developed world. This is a bizarre turn of events for the energy rich Australian economy.

At an industrial level, Australian sugar mills have generated and supplied electricity for over 100 years. Where the industry initially serviced its own needs, all of Australia's sugar mills generate and export electricity, supplying generation to adjacent population centres along the eastern coast of Australia. Sugarcane is, in its simplest form, a highly efficient convertor of solar energy into stored energy. When sugar mills invest in expanded cogeneration, there is a flow-on economic benefit to the local industry and regional economy, a broader impact on regional energy security and a boost in industry confidence.

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The Australian sugar industry is well aware of the leading causes of electricity price increases experienced by the industry over the last five years, with distribution networks clearly the main contributor. ASA supports the concept that electricity tariffs should reflect the efficient cost of providing services to consumers assigned to the tariff. However, we do seriously question the way in which this principle is applied by distribution network service providers (DNSPs) – especially by those servicing rural and regional Queensland (Ergon). Current electricity pricing rules enable large profitable DNSPs to take full advantage of a regulatory pricing regime that rewards expenditure and increased costs. New disciplines are required to prevent the further exploitation by DNSPs of these regulatory anomalies.

The following submission outlines the key findings made by the industry over the last two years, following extensive investigation through commissioned work. Although focused on the regional Queensland distribution network, Ergon, we bring these findings to the Senate's attention, as it is our understanding that a number of the concerns raised are not unique to Ergon, but reflected in numerous other state government owned networks. As such, the following documents are included for your information:

- Carbon + Energy Markets (CME). 2014. *Advice to CANEGROWERS and the Australian Sugar Milling Council on Ergon Electricity Tariff Issues.*
- ASA submission to the Queensland Competition Authority (QCA).
- Carbon + Energy Markets (CME). 2014. *Subsidies for the Expansion of Renewable Electricity Generation: Consideration of the Broader Electricity Market Context.*
- Commodity Intelligence. 2012 *Electricity Market: When Sugar Mills Export Electricity to the National Electricity Market.*
- CANEGROWERS submission to the Australian Energy Market Commission – *National Electricity Amendment (Distribution Network Pricing Arrangements) Rule 2014.*

Our findings, covered in the body of work outlined above, have been used to facilitate a better understanding of the mechanisms against which Ergon network has been able to continue to inflate electricity prices, maximising its profits at the expense of regional energy users. Key approaches to ensure this profit base have included:

- Revaluing unaltered assets upwards, to inflate the revenue collection base;
- Very high asset investment per connection;
- Very high operating costs per connection; and
- Conflating CSO payments to enhance network profits.

These factors combined allow Ergon Energy to enjoy the highest profits per connection across the National Electricity Market (NEM). Yet Ergon does this with investment in the simplest and lowest cost technology for the greater proportion of its network (i.e. single wire earth return (SWER) lines and overhead connection. Ergon has been identified by both the Queensland Government's own Independent Review of 2012 and the Productivity Commission Inquiry into electricity prices in 2013 as the most inefficient network in Australia.

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Further Ergon appears to have leveraged community service obligations (CSOs) into a revenue generating mechanism that enables record profits. CSOs are a mechanism intended to close the gap in the cost of delivering electricity between metropolitan and regional Queensland, ensuring that regional Queenslanders are not disadvantaged by living outside of south east Queensland. Consequently, the CSO payment to Ergon is allegedly based on paying the gap between Ergon and Energex network services. Increasingly, the Queensland Government has pointed to the unsustainability of CSO payments, as the overall cost continues to rise year on year. However, as demonstrated in advice to the industry[1], there is no transparency around the calculation of the CSO, and from the data reviewed from 2007/2008 to 2012/2013, no consistency in how the calculation is applied. What is however clear, is that the CSO is a payment from government to Ergon to government (shareholder), and directly contributing to Ergon's profits.

It is also worth noting that Ergon, and its shareholder, continue to misrepresent the binding nature of the AER's decision around the regulation of revenue. The AER sets the <u>maximum</u> revenue that a network operator can recover. The regulated amount is not a mandated recovery amount and it is not a minimum revenue recovery amount. Some state governments, with network ownership, have foregone the maximum allowable revenue determined by AER for their particular network, to reduce the financial strain on the dependant customer base. In Queensland, the government continues to argue that it has been directed by the AER to collect this level of revenue.

