30 May 2018

Mr Warwick Anderson
General Manager: Network Finance and Reporting
Australian Energy Regulator (AER)
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Dear Mr Anderson

Re: Submission to AER position paper on Profitability measures for network businesses

The Agriculture Industries Energy Taskforce[1] (the Taskforce) appreciates the opportunity to provide comments on the recently released AER position paper on profitability measures for network businesses.

The Taskforce submission in December 2017 *(Attachment 2)* to the original AER discussion paper on profitability measures is attached to these additional comments, which we now provide in response to AER's recent position paper and proposed profitability measures.

Australia has the highest electricity prices in the world. This should be a matter of acute shame for those determining energy policy in Australia, to know that the unsustainable cost of electricity is causing significant negative impacts for many of our highly efficient agriculture industries. High energy costs are impeding Australia's transition from a 'mining boom' to a 'dining boom'.

Every effort must be applied to ensure that Australia returns to the lower quartile against international comparison with other high income OECD countries. The Taskforce specifically recommends:

- A 30% reduction in the regulated electricity prices based on the 2014-15 financial year.
- A medium to long term price capped at 8 cents per kilowatt-hour for the electrons (R) and a similar ceiling of 8 cents per kilowatt-hour for the network (N).
- A rule change via the Australian Energy Market Commission (AEMC) to enable the AER to optimise an electricity network's regulated asset base (RAB) similar to the pre-2006 NEM rules that required the regulator to optimise the transmission and distribution network regulated asset base/s.
- A national food and fibre tariff model/s.
- Fundamental reform of the National Electricity Market (NEM) to address the lack of genuine competition, the operation of the contract bidding process and a market where consumers' interests are fairly represented.
- Stability and certainty in national energy policy to allow investment.

[1] *National Irrigators' Council, NSW Irrigators' Council, NSW Farmers Assn, Cotton Australia, National Farmers' Federation, Bundaberg Regional Irrigators Group, Central Irrigation Trust (SA), CANEGROWERS, Dairy Connect, Queensland Farmers Federation, Australian Pork Limited, Pioneer Valley Water*

We again highlight to the AER the issues faced by Australia's agriculture industries due to the high cost of electricity. This is putting at risk our ability to compete with the world as a provider of food and fibre. It is equally important that the other key entities, involved in the various pieces of work as part of the Government's objective to provide reliable and affordable energy, also understand this.

Australian producers have an opportunity to meet the demand of an ever-increasing global need for clean, green food and fibre, but instead face the risk of industry viability against the reality of high electricity costs. These cost pressures are imposing unsustainable barriers on the agricultural sector and are driving down Australia's competitive edge.

Australia's 135,000 farmers produce enough food to feed 80 million people, providing 93 per cent of the domestic food supply, and support an export market valued at more than AU$41 billion per annum (over 13 per cent of export revenue)[2]. With population growth and rising personal income, the emerging middle class in Asia provides the major market for over 60 per cent of Australian agricultural exports.

More than 75% of Australian agriculture produce is exported. As a sector that is highly exposed to trade, agriculture must remain competitive in the international market. Consequently, reliable, affordable and sustainable electricity supply are a necessary pre-condition for the economic development of agriculture. It is also key to ensuring farmers remain profitable and can efficiently invest in agriculture.

