

15 April 2019

Mr Charles Millstead
CEO
Queensland Competition Authority
Level 27, 145 Ann Street
Brisbane QLD 4000

Lodged at: www.qca.org.au/submissions

Dear Mr Millstead

CANEGROWERS submission in response to QCA's DRAFT Regulated Retail Price Determination 2019-20

Thank you for the opportunity to make a submission in response to QCA's draft regulated retail electricity price determination for 2019-20.

Representing around 75 per cent of Australia's sugarcane growers, CANEGROWERS is the peak body for the sugarcane industry in Australia. The Queensland sugar industry relies heavily on irrigation. The cost of the electricity used in that task is threatening the international competitiveness of farmers in our industry and in other agricultural industries across the state. CANEGROWERS is also an active member of Queensland Farmers' Federation (QFF) and endorses the points raised in the QFF response to QCA's draft determination.

CANEGROWERS is concerned that QCA's methodology used in the DRAFT determination for assessing both retail and network costs results in regulated cost allowances that exceed actual costs. QCA's failure to call out the flawed methodology will result in regulated retail prices for regional Queensland that are inefficient and will retard regional Queensland's economic growth and development.

CANEGROWERS has sought the assistance of the Sapere Research Group (Sapere) in preparing this response. Sapere's report is attached.

Retail cost allowances

CANEGROWERS is concerned that the retail cost allowance methodology employed by QCA includes non-existent costs. Sapere write:

The market benchmark used by QCA incorporates non-existent costs reflected in NEM retail prices in markets that are no longer subject to price regulation, and where there is no effective market monitoring. There is evidence from a number of careful studies that retail prices significantly exceed efficient costs for the majority of electricity retail consumers, and that this is persisting for an extended duration rather than merely transitory.

In its Retail Electricity Pricing Inquiry, the ACCC also pointed to the ineffectiveness of competition to discipline retail prices when it reports the national Electricity Market (NEM) does not display the characteristics of a well-functioning market, such as low levels of concentration, low margins and price, and a large degree of price moderation. This led it make a number of recommendations directed at improving the operation of the retail market.

The best available data and the analysis conducted by the ACCC clearly shows that the data upon which the QCA bases its estimates of retail costs for regional Queensland is too high.

CANEGROWERS recommends, that taking account of account of the ACCC findings, QCA revise downwards its estimate of retail costs and retail cost allowance in its final determination.

Transitional tariffs

Energy Queensland has submitted incomplete network tariff proposals to the Australian Energy Regulator (AER) for the 2020-25 regulatory period for its Ergon and Energex networks. CANEGROWERS has been closely involved in the customer consultation phase of this project. We look forward to receiving Energy Queensland's detail tariff structure statement for evaluation and repeat our concern that it is premature to class transitional tariffs as obsolete until the final tariff structures are known.

Despite the lack of detail for the next regulatory period, during the course of the customer consultation process it became clear that several projects for which Energy Queensland received regulatory approval and included in its network cost build up or the current regulatory period charge customers have not been delivered.

This means the allowed costs QCA has included in the cost stack for the Ergon Network during the current regulatory period amount to charges for services and activities that have not and will not be delivered. One consequence, of QCA's present approach to setting regulated retail prices is that the so-called non-cost reflective, irrigation electricity tariffs in Queensland have risen by more than 136 per cent over the past decade compared with a 24 per cent increase in the consumer price index (CPI) over the same period.

In our initial submission to the draft determination CANEGROWERS expressed concern that QCA has not demonstrated that the so-called transitional tariffs are set at levels that do not more than cover the actual costs of delivering electricity to agricultural producers. The analysis prepared by Sapere based on information provided by Energy Queensland indicates that transitional tariffs are more likely to reflect the actual costs of supplying electricity than the replacement standard business tariffs. Therefore, phasing out of legacy tariffs would be in breach of Section 90 (5) of the Electricity Act 1994 (Queensland).

The analysis contained in QCA's draft determination shows the majority (more than 50 per cent) of those on tariffs 62, 65 and 66 would be worse off by a move to standard business tariffs. This assessment is supported by the experience of those irrigators who participated in Energy Queensland's trial of a seasonal time of use tariff (T24) for the agricultural sector. In this trial customers on transitional tariffs (T62, 65, 66) a group of customers switched from their current transitional tariff to being billed under tariff 24 to assist both the agricultural producers and Energy Queensland understand the cost impacts moving to this new tariff. In this trial, almost without exception, the agricultural producers were found to be worse off when charged under T24 compared with the irrigation tariff.

