Major Energy Users Inc.

12 September 2012

Ms Sophie Dunstone
Committee Secretary
Senate Select Committee on Electricity Prices
Parliament House
Canberra

By email to: electricityprices.sen@aph.gov.au

Dear Ms Dunstone

Review of Causes for High Electricity Prices

About Major Energy Users

The Major Energy Users Inc (MEU) represents large energy consumers operating in the NEM and in other jurisdictions. The MEU comprises some 30 major energy using companies in NSW, Victoria, SA, WA, NT, Tasmania and Queensland. MEU member companies – from the steel, minerals processing, cement, paper and pulp, automotive components, tourism, mining and mining explosives industries – are major manufacturers in the NEM and in other jurisdictions, are significant employers, and are located in many regional centres.

Analysis of the electricity usage by the members of MEU shows that in aggregate they consume a significant proportion of the gas produced and electricity generated in Australia. As such, they are highly dependent on the transport networks to deliver efficiently the energy so essential to their operations. Many of the members, being regionally based, are heavily dependent on local suppliers of hardware and services, and have an obligation to represent the views of these local suppliers. With this in mind, the members of the MEU require their views to not only represent the views of large energy users, but also those of smaller power and gas using facilities, and even at the residences used by their workforces.

The companies represented by the MEU (and their suppliers) have identified that they have an interest in the **cost** of the energy networks services as this comprises a large cost element in their electricity and gas bills.

Although electricity and gas are essential sources of energy required by each member company in order to maintain operations, a failure in the supply of electricity

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or gas effectively will cause every business affected to cease production, and MEU members' experiences are no different. Thus the **reliable supply** of electricity and gas is an essential element of each member's business operations.

With the introduction of highly sensitive equipment required to maintain operations at the highest level of productivity, the **quality** of energy supplies has become increasingly important with the focus on the performance of the distribution businesses, because they control the quality of electricity and gas delivered. Variation of electricity voltage (especially voltage sags, momentary interruptions, and transients) and gas pressure, by even small amounts, now has the ability to shut down critical elements of many production processes. Thus member companies have become increasingly more dependent on the quality of electricity and gas services supplied.

Each of the businesses represented by MEU has invested considerable capital in establishing their operations and in order that they can recover the capital costs invested, long-term **sustainability** of energy supplies is required. If sustainable supplies of energy are not available into the future, these investments will have little value.

Accordingly, MEU members are keen to address the issues that impact on the **cost, reliability, quality** and the long term **sustainability** of their gas and electricity supplies.

The members of MEU have identified that energy transport plays a pivotal role in the energy markets. This role encompasses the ability of consumers to identify the optimum location for investment of its facilities, and providing the facility for generators and gas producers to also locate where they can provide the lowest cost for energy supply. Equally, consumers recognise that the cost of providing the transport systems are not an insignificant element of the total cost of delivered energy, and due consideration must be given to ensure there is a balance between the two competing elements of low cost generation and the cost of connecting these to the market.

The MEU response to the Senate Select Committee request for submissions

The MEU has been an active consumer advocate for over 15 years in relation to electricity prices and has provided considerable input into the issue.

Rather than reiterating all of the issues in depth in this response the MEU has provided a brief overview of the issues that it considers are the main causes of the high prices and then provided a link to the most recent submission it has made in relation to the cause identified. Whilst the MEU has tended to nominate just one recent submission on each issue, the links can also be used to access other submissions made by the MEU on the same issue.

The MEU trusts that this provides the Committee with the best approach to its assessment of the concerns of consumers.

Analysis of the causes of high prices

The cost of electricity to consumers is comprised of a number of discrete elements, and each of those is subject to different cost pressures.

Wholesale electricity is electricity bought from generators, either directly or indirectly. Some generators have used their market power to increase the cost of electricity to consumers and this, for example in South Australia, has resulted in wholesale electricity prices rising by 50% or more.

The MEU has proposed a rule change to the AEMC to limit the exercise of generator market power. In its draft decision, the AEMC has implied that generators should be able to use their market power to increase prices, providing that they do not result in prices which more than exceed a level 20% above long run marginal cost for more than four consecutive years. This will have a chilling effect on downstream investments.

The AER has also raised its concerns about the exercise of generator market power and considers that it needs to be constrained

The MEU's most recent submission on this issue can be found at http://www.aemc.gov.au/Media/docs/Major-Energy-Users---120722-16530073-f848-419b-a812-be3690701e80-0.PDF

Risk margins are costs that are added to the wholesale costs of electricity in order to manage the risks both generators and retailers face when operating in the energy only market that applies in the NEM. It is recognized that energy only markets are essentially volatile because of the style of the market[1] and the extent of the swings the market can see from the floor price of -$1000/MWh to the cap price of $12,900/MWh. This wide range when combined with significant swings in demand that do occur, creates a very volatile market.

When this volatility is combined with exercise of generator market power, both retailers and generators have to increase the risk premiums they apply in order to manage the swings in prices and demand. Whilst each provider has its own level of risk premium to suit the degree of risk they face, the MEU has seen risk premiums as high as 20-30% of the cost of electricity being applied.

In the more stable environment that applied in the early years of the NEM before the large increases to the market price cap, risk premiums were more likely to be less than 10%.

Network costs can be the single largest contributor to the delivered price of electricity. For residential consumers network costs are up to 60% of the

[1] In contrast capacity markets used more extensively for electricity markets tend to see less excessive swings in electricity prices

delivered cost of electricity; for large users of electricity the network costs are likely to be closer to 40% of the delivered cost.

