CANEGROWERS

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19 September 2013

Mr Chris Pattas and Mr Sebastian Roberts
General Managers
Australian Energy Regulator

Sent via email: expenditure@aer.gov.au and incentives@aer.gov.au

CANEGROWERS submission to the AER *Better Regulation* program

Dear Mr Pattas and Mr Roberts,

Today I am writing to you to submit the CANEGROWERS submission regarding two different guidelines: Forecast Expenditure Assessments and Incentives Guidelines.

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 myself or if you have any further questions relating to our submission.

Yours faithfully

Ron Mullins
ACTING-CHIEF EXECUTIVE OFFICER

CANEGROWERS SUBMISSION

Australian Energy Regulator
Better Regulation

Expenditure Forecast Assessment

Efficiency Benefit Sharing Scheme
Capital Expenditure Incentives

September 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 cane 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 cane 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 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.

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19 September 2013

Mr Chris Pattas and Mr Sebastian Roberts
General Managers
Australian Energy Regulator

Sent via email: expenditure@aer.gov.au and incentives@aer.gov.au

Thank you for the opportunity to comment on the Expenditure Forecast Assessment, Efficiency Benefit Sharing Scheme (EBSS) and the Capital Expenditure Incentives (CESS) Guidelines as a part of the AER's *Better Regulation* program.

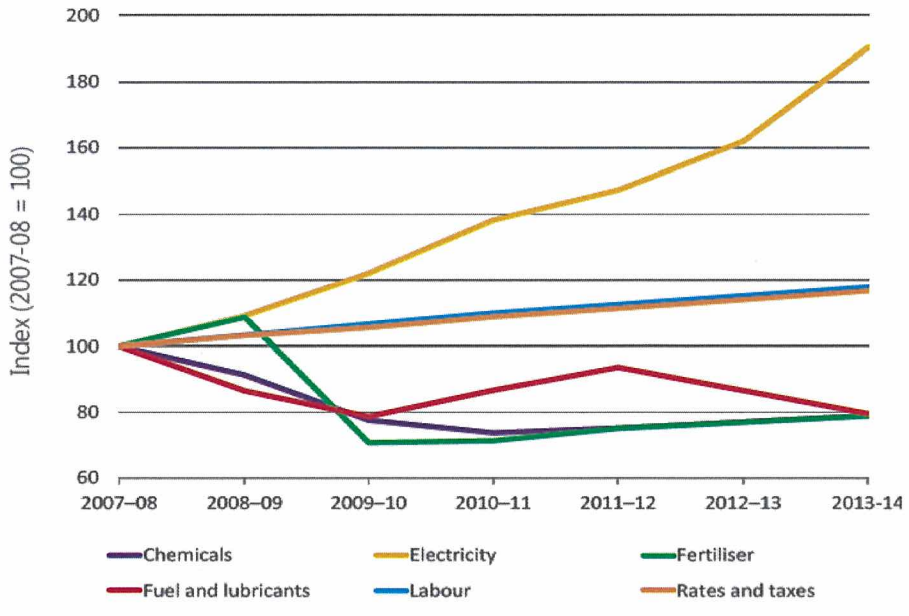
At present, the sugarcane industry is struggling to grapple with the rapidly rising cost of electricity. The growing sugar deficit in the East Asia region should be providing a large economic gain to sugarcane growers in Australia and the industry should be in an expansion phase. However, high cost of production (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.

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 is broken. Over the past seven years, the retail price of electricity has effectively doubled, with the majority of price increases coming from networks 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.

Further, The AER's admission that demand and expenditure forecasts are likely to be biased upwards given a-symmetric information is profoundly alarming (AER, *Explanatory statement: Draft Capital Expenditure Incentive Guideline. P.18).*

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 Expenditure Forecast, EBSS and CESS Guidelines 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 irrigators.

