

Committee Secretary
Senate Standing Committees on Environment and Communications
PO Box 6100
Parliament House
Canberra ACT 2600
ec.sen@aph.gov.au

5 December 2014

Dear Secretary,

Bell Bay Aluminium (BBA) welcomes the opportunity to make a submission to the Senate Standing Committee on Environment and Communications regarding “The manner in which electricity network companies have presented information to the Australian Energy Regulator (AER) and whether they have misled the AER” (the Inquiry). As Tasmania’s largest electricity consumer for almost 60 years, the cost of transmission is of paramount importance to the existence of BBA.

BBA directly and indirectly employs more than 1500 Tasmanians and contributes \$690M per annum to Tasmania’s Gross State Product. It was the first aluminium smelter built in the Southern Hemisphere, commencing production in 1955 as a joint venture between the Commonwealth and Tasmanian Governments, attracted by the availability of competitively priced electricity used in the smelting process. We are a major stakeholder in Tasmania and the Tasmanian electricity market, with power contracts to 2025 and a maximum demand of 325 Megawatts. As Tasmania’s largest electricity consumer, the Bell Bay smelter consumes more than 25% of the State’s electricity demand.

Since the Global Financial Crisis (GFC), the Australian aluminium industry has faced unprecedented challenges to its viability from depressed aluminium prices and the continued strength of the Australian dollar resulting in the closure of NSW and Victorian smelting operations. The aluminium price today in Australian dollar terms is more than 20 percent lower than it was during the GFC and 40 percent lower than the long-term average. Over the same period, the delivered price of electricity in Tasmania has increased markedly. In particular, charges associated with transmission services and the Federal Renewable Energy Target (RET) have both increased by more than 200% for BBA in the last 5 years.

The 200% increase in transmission network charges over the last five years has crippled investment by the small number of major industrial users in Tasmania, undermining and threatening not only the viability of those businesses, but also that of the Network businesses which rely on revenues from these industrials to fund their activities. Urgent and significant intervention is required to ensure the overall delivered energy cost is reduced which in return will restore business confidence.

In response to the impacts of external forces including RET, transmission, freight costs and depressed market conditions, BBA employees have worked tirelessly to deliver millions of dollars in cost savings and business improvements from across all parts of our business in areas such as capital expenditure, maintenance, raw materials, workforce numbers (20% reduction since 2011) and productivity to remain viable. BBA has limited ways in which costs can be further reduced. The continuation of high costs for RET, transmission and freight can only be offset by further reducing the workforce and capital expenditure, a negative impact on the long term viability of BBA. The creation of TasNetworks was intended to provide benefits to all consumers but note that the \$8million of savings to date in our experience is insignificant when compared with the 200% increase in transmission changes over the last five years.

Specific comments on the terms of reference for the Inquiry are included in this submission. No part of this submission is confidential. BBA is not in a position to and does not in the following comments provided in this submission, imply or suggest in any way that the electricity network companies have misled the AER. BBA looks forward to continuing dialogue with the Senate Committee.

Regards

Ray Mostogl
General Manager, Bell Bay Aluminum

Terms of reference:

(a) the manner in which electricity network companies have presented information to the Australian Energy Regulator (AER), and whether they have misled the AER in relation to:

BBA is not in a position to and does not in the following comments provided in this submission, imply or suggest in any way that the electricity network companies have misled the AER. BBA has however, commented on its experience as a major consumer of electricity in Tasmania and much of the commentary relating to TasNetworks recent (2014) revenue proposal submitted to the AER.

(i) their weighted average costs of capital,

Within the Networks Regulations, the meteoric rise in transmission charges has been largely attributed to overspending leading to the expansion of the Regulated Asset Base (RAB) and then the Weighted Average Cost of Capital (WACC) over-compensating the State owned providers of monopoly network services for the risk they are genuinely taking. Changes to regulations which address the over investment (including recognition of stranded assets and associated impairments) and the inappropriate treatment of the investment risk would go a long way to reversing the increased network charges which have been borne by consumers, in particular the small number of major industrial consumers in Tasmania. Arguably, this has also penalised the electricity industry by effectively incentivising consumers to avoid high prices by switching to other forms of generation, thereby affecting the capability of the network. The current regulations and the way in which TasNetworks chooses to operate within them, if unchanged, will potentially lead to a “death spiral”. Lost charges are recouped by charging existing consumers more, making more businesses unviable and driving further switching to reduce network use thereby increasing the “death spiral”, and so on.

While TasNetworks recently proposed a WACC of 7.58% in their revenue proposal which is a lesser amount than allowed by the AER, BBA considers this should be further reduced. For example the Market Risk Premium (MRP) which is currently set at 6.5%; could be reduced to 6% and the equity beta, currently at 0.7, could be lower noting that the “AER Better Regulation: Rate of return Guideline”, indicates that 6% is more appropriate for MRP and the equity beta has a range of 0.4 to 0.7.

