INCITEC LTD

SUBMISSION TO THE QUEEENSLAND COMPETITION AUTHORITY: DISTRIBUTION PRICING PRINCIPLES

By INCITEC

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1. INTRODUCTION

INCITEC welcomes the opportunity to provide views on the Network Pricing Principles Issues Paper prepared by the Queensland Competition Authority (QCA). The decisions taken by the QCA on the monopoly network services will have significant implications for the international and domestic competitiveness of major electricity consuming industries in this State.

As INCITEC has pointed out in an earlier submission[1] to the QCA, prevailing distribution charges in Queensland are now considerably higher than those applying in the other States. Estimates made by INCITEC suggests that Queensland distribution charges are at least 25% higher than the best of the other States, and probably higher when the Ergon charges are incorporated into the calculations.

We consider that the disparity makes it essential that the QCA ceases to adopt the preferred position of allowing "the prices established by the Minister…….. to apply to 30th June 2001." Instead, we propose that the new tariffs determined by the QCA under the current review should apply retrospectively as at 1st July 2000. Queensland industry and other consumers should not have to bear unreasonably high tariffs for a further year before they can be reduced to levels comparable to those applying in the other States. Our view is that the QCA's review and the proper application of network pricing principles (such as those adopted by Regulators in NSW and Victoria) would result in a substantial reduction in network prices in Queensland, and help to restore the relative competitiveness of Queensland industry.

2. NETWORK TARIFFS IN QUEENSLAND

The QCA's Issues Paper correctly points out that the only network charges applicable to generators are 'shallow' connection charges. This is contrary to the practice in Queensland prior to the advent of the National Electricity Market (NEM), when generators were charged 50% of the network charges – we believe that to be a much more logical and fair arrangement. Economic efficiency requires that beneficiaries (not end users alone) should contribute to the costs of networks, and this principle has been strongly endorsed by the National Electricity Code Administrator (NECA) in its Transmission and Distribution Network Pricing Review. NECA has moved away from a position of generators bearing little or no network charges (at least for new generators) and there is strong support from most markets participants that the principle should also apply to existing generators. The ACCC is due to issue its draft decision on the proposed NECA code changes in the near future.

We consider that Queensland can set an example to the other jurisdictions by moving in a more economically efficient direction by requiring all generators to bear a fair share of network charges related to the marginal cost of delivering energy from their location to the major load centres.

[1] INCITEC: Submission To The Queensland Authority Electricity Distribution Price Review. July 2000.

3. NETWORK TARIFFS IN OTHER JURISDICTIONS

INCITEC would wish to point out that network pricing practices in all States (at least until very recently, as the Regulators in some States have sought to address the problems) are not 'cost reflective' by any means, and contain substantial hidden cross-subsidies. These cross-subsidies have been a major impediment to local generation (including self-production by industry, co-generation and renewable sources), and have constrained competition, thereby denying major electricity users sustainable lower prices.

We believe that it is far better to remove all impediments to competition, but where impractical to do so all subsidies should be made transparent (if political reasons dictate by applying uniform tariffs) and available to all customers irrespective of the source of their electricity supply.

The description in the Issues Paper of Victorian practices is, we believe, quite incomplete and does not mention the inherent cross-subsidies embedded in the distribution tariffs under the Victorian Tariff Order. These involved asset value adjustments of up to 21% and adjustments of as much as 42% in TUOS charges between city and country distributors. The Victorian Regulator-General has pointed out that[2]:-

> "Both these adjustment mechanisms have significant implications for the setting of cost reflective network prices. DBs serving the metropolitan areas which have had their asset values and transmission payments adjusted upwards would have to apply a higher than cost reflective network charge to recover the costs associated with these adjustments. DBs servicing the rural areas of the state (Powercor and Eastern Energy) would on average have network tariffs that are less than cost reflective since their asset values and transmission payments have been adjusted downwards.
>
> While the objective has been to maintain, in the medium term, a cross-subsidy between metropolitan and rural consumers by modifying asset values used in the determination of maximum tariffs and applying an equalisation adjustment in the calculation of transmission charges, a consequence may be that some commercial decisions may be distorted such that the most efficient outcomes from the community's perspective are not automatically chosen. As metropolitan electricity distributors are, in effect, taxed by the cross-subsidy arrangements, an issue arises of whether the metropolitan distribution companies may be at a competitive disadvantage in supplying metropolitan customers compared to rural distribution companies". (page 14)

[2] Office of the Regulator-General, Victoria. Powercor's Application For A Variation To Their Distribution Licence To Include The Docklands Area. Discussion Paper, July 2000.

INCITEC considers that the QCA has an opportunity in the current regulatory review to roll back cross-subsidies embedded in the Queensland distribution networks. Recent reviews by regulators in NSW and Victoria have resulted in more cost reflectivity in network charges, for example, by removing rate of return differentials between different distributors. Moreover, these regulators have sought to encourage distributors to apply more economically efficient network prices by requiring appropriate information disclosure and the adoption of more efficient pricing principles.

4. CODE USE OF COST REFLECTIVE TARIFFS

We would point out that the method for calculating tariffs under Part E of Chapter 6 of the Code is not 'cost reflective' and this has been acknowledged by NECA and other Regulators.

Whilst, there is general agreement amongst Regulators and stakeholders that the network pricing process as outlined in Part E is overly prescriptive and at times contradictory, the principles and objectives (e.g. prevention of monopoly rents and efficient and cost-effective regulatory environment) as contained in Attachment A of the Issues Paper are strongly supported, and should be the framework applied by the QCA in the current regulatory review.