In summary, CANEGROWERS calls on the AER to:

- Realign incentives between NSPs, their shareholders and consumers to protect consumers from forecasting errors. The AER can do this by:
    - Introducing an annual forecasting review mechanism that can revise expenditure forecasts. This would require the robust use the step-change mechanism;
    - Encouraging non-CAPEX measures (such as network tariffs design) to be used in expenditure assessments when developing REPEX and AUGEX forecasts. The current DMIS is not sufficient;
    - Approving expenditure forecasts based on customer classes in the NSP network tariff structures to limit cross-subsidies between consumer groups;
- Include a regulated efficiency dividend in all CAPEX and OPEX expenditure assessments;
- Develop an ex-post regime that ensures all CAPEX is both "used and useful" – including CAPEX approved at the start of the regulatory period;
- Scrutinize non-commercial (legislative) CAPEX to ensure it is in the interests of consumers – if not then the CAPEX should be excluded from the RAB;
- Ensure all information provided in the RIN is made publicly available;
- Design the CESS and EBSS with a 100:0 incentive power to place competitive market pressures on NSPs
- Allow NSPs to recover actual depreciation on CAPEX to incentivise efficient spending

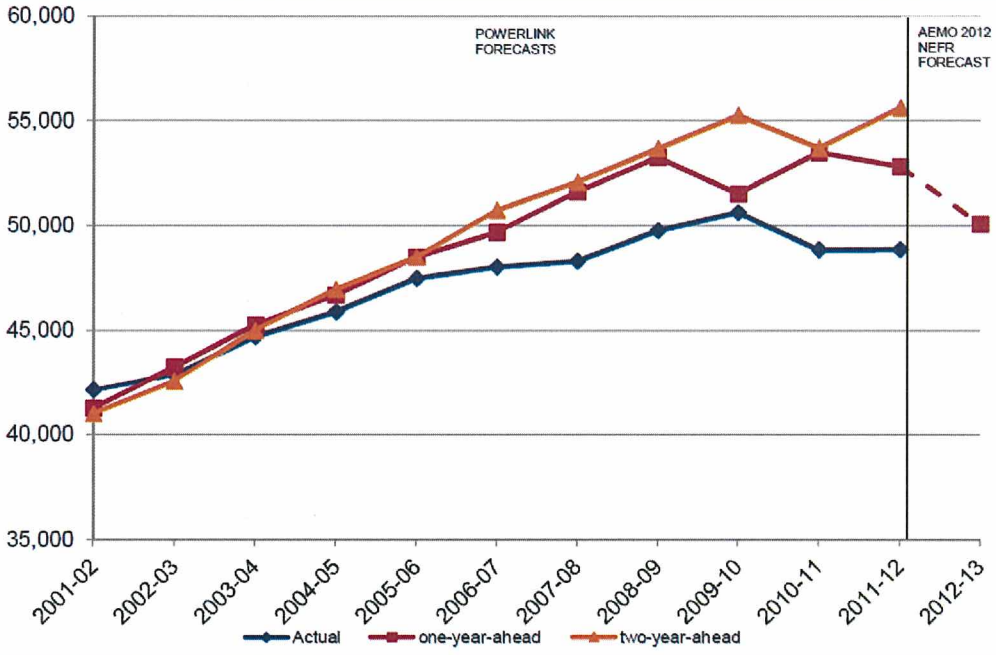
This submission will outline the case for reform for the expenditure assessment and incentives guidelines as well identify the shortcomings of the Draft Guidelines and suggestions for improvement.

Expenditure Forecast Assessment

The case for reform

Constant failure to effectively predict future electricity demand has been one of the major causes of network price increases in Queensland under the NSP revenue cap. As figure 2 shows, there is a large and persisting forecasting error across Queensland's NSPs. To maintain the regulated revenue stream, prices have had to increase to make up the short-fall in allowed revenue. These additional increases have caused significant financial stress for consumers, particularly trade-exposed irrigators.

Figure 2: one- and two-year-ahead energy forecasts



Source: AEMC

In the AEMO's *Electricity Forecast Demand Accuracy* report, the causes for lower than forecast actual demand have been extensively analysed. AEMO concluded that structural decline and contraction in demand across the economy, consumers' response to price increases and a high rate of uptake for rooftop photovoltaic systems were the main causes of forecasting errors.

Substitution and a growing elasticity to electricity consumption following large price increases will be continued by consumers across the Queensland's networks while prices continue to increase at unacceptable rates. The economics of demand and supply show that increases in price will reduce demand. However, under the revenue cap, reduced demand perversely causes increases in price. Higher prices further reduce demand and a negative cycle begins – observed as the death spiral.

The AER much acknowledge this negative cycle 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.