The prices of transitional tariffs more than cover the cost of delivering electricity to agricultural producers. CANEGROWERS urges QCA to review its analysis of these tariffs and recommend their continuation.

Modern efficient network tariffs should reflect the fact that the long run marginal cost of supplying electricity to users, including irrigators, on non-congested parts of the network are very low. Modern network tariffs would support base load and off-peak (infra-marginal) use profiles, including worthwhile time-of-use incentives, encouraging users to switch their usage to off-peak periods and over the weekend. It is premature to label the present transitional tariffs as obsolete and current retail tariffs should remain available until Energy Queensland's Regulatory Proposal and Tariff Structure Statements 2020-25 is approved by the AER.

Conclusion

QCA's methodology used in the DRAFT determination for assessing both retail and network costs results in regulated cost allowances that exceed actual costs. QCA's failure to call out the flawed methodology will result in regulated retail prices for regional Queensland that are inefficient and will retard regional Queensland's economic growth and development.

In accordance with provisions of the Electricity Act 1994 (Queensland), CANEGROWERS calls on the QCA to determine efficient retail prices for Energy Queensland's Ergon Network that reflect the actual costs of prudently and efficiently supplying electricity in the state's regional areas.

We look forward to discussing this submission with your team. In the meantime, please do not hesitate to contact Warren Males, CANEGROWERS Head-Economics for further information.

Yours sincerely

A handwritten signature in black ink, appearing to read 'D. Galligan', written in a cursive style.

Dan Galligan
Chief Executive Officer

Encl.

Report for CANEGROWERS

Comments on Queensland Competition Authority Draft Determination for Queensland regional electricity prices

Simon Orme, James Swansson

April 2019



About Sapere Research Group Limited

Sapere Research Group is one of the largest expert consulting firms in Australasia and a leader in provision of independent economic, forensic accounting and public policy services. Sapere provides independent expert testimony, strategic advisory services, data analytics and other advice to Australasia's private sector corporate clients, major law firms, government agencies, and regulatory bodies.

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Contents

| | |
|---------------------------------------------------------------|-----------|
| Executive summary | v |
| 1. Introduction | 7 |
| 2. Estimation of retailer costs | 8 |
| 2.1 QCA proposal | 8 |
| 2.2 Is the QCA proposal consistent with its Act? | 8 |
| 2.3 Available empirical analysis | 8 |
| 3. Are legacy irrigator tariffs cross subsidised?..... | 10 |
| 3.1 Assertion there is a cross subsidy | 10 |
| 3.2 Empirical analysis..... | 11 |
| 3.3 The network tariff problem | 14 |

Tables

| | |
|-----------------------------------------------------------------|----|
| Table 1 Comparison of volume weighted average spot market costs | 12 |
| Table 2 Ergon SAC STOUND peak prices | 15 |

Figures

| | |
|-------------------------------------------------------|----|
| Figure 1 Illustration from QCA Factsheet | 10 |
| Figure 2 Demand duration curve- Queensland canegrower | 13 |
| Figure 3 Monthly demand network tariffs | 14 |

Executive summary

Introduction

The authors have been retained by CANEGROWERS to provide expert advice on the Queensland Competition Authority Draft Determination Regulated retail electricity prices for 2019-20 (regional Queensland), dated February 2019.

This memo provides data and analysis in support of evidence-based submissions from CANEGROWERS to the QCA Draft Determination dated February 2019, on the following two matters.

- The use of existing retail cost estimates to set allowed retailer costs; and
- The evidence for the assertion that legacy retail tariffs incorporate an ‘obsolete subsidy’ from other customers.

Estimation of retailer costs

The best available data and analysis conducted, both by us in 2016 and more recently by the ACCC, clearly show that the retail cost methodology the QCA proposes for its estimates of retail costs for regional Queensland is unsound. This is because it includes non-existent costs.

Inclusion of non-existent costs in regulated retail prices in a Final 2019 Retail Price Determination would appear to be inconsistent with the relevant statutory criteria under which QCA is required to set prices. These criteria are set out under Section 90 (5) of the Electricity Act 1994 (Queensland). These include, among other things, reference to the ‘*actual cost of making, producing or supplying the goods and services*’ (emphasis added).

Are legacy irrigator tariffs cross subsidised?