The cost of network services has been escalating massively in recent years – in NSW some large electricity users saw step increases of 50% in network costs in 2009. The main cause of this increase has been the over incentivising of network providers to invest in networks. This over-incentive has been compounded by an absurd approach to setting the debt risk premium which is a part of the development of the rate of return applied to the assets provided by network owners.

A major cause of the over incentivisation of the network businesses can be attributed to the AEMC when, in 2007, it determined new rules to apply to the economic regulation of transmission network businesses and the prescribed rate of return. The principles underpinning these rules were subsequently embraced by Federal and State governments when determining the rules to apply to electricity distribution (and gas) network businesses. The results from the round of pricing reviews have been disastrous for electricity consumers.

The AER (after many complaints by the MEU in responses to revenue reset decisions) has proposed a suite of rule changes designed to limit the incentives embedded in the network regulation rules. This suite of rule changes is currently under review by the AEMC and the draft decision clearly shows how consumers were so badly served by the AEMC inspired rules back in 2007.

The MEU most recent submission on this AER rule change proposal can be found at http://www.aemc.gov.au/Media/docs/Major-Energy-Users-MEU---received-17-April-2012-6d7450c0-1872-4977-a6eb-59e17768b706-0.PDF.

This response addresses both the issues of over-incentivisation of investments, the cost of debt concerns the MEU has and other aspects that have led to unnecessarily high electricity prices.

A subset of the causes of high costs for networks can be attributed to the **Limited Merits Review** process for regulatory decisions by the AER has led to many of the AER decisions made being appealed. Appeals are made with little risk to the network providers as the cost of an appeal is considered to be an acceptable regulatory cost and included in the regulated revenue allowed. The structure of the appeals process actively acts against involvement by consumers in the appeal and the process used by the Australian Competition Tribunal assesses only the specific issue in isolation of the impacts on other elements within a regulatory decision.

The Limited Merits Review Panel (a review panel established by the Standing Committee on Energy and Resources) is currently reviewing the appeal process and would appear to be agreeing with consumers that the current process is inappropriate and that the Australian Competition Tribunal

appears to be oblivious to the National Electricity Objective ("…in the long term interests of consumers…")

The MEU two most relevant submissions on limited merits reviews can be found at http://www.scer.gov.au/files/2012/03/MEU-letter-to-LMR-secretriat-13Apr12-final.pdf and https://scer.govspace.gov.au/files/2012/06/MEU-Submission-to-LMR-August-20123.pdf

Plethora of renewable energy incentive schemes have added to the cost of electricity seen by consumers. The Renewable Energy Target (RET) scheme was intended to provide the basis for an incentive for renewable energy providers to build a market in Australia. It was to achieve by 2020, 20% of electricity used to come from renewable sources. However, various State governments have introduced their schemes to boost renewable energy such as the VRET in Victoria and the various feed-in tariffs for solar energy introduced by other state governments.

The cost of these state schemes cannot be under-rated. For example the cost of the feed-in tariff scheme used in SA has resulted in network prices increasing by over 20% in 2012/13 just to recover the PV rebate payable.

The decision to split small scale technologies (SRES) from the RET (and have this amount uncapped) has resulted in SRES costs for 2012 adding a nearly 25% premium to wholesale electricity costs – this is in addition to the 10% premium applied to the wholesale price of electricity for the basic RET scheme.

The MEU's most recent submission on this issue (made to the Climate Change Authority) is currently unpublished by the CCA and a copy of the submission made is attached to this response.

Energy Savings and Carbon Abatement Initiatives are applied nationally and by State governments. Examples include the GGAS and ESS in NSW and VEET in Victoria. These add costs (transaction costs and direct costs) to the supply of energy used by consumers. Some schemes have been so badly developed that it would seem that they were introduced to meet political deadlines and objectives rather than be appropriately targeted initiatives.

For example, the Victorian Energy Efficiency Scheme (VEET) has added considerable costs to retail electricity and gas contracts to all electricity users. Until recently all users in Victoria were expected to fund the scheme, even those which were prevented from participating in the scheme from an energy efficiency perspective. Recent changes have exempted certain very large users of electricity from funding the scheme, which means that those not exempted will have to pay more.

The MEU's most recent submission on this issue of energy initiatives can be found at http://www.climatechange.gov.au/government/submissions/closed-

consultations/~/media/submissions/nesi/NESI-Submission-MajorEnergyUsers-20120228.pdf

Draft energy white paper (released by the Department of Resources Energy and Tourism) implies that Australia has relatively low electricity costs when measured on a world scale but implies that prices will rise in the future, especially gas which is being exported in ever increasing amounts with the result that domestic prices for gas will rise to world parity levels. As gas is currently the fuel of choice for power generation, this means that electricity prices will also rise as gas prices rise.

Australia has already lost its international competitiveness in electricity prices under the weight of poor energy policy development and regulatory arrangements. Coherent reforms are urgently required to reverse this strategic failure to maintain our historical competitive advantage.

The MEU responded to the earlier requests for input into the draft Energy White Paper and it's most recent submission on this issue can be found at http://www.ret.gov.au/energy/Documents/ewp/draft-ewp-2011/submissions/168.Major-Energy-Users-Inc.pdf

The MEU trusts that this submission assists the Committee in its deliberations.

Yours sincerely

Public Officer
Major Energy Users Inc