(ii) the necessity for the infrastructure proposed,

BBA acknowledges the work TasNetworks has recently completed to reduce its Capex by 52% and Opex by 12% for future revenue periods. However, this reduction has not translated into lower transmission charges from its current base. As the majority of the proposed Capex program is simply classified as replacement work, it is unclear whether the level of Capex of \$275.9M is above the minimum required and whether some of this should be deferred to the next revenue period.

Additionally, a reduction in Opex of 12% is out of step with the six-fold increase in employees justified to support the capital expansion which occurred between 2008 - 2012. BBA considers that 50% reduction in capital expenditure should translate into a similar significant reduction in Opex expenditure to support the reduced program.

(iii) their regulated asset valuations, and

TasNetworks has 49 substations, seven switching stations and 11,176 hectares of easements. TasNetworks have proposed an escalation factor of between 4.7% and 5.1% for land based on structural adjustment occurring in mainland rural water allocations and the trend towards increased

foreign investment. We query whether comparing prices paid by foreign investors for Tasmanian agricultural holdings is an appropriate comparison point for the significantly smaller parcels of land used for electricity infrastructure with limited scope for alternate use.

(iv) actual interest rates claimed against actual borrowing costs;

There is no transparency for consumers in terms of being able to compare actual borrowing rates with interest rates claimed. Consumers should be entitled to know what additional revenue is delivered by this method to TasNetworks and in turn the State of Tasmania as its owner.

(b) how electricity companies, including state government owned electricity companies such as Energex, have calculated the weighted average cost of capital and how this measure has changed over time;

The WACC is determined by the guidelines provided by the AER. It has been acknowledged that TasNetworks has proposed a WACC less than that approved by the AER; however we do not understand why the AER is not setting the WACC at the minimum level in the first instance. The WACC has reduced over the revenue reset periods, but only due to pressure from users of the system. The current pricing method's reliance on a WACC and fixed recovery amounts over the term of the revenue period is disconnected from a recovery method which should be dynamic and move in line with market trends which reflects the reality being faced by consumers.

(c) where anomalies are identified in relation to price structuring or allegations of price rorting by electricity companies, such as Energex, are raised, the possibility of these matters being investigated by a national independent body created by the Federal Government with the required powers and reach to investigate and prosecute, where necessary;

Bell Bay has no comment on this issue

(d) to ascertain whether state-owned network companies have prioritised their focus on future privatisation proceeds above the interests of energy users;

We are not in a position to comment on this but note that the fragility of Tasmania where only a small number of industrial customers consume a large proportion of the State's energy, it is imperative that TasNetworks and its owner focus on finding the right balance between service delivery, reliability and cost in order to minimise the risk of losing one of the State's major users which under a regulatory regime of seeking a full cost recovery from remaining consumers, has the real potential to kick off a "death spiral" for TasNetworks as noted earlier in our commentary.

(e) whether the arrangements for the regulation of the cost of capital are delivering allowed rates of return above the actual cost of capital;

In line with earlier comments, the AER should set WACC at a minimum level and there should be transparency on interest rates to ensure network companies and their owners are not leveraging additional revenues.

(f) whether the AER has actively pursued lowest-cost outcomes for energy consumers;

We are not in a position to comment on whether the AER has actively pursued this but do note in terms of outcomes for Tasmania, this has proven not to be the case as the regulatory process has seen the DNSP and TNSPs prior revenue reset proposals approved, provided they fit within the

published guidelines. In our view, the AER should set the minimum only for recoveries and pass the benefits on to the consumer in the form of lower delivered electricity pricing.

(g) whether network monopolies should have the right to recover historic overspending that has delivered unwanted and unused infrastructure;

This should not be allowed. However we understand it is allowed under the Rules and as such, the Rules should be changed. Stranded assets should be dealt with by writing off the cost or parking the cost until the asset is required. This way the RAB will be lower and reflect market energy demands. In non regulated industries, if a poor investment decision is made, there is little scope to force consumers to pay charges to cover the cost of such investment. In this sense, the risk of a poor investment decision is borne by the business. We fail to understand why monopoly network providers should not be in the same position. BBA has concerns that rewarding poor decision making and infrastructure investment with a guaranteed return does not drive accountable and judicious decision making in determining capital investment decisions.

The system currently provides perverse incentives in that State Governments (via Federal bodies) can request a higher level of reliability, the State owned TSNP then submits a capital plan to achieve the requested reliability, the new equipment is installed, and the RAB increases thereby increasing the economic return to the owner (the State Government).