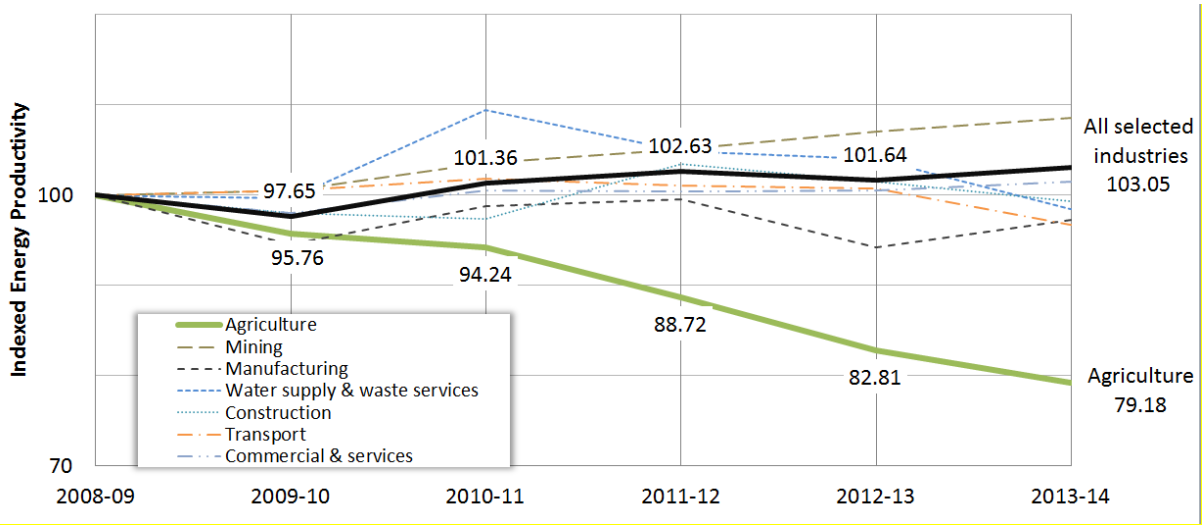
Reform of Australia's water resources sector in recent years has resulted in greater competition for water resources. While water savings have been achieved on-farm through investment in infrastructure, the resulting higher use of energy has coincided with a dramatic increase in the cost of electricity. Analyses show that irrigators' and growers' electricity bills have increased in excess of 100% in most cases, and up to 300% for some over the period 2009-2014, mainly due to the rising cost of network charges imposed by the network companies.

Affordability and reliability are key for agricultural producers – wholesale price spikes and outages can result in annual returns for some farmers being undermined over a period of a few hours. However, overinvestment to enhance reliability comes at the expense of affordability. Efficient investment in, combined with efficient operation and use of, electricity services is crucial for farmers, consumers broadly and the wider economy.

Most sectors of Australian industry have achieved significant gains in energy productivity over the past decade. The conspicuous exception is agriculture, where energy productivity is declining.[3] The chart below shows a decline of 21% since 2008.

[2] *Australian Bureau of Agricultural and Resource Economics and Sciences. (2014). Agricultural Commodity Statistics.*
[3] *(Eyre, 2016) http://www.aginnovators.org.au/blog/new-thinking-needed-about-regional-electricity-supply*

Figure 1: Indexed energy productivity performance of industry sectors. Agriculture energy productivity has declined 21% since 2008 (Eyre, 2016).



Analysis by NSW Farmers has suggested that greater reliance on diesel due to higher electricity costs, as irrigators switch from mains electricity to diesel generators, is a key factor in low energy productivity.

The current situation is untenable. With the objective of achieving affordable energy costs and in good faith, the Taskforce collectively (and Taskforce members individually) continues to participate in the significant work occurring as part of Government initiated inquiries (ie COAG Energy Council, ACCC, Finkel Review, AER) and the raft of initiatives emerging from this work. Each of these initiatives should be considered in association with each other, including COAG's work in the design of the National Energy Guarantee (the Guarantee), the AER's consideration of the Rate of Return guideline and profitability measures for network businesses. It is critical that this effort collectively delivers **lower energy costs for consumers**.

The high cost of energy for the agriculture sector sits starkly against the backdrop of the excessive profits of regulated electricity and gas businesses. Supported by research provided to us by Sapere Research Group, we have been critical of the methodology used to allow network owners to *'exceed efficient costs, prices and profits'.* The parallel consideration of the Rate of Return guideline is fundamental. This methodology must be changed to ensure a reasonable rate of return commensurate with the secure monopoly position of network owners and to ensure that 'gold plating' of assets is discontinued.

The objective of Australia's National Energy Market (NEM) must be to provide equity in the system, that ensures Australia's competitive position is maintained, and that Australian consumers are able to meet the cost of their energy bills. To support this endeavour, the entrenched behavioural and systemic problems in the NEM must be addressed.

We would like to see the AER adopt a performance measurement framework to enable an accurate assessment of the profitability of regulated electricity and gas businesses, comparable to that of other ASX entities. Until this occurs, meaningful and systemic change will not be realised.

Taskforce members have been involved in the current rate of return guideline (Guideline) and support the submission provided by the Consumer Reference Group to that process. The rate of return is a key component of the allowed revenue determined by the AER that service providers can recover from customers for the use of their networks. We contend that the examination of the Guideline therefore must be considered in tandem with the examination of profitability measures for networks.