Allocation of risk for forecasting errors

The major issue associated with the Expenditure Forecast Assessment Guideline is the allocation of risk for forecasting errors which are the basis for excessive and inefficient expenditure. The guidelines presented by the AER do not attempt to resolve this issue.

Risks ought to be borne by those best placed to meet them. Consumers (particularly trade-exposed irrigators) are not best placed. The WACC compensates NSPs for non-diversifiable risk, so it is not appropriate to charge consumers a further premium on prices for NSP forecasting failures.

Consumers did not set overly-optimistic demand forecasts, yet they are paying higher prices while NSPs enjoy a regulated revenue stream (compounding annual revenue increases of 6% for Powerlink, 10% for Ergon and 14% for Energex). If the AER is to appropriately execute the NEO, the nexus between demand forecasting, expenditure assessment and the revenue cap must be reconfigured to protect consumers from NSP forecasting errors. There are several ways in which this can be done.

1. **Allow for re-assessment of forecasting and expenditure allowances during the regulatory period**

The existing allowance and incentive structures are not operating in the interests of consumers. For example, in the current regulatory control period, Ergon has reduced its expenditure from its forecast allowances by 22 per cent in response to falling demand – however, Ergon is still charging its customers the full allowed rate. Any benefit associated with reducing expenditure must flow onto consumers immediately and not be captured as a windfall gain for NSPs.

CANEGROWERS supports the development of Annual Benchmarking Reports, to be considered when assessing expenditure proposals. However, the Annual Benchmarking Reports should also be used throughout the regulatory control period to assess expenditure proposals against annually revised demand forecasts and to account for step-changes (up or down) in expenditure. This would ensure that there is far less potential for demand forecasting errors to occur, protecting consumers from paying for forecasting errors on behalf of NSPs.

An annual forecasting review mechanism, used in conjunction with the Annual Benchmarking Reports would have prevented the current divergence between the forecast and actual demand in Queensland and reduced the cost of supplying electricity to consumers throughout the current regulatory control period by cancelling unnecessary investment. CANEGROWERS encourages the AER to consider the development of such a mechanism.

2. Develop a requirement for NSPs to manage network load through non-CAPEX mechanisms

If consumers' interests are to be protected, the AER's approach to expenditure forecasting needs to change. The Draft Guideline assumes that future growth in expenditure forecasts is unavoidable – no attention is paid to asset utilisation. This approach is out of step with reality. In Queensland, NSPs do not need to build more network to meet demand growth, they need to be incentivised to increase utilisation across a range of inefficient investments made on a non-commercial basis in the current regulatory control period.

The AER needs to encourage non-CAPEX mechanisms, such as developing time of use (ToU) and Critical Peak Pricing (CPP) network tariff schedules that monetise cost of peak investment and incentivise utilisation in off-peak periods. This should be done as a part of the AER's approach to assessing CAPEX, particularly in relation to future replacement (REPEX) and augmentation (AUGEX). Powerlink, Ergon and Energex should not continue to be rewarded for continued over-engineering of their networks.

A regulatory approach during expenditure assessment is needed because the current Demand Management Incentive Scheme (DMIS) is not good enough. The DMIS sends a weak incentive signal, is non-binding and will not deliver the required change in NSP expenditure behaviour to contain future price increases.

3. Link forecast expenditure to tariff classes that reflect investment decisions

QLD NSPs have built large sections of their networks to cater for increased demand from specific consumer classes that has never been realised. For Energex and Ergon, the uptake of rooftop solar PV systems was quicker than expected and the rate of population growth was lower than predicted. These two factors are major contributors to forecasting errors, driving prices higher in the current regulatory control period. In regional Queensland, the delay of significant LNG projects have also negatively impacted on Powerlink and Ergon's forecasts. Under the current regulatory regime, all customers must pay higher prices for the reduction in sector specific demand so the NSP can maintain a regulated revenue. This is not fair to consumers – particularly irrigators.

The network used by irrigators has not significantly changed over the past seven years, but the network charges irrigators are required to pay (for the same service) have doubled. Irrigators have not been the cause of new investment and have not received improvements in reliability or security of supply. Yet, irrigators are expected to pay for forecasting errors by NSPs as well as cross-subsidise other consumer groups for assets built for alternative users (i.e. domestic users and the resource industry). This is unacceptable. It does not reflect the NEO's objective of lowest cost supply. Every effort should be made by the AER to protect irrigators from this inequitable cost allocation.