For example, TasNetwork's (formerly Transend) profitability has improved considerably such that it is currently delivering benefits to the Tasmanian Government of more than 30% of sales revenue. This is a remarkable level of profitability for a regulated utility with low levels of demand or cost risk. This is as a result of a number of factors including:

- Transend's "asset age" data shows a weighted average remaining life of 22 years in 2009. Three years later the average asset age was 29 years. Achieving this level of average asset life extension has been on the back of significant capital expenditure, particularly in transmission lines and cables.
- The AER's regulatory determination for Transend envisaged peak annual demand in 2012 of 2,100 MW; whereas actual peak demand was 1,591MW (24% lower). The fixed five year time frame for revenue recovery meant that the GFC and other significant global market impacts which was immediately reflected in a down turn in demand, was not reflected in an equally significant down scaling of transmission charges.
- The "true" cost of borrowings are closer to 5%, even though 10% was used in determining the charges for the last revenue period. Transend's income was boosted by \$30M per year just on this feature alone.

(h) how the regulatory structure and system could be improved;

The regulatory framework applicable to Tasmania and the National Electricity Market (NEM) more broadly, has seen businesses and consumers face year on year cost increases in Tasmania in the order of 200% over the last five years. These cost increases provide a negative incentive for Tasmanian businesses and consumers, at a time when business in particular, can least afford it. Put simply, the balance has been lost and is well past the point of being sustainable and as a consequence of the network businesses and their owners leveraging the regulations to create profit centres funded by consumers, consumers are not seeing a cost effective service.

In this context, material changes to the regulatory frameworks need serious consideration, to reform a process which is currently misaligned to the more immediate needs and interests of Tasmania's businesses and consumers. As such, it is important to note that while the regulatory frameworks applicable to regulated transmission and distribution businesses in the NEM set the maximum revenues those businesses are entitled to recover from their customers, there is no regulatory impediment to those businesses electing to recover less than the maximum approved revenues. Given the owner of the transmission and distribution business in Tasmania is the State Government, we consider there is also scope for the Tasmanian Government to ensure the right incentives for businesses and consumers are in place.

The Rules currently provide two potential regulatory pathways for providing reduced transmission charges:

- A prudent discount regulated pathway; and
- A viability discount for a customer in distress.

Where a TNSP supported a prudent discount and the TNSP sought to recover more than 70% of this discount via other customers, then it needs approval from the AER. If however, a TNSP does not want to recover more than 70% of this discount via other customers, then there is no requirement to approach the AER. Alternately, in our view, there is no impediment to the TNSP working through a commercial process to achieve the same result (again where they are not seeking to recover more than 70% of a discount from other customers).

Whilst the rules notionally provide for a Prudent Discount (Clause 6A.26), principle issues are that the TNSP is not obligated to progress an application nor to take those applications forward to the AER and only a TNSP can make a submission to the AER (not a customer). Again, this is an example of a perverse incentive which discourages the current implementation of the Rules from being effective and locks customers into a monopoly supplier, regardless of cost outcomes of viable alternatives.

(i) whether the arrangements for the connection and pricing of network services is discriminating against households and businesses that are involved in their own electricity production;

We are not in a position to comment on this point but note that the unsustainable cost increases faced by consumers over the last five years in particular, have incentivised households and businesses to be involved in their own electricity production. This signals that we have a serious issue when a user can supply its own load on a more cost effective basis than a connection to the grid. In addition, under the current regulatory regime, for each load lost, the regulated business is entitled to recover the lost revenue from the remaining customers, a situation which is detrimental to all Tasmanian business and consumers.

(j) whether the current system provides adequate oversight of electricity network companies; and

Rather than being an issue of oversight, the current regulatory arrangements have provided an environment where the owners of the regulated businesses have created profit centres at the expense of consumers, to well beyond the point of sustainability.

(k) any other related matter.

As an aluminium smelter, operating continuously 24 hours/ seven days a week, a secure and reliable electricity supply is important to BBA. However this requirement needs to be delivered in an efficient and cost effective manner. Excessive transmission charges, resulting from poor planning and excessive expenditure, are a serious threat to BBA's ability to remain competitive in the global market. TasNetworks is responsible for operating and managing the transmission system in a manner that is both prudent *and* efficient.

A key consideration in the area of reliability investment is who pays for what. While reliability of a central asset may be warranted for one consumer class or location, should the cost of the improvement be levied across all consumers?

There needs to be an appropriate balance between cost and risk and this has been lost.

There is no debate that aluminium smelting is highly reliant on a dependable supply of energy. Debate occurs when proposals to increase reliability are implemented which the consumer did not ask for and to manage risks in a “gold plated” manner. The case is even more questionable when system reliability has been shown to deteriorate after five years of “investment to improve reliability”. Reliability is a cost and risk proposition. The optimum is for the service provider and the consumer to agree on the business case, for the reliability improvement to be delivered in an efficient manner and finally for the predicted improvement to be demonstrated via system performance data. BBA welcomes all opportunities to consider trading cost for reliability but would prefer a mindset which says how can we achieve reliability for the lowest possible cost.