Most CANEGROWERS members remain on transitional tariffs (i.e. tariffs 20 (large), 21, 22 (small and large), 37, 47, 48, 62, 65 and 66). A Fact Sheet accompanying the Draft Determination states that: ‘for some customers on transitional and obsolete tariffs, particularly those with high usage levels, their electricity costs are subsidised to a greater extent than other regional business customers.’

The best available empirical data, alongside analysis of relevant wholesale and network costs, support a finding that existing legacy tariffs are more cost reflective than the proposed replacements. The assertion legacy tariffs are subsidised by other customers does not appear to have any empirical basis and appears to be false.

1. Introduction

The authors have been retained by CANEGROWERS to provide expert advice on the Queensland Competition Authority Draft Determination Regulated retail electricity prices for 2019-20 (regional Queensland), dated February 2019.

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- The use of existing retail cost estimates to set allowed retailer costs; and
- The evidence for the assertion that legacy retail tariffs incorporate an ‘obsolete subsidy’ from other customers.

2. Estimation of retailer costs

2.1 QCA proposal

In its Draft Determination the QCA proposes to apply its existing retail cost allowances.¹ The QCA's existing retail cost allowances can be traced back to benchmarking analysis undertaken by ACIL-ALLEN in 2015/16.²

The methodology for the benchmarking analysis inferred retail costs by deducting a series of non-retail costs from market retail price observations for business and small business customers.³ The key assumption is that the resulting retailer residual reflects retailer costs (both retail operating cost and retailer operating margin). In other words, the benchmarking assumed that in the retail markets covered (nine electricity distribution areas) competition was effective in constraining prices to no more than efficient cost, including retailer costs.

2.2 Is the QCA proposal consistent with its Act?

The best available data and analysis conducted, both by us in 2016 and more recently by the ACCC, clearly show that the retail cost methodology the QCA proposes for its estimates of retail costs for regional Queensland is unsound. This is because it includes non-existent costs.

Inclusion of non-existent costs in regulated retail prices in a Final 2019 Retail Price Determination would appear to be inconsistent with the relevant statutory criteria under which QCA is required to set prices. These criteria are set out under Section 90 (5) of the Electricity Act 1994 (Queensland). These include, among other things, reference to the '**actual** cost of making, producing or supplying the goods and services' (emphasis added).

2.3 Available empirical analysis

As noted in a report for CANEGROWERS prepared by Sapere and part-funded by Energy Consumers Australia, the benchmark data used by the QCA includes non-existent costs.⁴

The methodology does not provide a basis for estimating efficient retailer costs under conditions where a large portion of observed electricity prices incorporate substantial "residues", or excess margins, over and above efficient retail costs. It amounts to incorporating non-existent costs in notified prices.

¹ See page 41 of the Draft Determination.

² See page 29-30 QCA's Final Determination Regulated electricity prices for 2016-17 dated May 2016.

³ See chapter 3 of ACIL ALLEN's methodology paper: Estimating Efficient Retail Operating Costs and Margin, dated 2 December 2016.

⁴ See page 6, Quantification of excess costs in QCA draft electricity retail price determination for 2016-17, dated 30 May 2016.

The market benchmark used by QCA incorporates non-existent costs reflected in NEM retail prices in markets that are no longer subject to price regulation, and where there is no effective market monitoring. There is evidence from a number of careful studies that retail prices significantly exceed efficient costs for the majority of electricity retail consumers, and that this is persisting for an extended duration rather than merely transitory.

The concerns set out in our 2016 report regarding the effectiveness of retail competition to constrain retail prices have been accepted in Part 3 of the ACCC's Retail Electricity Pricing Inquiry (REPI). Among other things, the REPI states that:

... there is a contrasting view, that price dispersion only reflects information asymmetry and search costs. The NEM does not display other characteristics of a well-functioning market, such as low levels of concentration, low margins and price, and a large degree of price moderation.

The REPI makes a series of recommendations to address retail prices that incorporate non-existent costs. These include among other things: the establishment of a default offer (recommendation 30); the application of the consumer data right (recommendation 31), better disclosure around discounting (recommendation 32), improvements to retail price monitoring (recommendation 40).

Inclusion of non-existent costs in regulated retail prices in a Final 2019 Retail Price Determination would appear to be inconsistent with the relevant statutory criteria under which QCA is required to set prices. These criteria are set out under Section 90 (5) of the Electricity Act 1994 (Queensland). These include, among other things, reference to the '**actual** cost of making, producing or supplying the goods and services' (emphasis added).