This issue can be overcome by approving expenditure forecasts based on customer classes, network tariffs as a suitable proxy. This would also ensure irrigators (and other minor users) do not pay for continued expenditure to manage non-existent peak-load growth. A mechanism of this nature would encourage NSPs to engage with consumer groups when forecasting demand and allow the AER assess if expenditure would be prudent and efficient.

Inclusion of an efficiency dividend for future expenditure

CANEGROWERS identifies two problems with the AER's Expenditure Incentive Guidelines. The EBSS and CESS are not of sufficient strength to encourage continual efficiency improvements by NSPs and they do not pass on efficiency gains to consumers in an adequate time-frame.

The AER must also include a regulated efficiency dividend in CAPEX and OPEX expenditure assessments, in addition to the CESS and EBSS mechanisms. The efficiency dividend should at least be in line with the annual productivity increase in Australia's trade-exposed industries – roughly around three per cent per annum.

For CAPEX

The AER's admission that demand and expenditure forecasts are likely to be biased upwards given asymmetric information is profoundly alarming (AER, *Explanatory statement: Draft Capital Expenditure Incentive Guideline. P.18).* CANEGROWERS encourages the AER to set what it believes are prudent and efficient cost levels, with required annual productivity improvements.

A prudent NSP (link any other business) would take the necessary action to improve its efficiency. That is, mirroring what would be expected under competitive market conditions. CANEGROWERS expect NSPs (including their shareholders) to wear the cost of any inefficiency rather than passing this onto consumer through inefficient or inflated prices. It is up to the NSP to determine how best to manage its cost within the efficient revenue allowances set by the AER. CANEGROWERS also expects the AER to not pass on inefficient costs to consumers through pass-throughs or in the WACC.

In addition, the AER should not provide non-market cost-allowances for NSPs above the expenditure forecast framework. For example, real price escalation, re-openers and pass-through provisions should not be provided to NSPs. Irrigators in the sugarcane industry are not able to apply to their customers in Asia to have higher electricity costs passed on in the price of raw sugar – so why should NSPs be provided this opportunity?

For OPEX

The AER's approach to forecast OPEX is overly generous to NSPs. All efficiency gains by NSPs are pointless if they are not passed onto consumers at the next Annual Pricing Proposal. Under the proposed EBSS, consumers will be paying a premium for OPEX for up to eight years while NSPs pocket a windfall gain. This is unacceptable and not in the interests of consumers.

The Rate of Change variable should also be revised to reflect competitive market forces. CANEGROWERS recommends several changes. Figure 3 demonstrates this relationship:

- Output growth should consider change in demand for electricity (falling demand but increasing supply would require NSPs to become more efficient with OPEX. Growing demand would allow increases in OPEX);
- Real price growth should be capped at CPI with no minimum; and

- Productivity growth should be set at the same rate of growth in the broader economy, with special consideration for productivity growth in trade-exposed industries.

Figure 3: Rate of change in OPEX assessment

AER rate of change formula:

$$Rate\ of\ change_t = output\ (\text{demand})\ growth_t + real\ price\ growth_t - productivity\ growth_t$$

Example 1: decreasing demand

$$Rate\ of\ change_1 = -2\% + 2.5\%\ (\text{CPI}) - 3\%\ (\text{trade exposed productivity rate})$$
$$Rate\ of\ change_1 = -1.5\%\ (\text{net reduction in OPEX})$$

Example 2: increasing demand

$$Rate\ of\ change_2 = 2\% + 2.5\%\ (\text{CPI}) - 3\%\ (\text{trade exposed productivity rate})$$
$$Rate\ of\ change_2 = 1.5\%\ (\text{net increase in OPEX})$$

Source: *CANEGROWERS*

Ensure CAPEX is truly prudent and efficient

An ex-post review that ensures CAPEX is "used and useful"

CANEGROWERS supports the development of an ex-post review mechanism, to ensure that expenditure in the regulatory period has been prudent and efficient before it is rolled into the RAB. However, the AER's proposed scheme has been designed for failure – it will not protect the short- or the long-term interest of consumers because it is too constrained in its scope. Under the Guidelines, expenditure will always be classed as efficient if it has been made in accordance with the allowed expenditure at the start of the regulatory period. This definition is inadequate, considering the frequency and magnitude of forecasting errors by NSPs and overly generous expenditure allowances by the AER.

