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19 December 2017

Mr Warwick Anderson
General Manager Australian Energy Regulator
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By email: rateofreturn@aer.gov.au

Dear Mr Anderson

CANEGROWERS submission to AER Review of the Rate of Return Guideline

Thank you for the opportunity to respond to the AER's Issues Paper "Review of the Rate of Return Guideline".

Escalating electricity costs are contributing to Australia losing its international competitiveness for agricultural exports. The impact is greatest on energy-intensive industries such as irrigated agriculture, where the exorbitant costs of pumping water have led many growers to make behind-the-meter decisions that would otherwise be unwarranted (for example, reduced production and/or investment in alternative energy sources).

CANEGROWERS seeks an electricity generating and distribution system that efficiently, sustainably and affordably delivers electricity to consumers with a regulated tariff structure and pricing system that would be characteristic of a competitive market. Prices and tariffs should provide performance incentives, encourage reductions in cost across the supply chain, and enable electricity users, particularly those in the traded goods sector, to remain internationally competitive.

Although interconnected, Australia's electricity transmission and distribution network are **natural monopolies**, each with their own clearly defined customer base. Generic application of principles that apply in a **competitive** market, including in the calculation of the weighted average cost of capital (WACC), to the regulation of natural monopolies is likely to exacerbate already strong incentives to overinvest in capacity, drive prices higher than efficient (socially optimal) levels and deliver suboptimal service level outcomes.

What irrigation consumers want
A regulated network price outcome, taking account of the natural monopoly market structure, that requires network businesses whether privately or publicly owned to price, operate and invest efficiently so that energy consumers pay no more than necessary for the safe and reliable delivery of services.

The incentive for wasteful over-investment in network capacity has resulted in Australia's network and retail prices being amongst the most expensive in the OECD.

There is another cost. The strong network investment incentives have drawn resources away from other investments in the sector and Australia's energy security has suffered. It has also caused, otherwise unnecessary, investments behind the meter as consumers respond to strong incentives to go off-grid.

CANEGROWERS is particularly concerned about the failure of the network pricing framework and regulatory oversight structure that delivers record profits to network service providers and their owners, often governments, at the expense of electricity users and the wider economy.

The AER's own Consumer Challenge Panel (CCP4), when examining the 2018-22 revenue proposals put by the Queensland networks (Powerlink and Energex in particular), questioned extraordinary profitability of those networks compared with the returns being achieved by businesses in other sectors of the economy. For example, CCP4 found that during the 2013-17 regulatory period, Powerlink achieved an annual return on equity of up to 75%, compared to the AER's assumed 9.4%.

With revenues that flow from the rate of return accounting for up to 60% of allowed revenues, and clear evidence of supernormal profits being made by network companies, a more fundamental review than the AER's proposed incremental approach is required.

Avoid setting regulated monopoly prices by reference to rate of return
During a public lecture in January 2016[1], Professor Ross Garnaut reminded his audience of an economic proposition by Averch and Johnson[2] published in the American Economic Review in 1962. "In regulating prices in a natural monopoly, avoid setting prices primarily by reference to the rate of return on investment". The reason is as simple as it is compelling. The regulated businesses, cautious to avoid underinvestment, argue for higher rates of return. The inevitable occurs. Rates of return set at levels higher than required, lead to wasteful over-investment. With network investment growing strongly at a time of declining network use, Professor Garnaut cites the national electricity market (NEM) as a case in point.

National Electricity Objective
The National Electricity Objective (NEO) requires the National Electricity Market to operate in the long-term interests of consumers of electricity with respect to price, quality, safety, reliability and security of supply. Excessive costs, profits and prices across the NEM are not consistent with the NEO and suggest a major failure in the governance arrangements established under the Australian Energy Market Agreement, 30th June 2004[3].

This consideration of the rate of return guidelines is fundamental. The rate of return methodology must ensure a reasonable rate of return commensurate with the secure monopoly position that network owners find themselves in. It must also ensure that there is no longer incentive to, and reward for, overinvesting in the 'gold plating' of assets.

Rate of Return – on what?
A fundamental issue in reviewing the rate of return guideline is to ask the question, 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.

[1] Ross Garnaut (2016), "Australia After Paris: Will we use our potential to be the energy superpower of the low-carbon world?" Public lecture hosted by the Young Energy Professionals, State Theatre Centre of Western Australia, Perth, 21 January
[2] Averch, H. and Johnson, L.L. 1962, "Behavior of the Firm Under Regulatory Constraint", American Economic Review, 52 (5): 1052–1069.
[3] Sapere Research Group (2017), "ACCC 2017 inquiry into electricity prices", report prepared for the Agricultural Industries Energy Task Force submission to the 2017 ACCC inquiry.