A final decision by QCA to set notified prices well in excess of efficient costs would be inconsistent with Section 3 of the Act, which states that the objects of the Act are to '*ensure that the interests of customers are protected*' and to '*set a framework for all electricity industry participants that promotes efficient, economical, and environmentally sound electricity supply and use.*'

Accordingly, we suggest the Final Determination needs to revise downward the current allowance for retailer costs. We consider that the methodology applied before the adoption of the benchmarking methodology was more closely aligned with efficient costs.

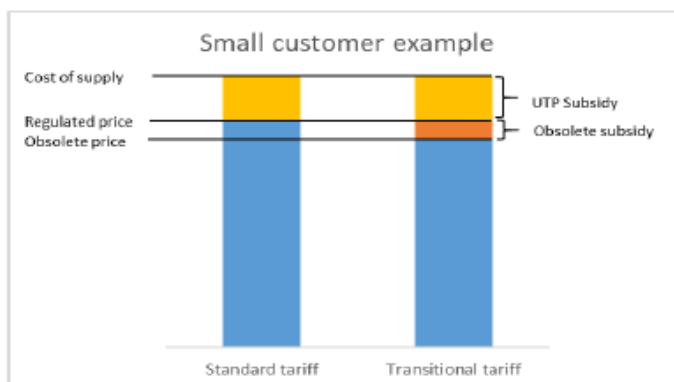
Even this treatment errs on the side of being generous because it includes "headroom" for competition. It also ignores the substantial cost reductions for the major retailers arising from dual fuel retailing (gas and electricity). Most gas consumers use the same retailer for electricity, thereby avoiding customer information system and billing costs for dual fuel retailers. The previous estimates could be rolled forward using the same CPI adjustment methodology proposed in the Draft Determination.

3. Are legacy irrigator tariffs cross subsidised?

3.1 Assertion there is a cross subsidy

Most CANEGROWERS members remain on transitional tariffs (i.e. tariffs 20 (large), 21, 22 (small and large), 37, 47, 48, 62, 65 and 66). A Fact Sheet accompanying the Draft Determination states that: ‘for some customers on transitional and obsolete tariffs, particularly those with high usage levels, their electricity costs are subsidised to a greater extent than other regional business customers. The illustration contained in the fact sheet is copied below.

Figure 1 Illustration from QCA Factsheet



Source: QCA

The basis for this claim is not set out in the Draft Determination. It appears to be based on the 2016 Queensland Productivity Electricity Pricing Inquiry. The Final Report of that enquiry states that:⁵

Transitional and obsolete tariffs are tariffs that, for a range of historical reasons, are set at levels not based on the actual costs of supplying electricity, even with the UTP suppressing prices for regional Queensland. In 2009, the QCA identified that a suite of historic regulated retail tariffs did not send efficient price signals to customers regarding the underlying costs of their electricity use.

No information is provided to support the claim that there is a subsidy in favour of irrigators – any evidence may be more than a decade old. There is no evidence to support the QCA claim that the transitional tariffs do not more than cover the costs of supplying electricity under those tariffs. Indeed, the best available evidence strongly suggests the claim is false and that there is no material subsidy in favour of irrigators. Instead, legacy tariffs are more likely to be reflective of the actual costs of supplying electricity than the replacement

⁵ See page 255 of the QPC report.

standard business tariffs. Therefore, phasing out of legacy tariffs would be in breach of Section 90 (5) of the Electricity Act 1994 (Queensland).

3.2 Empirical analysis

The best available empirical data, alongside analysis of relevant wholesale and network costs, support a finding that existing legacy tariffs are more cost reflective than the proposed replacements. The assertion legacy tariffs are subsidised by other customers does not appear to have any empirical basis and appears to be false.

A report prepared by Sapere for the Agricultural Industries Energy Taskforce in 2018⁶, co-funded by Energy Consumers Australia, assesses among other things the extent to which retail prices for irrigators diverge from efficient costs. A key conclusion is that irrigation demands in Queensland and elsewhere have a materially lower cost to supply compared with typical small business demand profiles of the same total volume of consumption. That is, these differences are directly attributable to consumption behaviour.