The AER should develop an ex-post regime that ensures all CAPEX is "used and useful" before it is included in the RAB – even for CAPEX that has been deemed "efficient" and "prudent" by investing within the assessment forecast. Continual growth of the RAB at a time of falling demand will not encourage price stabilisation and will not encourage better utilisation of existing assets. While the AER's proposed changes are a slight improvement to the previous practice of rolling all CAPEX into the RAB, the guideline is still not in the short- or long-term interest of consumers. This protection does not currently exist.

In jurisdictions where the role of owner, policy maker and retail price regulator are the same entity (primary in Queensland and New South Wales), a robust and effective ex-post mechanism is critically important. A stronger ex-post review mechanism would ensure investments are "used and useful," providing a reasonable protection to consumers.

Non-commercial legislative requirements

In the Explanatory Statement of the Expenditure Forecast Assessment Guideline, it is assumed that expected demand and the reliability, quality, security and safety standards (legislated or otherwise) are proxies for the level of service from which customers gain the most value.

Experience of "gold-plating" in the current Queensland DNSP regulatory control period shows that this expectation is misguided and not in the short- or long-run interests of consumers.

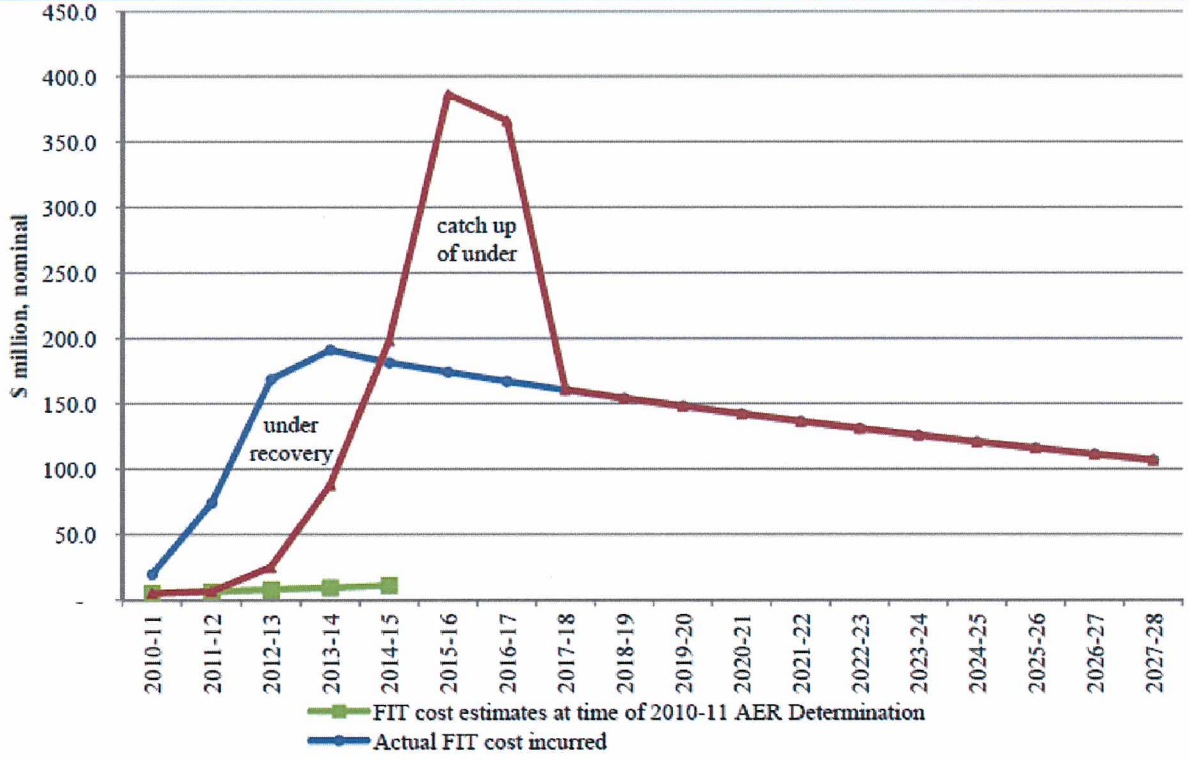
If state governments (particularly governments that are shareholders, legislators and retail price regulators of NSPs) desire non-commercial investments from NSPs, the AER should require the cost of the investments be 100% subsidised by consolidated state revenue – not through increased network prices for consumers.