In reports prepared for CANEGROWERS and the NSW Public Interest Advocacy Centre, using data contained in Queensland and NSW network's Distribution Annual Planning Reports, the Sapere Research Group[4] assessed distribution congestion and found spare capacity across almost all zone substations across both NSW/Queensland. This suggests there is no congestion in the parts of the network that supply irrigators in NSW and Queensland.

According to the Sapere Research Group, network prices incorporate the double effect of excessive returns on an excessive asset base.

Under the transition to the National Electricity Rules (NER), the risk around network demand and capacity was shifted from network companies to consumers. The method for setting the RAB was changed. The present roll forward approach replaced the optimised discounted replacement cost (ODRC) methodology. Adjustments are made for capital expenditure, depreciation, disposals and inflation. A second inflation adjustment is made to avoid over-compensating for its effect. The calculated RAB remains otherwise unaltered. There is no optimisation to take account of excess expenditure or excess capacity and there is no *ex-post* review of the efficiency of capital expenditure.

With the change in approach, consumers are funding the excess capacity. The network investment risk has moved from networks to consumers. It is concerning that this occurred without a corresponding reduction in the allowed cost of capital.

Writing down assets in the competitive market is commonplace and is provided for in the International Financial Reporting Standards (IFRS). IAS 36 "Impairment of Assets" seeks to ensure that an entity's assets are not carried at more than their recoverable amount (i.e. the higher of fair value less costs of disposal and value in use). It also defines how the recoverable amount is determined.

Drivers of monopoly rent

CANEGROWERS note that the AER is separately examining the profitability of regulated gas and electricity network businesses. It will be important that the information from that review relating to drivers of network profitability and the factors that are sustaining the excessive network profitability, regulatory period after regulatory period, is made available to the AER's rate of return guideline review team.

<u>Debt-Equity</u>

The AER allows a 60:40 debt to equity ratio in its WACC calculation. This appears to be a departure from the gearing network companies apply to the regulated parts of their businesses and is certainly the case for Queensland's government-owned networks – Energex, Ergon and Powerlink.

The Queensland government has progressively and significantly increased Energy Queensland's (the holding company for Ergon and Energex) gearing, to 86:14[5].

Application of the regulatory pricing framework is imposing a tax on Queensland's electricity consumers. The tax has two components:

[4] Sapere Research Group (2017) "Evaluation of electricity distribution tariff structure proposals submitted by Ergon and Energex", a report prepared for CANEGROWERS, dated February 2017 and "Evaluation of NSW 2016 revised electricity network tariff structure statements", a report prepared for the NSW Public Interest Advocacy Centre, May 2017.

[5] Energy Queensland Limited (2017), Annual Financial Statements for the year ended 30 June 2017 (https://www.energyq.com.au/__data/assets/pdf_file/0011/498188/Energy-Queensland-Annual-Report-Financial-Statements.pdf)

i. the difference between the actual and assumed level of gearing
ii. the difference between the Queensland Treasury Corporation's actual cost of borrowing and the AER's BBB+ regulatory allowance.

Market Risk Premium and Equity Beta

The standard calculation of Market Risk Premium (MRP) and Equity Beta (ß) for the regulated components of electricity network businesses, as if they were operating in the competitive markets, is likely to overstate the risks that natural monopoly network firms face.

MRP and ß are short term measures of risk and volatility respectively. The reality for a regulated network business is that the short-term risks they face are very low. Shortfalls in one regulatory period can be recouped in the next.

As noted, with network prices above efficient levels, consumers are investing behind the meter and go off-grid to manage the risk of spiralling electricity prices. Network businesses face a risk of regulatory failure. This risk should be removed through the AER's current review process, not compensated for by higher risk premiums.

Conclusion

The underlying objective of the regulatory pricing framework should be that network businesses whether privately or publicly owned to price, operate and invest efficiently so that energy consumers pay no more than necessary for the safe and reliable delivery of services.

To avoid a significant resource misallocation, driven by a pricing framework and incentive structure that rewards over-investment, it is important that all aspects of the rate of return are reviewed. The rate of return review must take account of the fact that the networks are natural monopolies, not businesses operating in competitive markets.

Business as usual is not sustainable.

Yours faithfully

Dan Galligan
Chief Executive Officer