This conclusion is based on responses by irrigators to a survey along with an analysis of interval data obtained from Energy Queensland for its Ergon network together with other distributors. This interval data, such as for an Ergon customer in Figure 2 below, is compared with publicly available system interval data commonly utilised as proxies for typical customer load profiles.

Total demand by State is indicative of the entire system demand including both the mass market of small customers together with very large commercial/industrial consumers. Hence it is not indicative of the demand profiles of the mass market small customer segment.

The net system load profile (NSLP) for each network area is produced by AEMO as the basis for wholesale market settlement of small residential and business customers with accumulation metering (small as opposed to a car factory or aluminium smelter) – it can be thought of as the aggregate demand of these customers, or de facto the ‘typical’ demand for this class. The NSLP is also the demand shape used for general small business tariffs which will replace legacy irrigator tariffs.

The key result from this analysis is provided in Table 1 below. The volume weighted average (VWA) wholesale electricity costs of individual irrigation demand profiles is compared with the VWA costs of the system demand profiles represented by the deemed profile for small customers in each network area. This comparison clearly demonstrates the reduced wholesale cost (using half hourly wholesale price data for the relevant periods) of supplying different irrigation profiles compared with supplying electricity under the relevant deemed demand profile.

⁶ See *Empowering irrigation consumers electricity purchase arrangements, Research reporting*, dated July 2018.

Table 1 Comparison of volume weighted average spot market costs

Individual irrigation demand prices are compared with contiguous deemed prices (\$/MWh).

| DNISP | Crop | Irrigation profile | Deemed profile | Irrigation/ deemed profile |
|----------|----------------|--------------------|----------------|-------------------------------|
| Ergon | Sugarcane | \$48.06 | \$107.83 | 59% |
| SAPN | Fruit and nuts | \$82.51 | \$134.95 | 64% |
| Powercor | Lucerne 1 | \$68.84 | \$82.60 | 83% |
| Powercor | Lucerne 2 | \$63.07 | \$82.60 | 76% |
| Powercor | Tomato | \$58.32 | \$82.60 | 71% |
| Powercor | Cotton | \$49.57 | \$82.60 | 60% |
| Powercor | Tomato | \$56.11 | \$82.60 | 68% |
| Powercor | Cotton-Lucerne | \$60.85 | \$82.60 | 74% |
| Powercor | Cotton | \$50.49 | \$82.60 | 61% |

Source: Sapere analysis of AEMO market price and individual customer profiles from Ergon and other distributors.

The unitised wholesale energy cost of the various irrigation profiles (IPs) is between 59 and 83 per cent of the deemed profile (NSLP) cost. This is a conservative measure of the risk adjusted difference in the wholesale cost of supply (see column 5 in Table 1 above) applying IPs relative to NSLPs, after taking into account forward wholesale trading risk.

This means that retail prices set on the basis of deemed small customer profiles over-compensate retailers, allowing them to cross-subsidise other customers by a substantial amount. Given the typically medium to high electricity volumes used for irrigation, the cross-subsidy portions of total annual irrigator bills are likely to be very substantial.

The reduced cost of the network component of retail prices for the irrigator profiles is difficult to quantify. This is largely because current network tariff structures for Ergon do not reflect the efficient long run marginal cost (LRMC) of supply.

Periods of network congestion and high supply costs do not align perfectly with wholesale congestion and high supply prices. Nevertheless, the highest network and wholesale supply costs are strongly related to periods of very high demand. Depending on the network tariff structure, the indicated unit price premiums for wholesale costs shown above are a useful indicator of the possible price premium contained in network charges.

Together, wholesale and network costs are by far the largest component of total retail supply costs and prices. If these delivered supply costs were 80 per cent of the total retail bill, and if delivered supply costs for an irrigator profile was 75 per cent of that for the relevant deemed