We note the expected release of the AER draft decision on the Guideline is in late June, followed by final decision in December.

As part of the review of the Guideline, the Taskforce has previously drawn attention to an issue that cannot be ignored, and that is, on what asset base is the rate of return being calculated?

Given the asset intensive nature of network businesses, the value attributed to the regulated asset base (RAB) is the principal influence on allowed costs, revenues and hence unit network prices. The RAB is a fundamental driver of allowed regulatory depreciation (return of capital) and together with the weighted average cost of capital (WACC) a fundamental determinant of networks' allowed return on capital.

The evidence of excessive industry profit and soaring prices supports our own observations that shareholders are benefiting at the expense of electricity consumers. It would appear that the owners of the electricity generation, distribution and transmission assets have a dominant voice in driving the policies adopted by the regulatory bodies. It is evident that the networks are taking every opportunity to undermine the prospects for energy efficiency and distributed generation, both of which represent competitive threats to their businesses.

During the development of the Taskforce's submission to the ACCC retail electricity price inquiry, we engaged Sapere Research Group, whose work confirmed that at every level of the electricity market *"costs, prices and profits across much of the sector, and at multiple points across the supply chain, exceed efficient costs, prices and profits".*

The Sapere report goes on to show that *"despite being subject to price/revenue regulation, network costs, profits and prices also appear to be excessive.*

"There is evidence of substantial excess network capacity across many parts of the NEM. We have not been able to identify a corresponding reduction in the allowed cost of capital to accompany risk transfer associated with the move to the RAB roll-forward method for setting the RAB at the start of the following price period (replacing the previous method which included provision for asset optimisation). Consequently, it appears that network prices incorporate the double effect of excessive returns on an excessive asset base."

The Taskforce has long argued that the current regulatory framework is enabling regulated network businesses to build in unacceptable returns. A performance measurement framework is necessary to understand the extent of the profitability of regulated electricity and gas businesses. The absence of such is enabling gold plating and resulting in unsustainable price increases to consumers.

As we have previously suggested, there is a critical need for the AER to move to a benchmarking model comparable to that of other entities. In this context it is hoped that the profitability measures proposed by the AER, if implemented, will signal the start of a much needed new approach.

We know that the regulated asset base (RABs) of Australia's electricity networks have been artificially inflated and inefficiently grown to excessive levels. Over the past fifteen years, the networks' RABs have increased by around 400%. These growth rates now put Australian electricity networks' RAB levels significantly higher than their international counterparts; we know that the RAB per connection levels of Australia's distribution networks are now up to nine times the levels of networks in the United Kingdom.

In a submission provided to the 2014 Senate inquiry into the performance and management of electricity network companies, the Taskforce raised the issue of network companies misleading the AER in relation to their weighted average cost of capital (WACC). The issues are complex and we

view regulatory design as the underlying reason for such failures. The determination of the WACC – an issue largely but not completely within the AER's discretion – is based on what the AER calculates to be the WACC of a 'benchmark efficient network service provider'. This calculation is by design, meant to be abstracted from the actual cost of capital of the regulated firms.

A range of factors embedded in a failed market are making Australia less competitive. The very comfortable arrangements for the owners of networks is a key issue. It is crucial to Australia's future agricultural competitiveness that the base calculation of the return these owners are allowed to build into their pricing models, is fundamentally reformed. These reforms should deliver a reasonable rate of return commensurate with the secure monopoly position held by network owners, and ensure that the practise of 'gold plating' of assets is discontinued.

The accompanying table at *Attachment 1,* provides comment on the AER draft proposed measures, calculation and suggested comparators. The Taskforce submission of December 2017 on AER discussion paper on profitability measures is at *Attachment 2.*

Thank you for your consideration of these comments.

Yours sincerely

Agriculture Industries Energy Taskforce*

** National Irrigators' Council; NSW Farmers; National Farmers' Federation; Cotton Australia; NSW Irrigators' Council, Irrigation Australia Limited; NSW Dairy Connect; CANEGROWERS; Queensland Farmers Federation, Central Irrigation Trust (CIT), Bundaberg Regional Irrigators Group (BRIG), Winemakers Federation of Australia, Australian Pork.*

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