The cost of two legislative programs (N-1 security standard and the Solar Bonus Scheme) have been particularly expensive and against the long-run interests of consumers in Queensland. The impact of these two programs on NSPs and consumers have been largely ignored by the AER.

Solar Bonus Scheme

The impact of the Solar Bonus Scheme (SBS) on consumers will be significant. Analysis by the Queensland Competition Authority (QCA) has found that the take-up of 44c/kWh rebate under the SBS was largely under-estimated. This has resulted in under-recovery of revenue that requires future catch-up. As figure 4 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.

Figure 4: Energex feed-in tariff payments and impacts on network revenue



Source: *QCA/Energex analysis*

The total cost of the SBS will peak in 2015-16 and will account for 29.5% of total DNSP charges, after accounting for the feed-in tariff payments, infrastructure and admin costs and in-house consumption. These are charges that should not be levied on all network users – the intent of the policy is non-commercial and should have been paid for by the legislator (as the shareholder), not consumers.

N-1 security standard

The Queensland government has a legislated N-1 security standard. The excessive standards-mandated redundancy in system development is the cause of increasing capital programs has been identified as the primary driver of capital investment in Queensland. This security standard is overly prescriptive and has resulted in over-engineering of the network with excessive redundancy being installed into the QLD DNSP networks as overall demand falls. The inflated RAB (which has grown at 13% year-on-year in the current regulatory control period) is currently delivery a large wind-fall gain to the Queensland Government at the expense of consumers. The N-1 security standard is not supported by QLD NSPs or consumers and is currently under review by the Queensland Government.

All of the excess redundancy is expected to be rolled into the RAB, despite the non-commercial nature of the investment. Due to a reduction in total demand in Queensland, it is almost certain that investment made to meet the N-1 security standard will be neither "used nor useful" in the foreseeable future. In a competitive environment, the company and its shareholders would carry all of the financial risk of this poor investment.

However, the AER incorrectly assumes that customers gain the most value from this standard and must pay for non-commercial expenditure as the CAPEX is rolled into the RAB. In future expenditure assessments, the AER should scrutinise the impact of legislative, non-commercial expenditure decisions to ensure that they are in the long-run interest of consumers. If legislative, non-commercial expenditure must to be approved, the CAPEX should not be included in the RAB.

Information for expenditure assessment

CANEGROWERS supports the collection of the information established in the Regulatory Information Notice (RIN). However, all of the information in the RIN provided to the AER should be made publicly available, immediately. The only suitable redactions would be for information deemed a breach of consumer or 3rd party privacy.

It is important to note that NSPs should not refuse to disclose information to the public on terms of "commercial in confidence." NSPs are natural monopolies and have no competitors –they have no competitive advantage to lose by providing the information.

Expenditure Incentives

CANEGROWERS does not support an incentive sharing scheme with a power of less than 100:0.

The AER exists as a regulator because of the absence of a competitive market for network services. This means that the role of the AER is to replicate incentives that would occur in a competitive environment. The 30:70 symmetrical sharing scheme is too generous for NSP and requires them to carry too little risk for their investment decisions.

In a competitive environment, a company (and its shareholders) must wear 100% of the risk of poor investment decisions. Why should NSPs be continuously shielded from commercial realities?

The risk of perverse outcomes for consumers are too high under the current EBSS and CESS – they are too generous for NSPs and will not provide adequate incentives for networks to increase productivity. Consumer will still be forced to burden 70% of NSPs' poor investment decisions.

CANEGROWERS would like to note that if the expenditure assessment guidelines are operating efficiently and effectively (by including the measures outlined above), NSPs would have little capacity to generate additional revenues under an EBSS or CESS system by reducing expenditure.

Forecast versus actual depreciation

CANEGROWERS supports the AER's analysis of actual depreciation on CAPEX overspend, for two main reasons. First, recovery of actual depreciation better replicates what would occur in a competitive market. Second, a lower increase in the RAB in the next regulatory control period is in the long term interest of consumers.

Allowing recovery of actual depreciation will provide a suitable incentive to reduce excess CAPEX in the current regulatory control period if the CESS is powered 100:0, as discussed above.