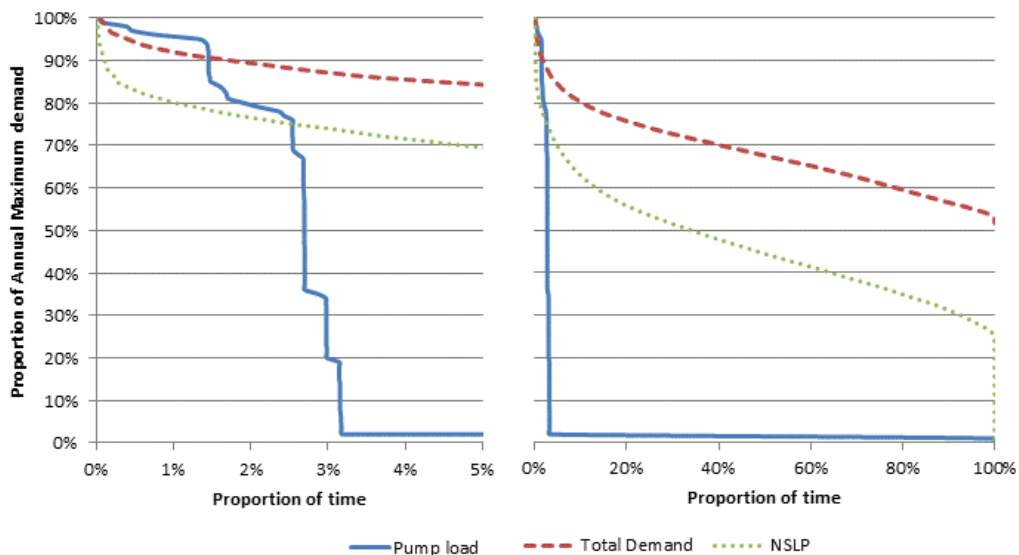
profile, then the retail price would be around 20 per cent or one fifth higher than the efficient retail cost.

This outcome reflects the following.

- There is no evidence to suggest that irrigation demand is high let alone increases during extreme heatwaves, when maximum annual demand and very high-power supply costs are most likely.
- It appears unlikely pumps are running at full capacity at times of peak system demand. Across states and different types of primary produce, use of pumps predominantly coincides with times when system demand is at just 30-55 per cent of system annual maximum demand.
- Seasonal irrigation demand peaks in late spring (Queensland) or early summer (elsewhere) reflect rainfall variations between regions. Irrigation demand peaks are not driven by very high temperatures.
- While about 45 per cent of irrigation equipment operates continuously over a day, other equipment is operated predominantly overnight and at a minimum during afternoons (at the mostly likely time of day of system peaks).
- Pump demand profiles are demonstrated by interval data generally to be ‘flat’: that is when pumps are being used, demand is at/above 90 per cent the pump’s maximum demand.

These features for individual customers are demonstrated in Figure 2 below and Figure 3, showing the NSLP, representing the typical profile of small customers, compared with total demand and a representative irrigation load.

Figure 2 Demand duration curve- Queensland canegrower



1. LH chart focuses on the first 5 per cent of the full LDC shown in RH chart.

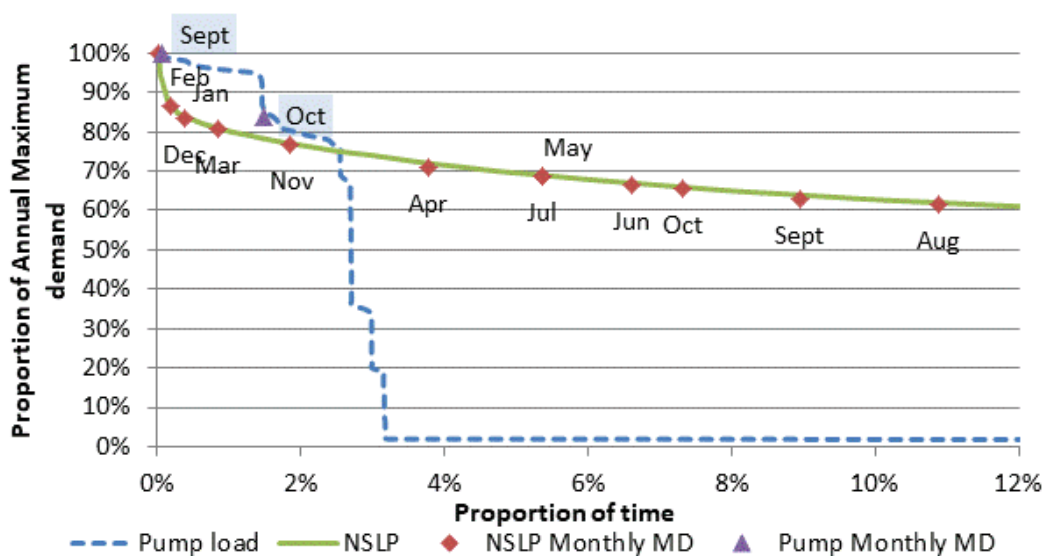
Source: AEMO market and individual demand profile data

Significantly, the deemed small customer profile is peakier than total demand – the top 20 per cent of this mass market of small customers has a duration of just about 90 hours, or

about one per cent of the year. So, the associated costs for small customers are going to be more extreme (and priced into those tariffs).