The AER is presently reviewing the regulated network pricing proposals for 2015-20 put forward by Ergon and Energex, having recently issued its draft determination on network prices for NSW distributors. Ergon and Energex regulatory proposals use a similar methodology to that used by their NSW counterparts. The principal areas of concern are:

1. Regulatory Asset Bases (RABs)
    - The current and proposed RAB levels are too high. Unless written down they will lock in a guaranteed return on past inefficient investments and, through the annual escalation provisions, will ensure excessive prices remain well into the future.
    - As occurs in other sectors of the economy, major asset write-downs are required to ensure the size of the asset base reflects declining network demand.
    - The risk of network investment decisions should be borne by the network owners, not be passed to users through a deeply flawed regulatory pricing framework.
2. Return on Capital – Weighted Average Cost of Capital (WACC)
    - Network Service Providers' departures from the AER Rate of Return Guideline result in "artificially high" proposed WACCs. These departure are designed to deliver excessive profits to Energex and Ergon.

[1] Carbon + Energy Markets (CME). 2014. *Advice to CANEGROWERS and the Australian Sugar Milling Council on Ergon Electricity Tariff Issues.*

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- Assets subject to a regulated price framework that provides a "guaranteed return" face much lower risk profile that other assets. The regulated return calculation for should be more reflective of actual financing costs, not contrived costs that include a notional allowance for competitive neutrality.

3. Capital Expenditure (Capex)
   - The levels of augmentation capex proposed by Ergon and Energex are inconsistent with flat/declining demand trends and recently reduced reliability standards.
   - The proposed levels of replacement capex appear to be significantly above underlying needs, given network use patterns and the emerging alternative electricity and energy alternatives.
   - Australia's electricity distributors have a history of overestimating the levels of demand in their forecasts. With electricity prices at historically high levels, alternative supplies available and new and emerging technologies becoming commercially viable, there is little to suggest that regulators can have confidence in the demand forecasts Ergon and Energex have developed for 2015-20.
   - The evidence does not support Ergon and Energex claims regarding "ageing assets" and the need for replacement capex.
4. Operating Expenditure (Opex)
   - We are concerned that the networks' past opex allowances were excessive and proposed opex levels are not reflective of prudent and efficient operating costs.
   - Benchmarking is expected to determine significantly lower allowances for operating expenditure.

Our underlying concern is that the cost escalations (driven by inaccurate forecasts of urban and industrial demand) in Ergon and Energex regulatory proposals are not reflective of the true costs of prudently and efficiently delivering electricity to agricultural industries. Truly cost reflective tariffs will be lower and take account of their impact on electricity users.

The perceived rorting of Ergon is not unique to the distribution network service provider (DNSP); in fact there is some considerable evidence that this behaviour is endemic among the most inefficient government-owned DNSPs within the NEM. This in itself creates a particular conflict of interest, as the overarching body providing direction to the Australian Energy Regulator (AER) is the COAG Energy Council. In effect, states have the capacity to affect the transparency and accountability of networks that they have a direct financial interest in.

For example, evidence to date, as presented during the Productivity Commission Inquiry, demonstrated that even when the AER has previously recommended a lower rate of investment than proposed by individual DNSPs, these companies have chosen to go ahead with the investment – and claim retrospective necessity return on profit. The Ministerial Council of Energy (predecessor to the COAG Energy Council) during this period found that AER should allow networks to increase their allowable revenue collected.

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Fundamentally, there is key reform required for the regulation and operation of networks, including:

- Enhanced investigative powers for AER in relation to the regulation and operation of all networks, with real and tangible penalties for deliberately misleading or lack of transparency in submitted material to the Regulator.
- Greater transparency in public reporting.
- Greater accountability around the representations made by networks and their government owners in relation to the rulings and directions of the AER.
- Benchmarking of efficiency and performance of networks within the NEM and compared with ‘like’ international service providers.

We welcome your questions and further discussion. Please contact either Dominic Nolan (CEO of ASMC) on 07 3231 5000 or Brendan Stewart (CEO of CANEGROWERS) on 07 3864 6444 in the first instance to discuss these papers.

Yours sincerely

Brendan Stewart
Joint Secretary, ASA

Dominic Nolan
Joint Secretary, ASA