Figure 3 below modifies Figure 2 above to label the demand duration curves at the maximum demand in each month. For small customer connections, coincident demand on the relevant part of the distribution network is represented by the NSLP. This illustrates that demand approaching the greatest utilisation of the network occur in summer months. A customer's own demand in other months, while perhaps varying significantly from this population average, can have little bearing on network utilisation.

Figure 3 Monthly demand network tariffs



Source: AEMO market and individual demand profile data

The figure above labels the maximum demand in each month of the irrigator demand. In this instance the pump demand occurs only in September and October, months in which the NSLP does not exceed 70 per cent AMD. During peak months for network utilisation this pump demand is virtually zero.

3.3 The network tariff problem

The QCA is no longer responsible for the setting of regulated network tariffs. Nevertheless, the “N” component of retail prices is relevant in considering whether there is a cross subsidy in favour of irrigators, as asserted.

The NEM is in the process of network pricing reform, intended to evolve network businesses and consumers away from predominantly ‘flat’ volumetric tariff structures to structures that reflect the spatial and temporal variation in network costs to consumers. The design principle of network pricing reform is that an element of the tariff sends the consumer a signal about the long run marginal cost (LRMC) of augmenting network infrastructure to meet additional demand. In the words of the National Electricity Rules, the LRMC tariff must have regard to:

the additional costs likely to be associated with meeting demand from retail customers that are assigned to that tariff at times of greatest utilisation of the relevant part of the distribution network; (Clause 6.18.5(f)(2))

In the first round of tariff structure reforms most distribution providers have advocated for and had approved “monthly maximum demand” tariffs as a step along the cost reflective spectrum. Monthly maximum demand tariffs include this LRM element as a price per unit demand (kW) for a *customer’s own maximum demand* in each month. This may be modified seasonally – Ergon’s Seasonal Time of Use Demand (STOUD) tariff features a peak rate in December – February, illustrated in the Table below.

Table 2 Ergon SAC STOUD peak prices

| Element | Unit | Off-peak | Peak | Premium | Premium % |
|---------|-----------|----------|---------|---------|-----------|
| Demand | \$/kW/mth | 10 | 97.088 | 87.088 | 871% |
| Usage | \$/kWh | 0.02375 | 0.02375 | 0 | 0% |

Source Ergon 2018-19 Pricing proposal, Attachment-1-2018-19-Network-Tariff-Tables

These tariff structures have been approved and implemented even though they appear to be in breach of the National Electricity Law.⁷ The problem arises from time of use energy or demand tariffs with very broad peak price charging windows.

The proportion of the year where premium peak prices are applied vastly exceeds the proportion of the time during which total demand across the system is close to its annual maximum. These tariff structures result in excessive charges for irrigators to the extent their energy or maximum demand is significant during periods of medium system demand – for example afternoons and early evenings from 1 December to 28 February. In some distribution areas, maximum demand tariffs are even applied outside the summer months.

Remaining on a flat tariff may also be problematic. This is because networks are being encouraged by regulators to impose a penalty on flat tariffs, in order to encourage retailers and consumers to switch to time of use tariffs. For many, time of use tariffs will result in lower network charges. To ensure allowed total revenue is recovered, these lower charges need to be compensated by higher charges on other customers, including those remaining on flat tariffs.

The fundamental problem with network tariff reform is that it is applying congestion pricing – essentially charging for future network capacity augmentations in current network bills – in the absence of congestion almost everywhere in the NEM outside Victoria. In addition to the problem of charging windows being set incorrectly, this situation has arisen because the threshold for applying congestion prices has been set relative to a proportion of maximum system demand instead of at the point where incremental demand triggers a requirement for augmentation. In reality, there is no forecast congestion at least to 2026 in either the Ergon or Energex networks.

In the small number of areas where congestion is a risk, this congestion is a result of new connections (e.g. coal seam gas related connection in regional Queensland or NSW), not

⁷ See http://www.canegrowers.com.au/icms_docs/280686_canegrowers-sapere-electricity-report.pdf

existing connections. Under the relevant regulations, the augmentation cost arising from these new connections should not be borne by existing customers via standard control network tariffs.