However, INCITEC strongly recommends the adoption of a transparent tariff setting process which would enable major electricity users to have individual tariffs, and be able to determine to its own satisfaction that the cost is correctly determined. This would require the assessment of the appropriately allocated capital charges specific for the (sub transmission) assets actually utilised, and appropriately allocated operating costs relevant to these assets, and appropriately allocated other costs, thus on a truly cost reflective basis. There is no need for this approach to be applied for all customers, but major customers would require this approach. Recourse would be required to the regulator should the tariff be not acceptable to the user.

5. OBJECTIVES OF NETWORK PRICING

Major electricity using companies have established in the other States that the structure of network tariffs can have profoundly anti-competitive effects and can be used to inhibit third party generation developments and favour government-owned generating companies. As all Queensland generation (and distribution) companies are government-owned or controlled by contract, the anti-competitive implications should be closely considered by the QCA.

We have strong views concerning the QCA's statement:-

> "Since primary controls in the form of capping a DNSP's total or average revenues are aimed principally at preventing monopoly rent extraction……."(page 12)

Regulation to prevent monopoly rent extraction is strongly supported, but in practice certain minimum requirements are necessary.

We consider that any system of regulation which determines a revenue stream to service an initial capital base (which is inflated through the use of the DORC asset value methodology and forward looking) actually embeds monopoly rents in the network revenues. Likewise, awarding a regulated rate of return that is too generous, or a less than rigorous approach to the treatment of efficiency gains, or failure to properly optimise the network systems, would allow networks to capture monopoly rents. The problem (for users) are actually accentuated as replacement costs will include the impact of inflation, and (where there is little technological change) user charges based on replacement costs of sunk assets will mean that users are being required to service a capital base which greatly exceeds its actual historic costs.

For the QCA to prevent monopoly rents, it would need, at the very least, to adopt an initial capital base which is closer to historical costs rather than at the DORC level.

The pricing objectives envisaged by NECA (and listed on page 13) are insufficient. Allocative efficiency objectives would appear to have been ignored. INCITEC has previously pointed to the QCA in its July 2000 submission the links between 'allocative inefficiency' or 'deadweight loss' with the adoption of the DORC asset valuation methodology. Thus, a higher asset valuation will tend to reduce allocative efficiency and investments, whilst the use of the 'exit' valuation (scrap value or DAC) by the regulator is the starting point for the economically efficient operation of the network. It is worth recalling that a key objective of the National Competition Policy reforms is the establishment of competitive third party access regimes to encourage economic growth and employment generation. We consider the QCA should adopt the allocative efficiency objective as a top three priority ranking.

Another omission from the objectives list concerns transparency, in particular, transparency of cross-subsidies and identification of impediments to competition. We suggest that the Regulator must identify and make transparent all cross-subsidies. The Victorian Regulator-General has revealed the cross-subsidies inherent in the Victorian Tariff Order in its Discussion Paper on the Docklands Review, and the QCA is encouraged to provide similar information. Moreover, the QCA should make transparent the tax and dividend payments paid to Government by the monopoly networks over the past five years, to enable assessment (using those as an indicator) as to whether monopoly rents are being recovered by the monopoly networks.

INCITEC believes that one of the problems with the network pricing provisions of the Code is the emphasis given to theoretical economic efficiency over basic equity considerations. This has resulted in a preoccupation with locational signals. We consider that network prices should be as low as possible, consistent with allowing a reasonable return on reasonable asset values, simple and easy to understand, broadly reflective of costs, and fair and reasonable between generators and customers and from customer to customer.

6. EFFICIENT PRICING

The discussion on efficient pricing in regulated industries seems to be at odds with the practice in truly competitive industries. Whilst it recognises that economic efficiency requires the use of short-term marginal cost pricing, it then suggests that that would not get a sufficient return on sunk costs. It then goes on to suggest that sufficient revenue has to be recovered, so as to signal for future new investments.

Industries in competitive markets (including, as envisaged, the wholesale electricity market) do not have the luxury of having their investments provided with price guarantees to recover sunk costs as well as to ensure future new investments. They are paid prices equivalent to short run marginal costs!

INCITEC is making the above point to underline our concerns that the whole system of regulation (despite the rhetoric) is not based on economic efficiency, but is financially drive, whereby the regulatory objective is to award a revenue stream to service (a forward-looking) cost base, which is usually based on replacement costs. In other words, economic efficiency in pricing has little to do with regulatory reviews. For those reasons, we reiterate our strong objection to any adoption of full replacement cost valuation in the initial capital base, which disadvantages users' interests and embeds monopoly rents.

INCITEC notes the approach taken by IPART to establish guidelines for pricing viz:-

- reflect economic costs by:
  - » reflecting the level of available capacity
  - » signalling future investment costs
  - » discouraging uneconomic bypass
  - » allowing negotiation to better reflect the economic costs of specific services
- provide a commercially sustainable revenue stream while recovering the gap between marginal and average costs in the least distorting manner possible
- reduce regulatory burdens by being
- simple
- transparent
- stable
- predictable.

Except where there is network congestion, the marginal costs of transmission and distribution are likely to be less than average costs. This creates a tension between economically efficient prices and prices necessary for commercial sustainability. The gap between marginal and average costs should be recovered in the least distortionary manner possible. A practical approach to minimising distortions would (according to IPART) recover the gap between marginal and average costs in a manner which:

- does not vary between locations;
- contains a fixed component; and
- to the extent a variable component is necessary, includes both energy and demand components.

We would endorse the above IPART approach provided (a) the initial capital base is closer to DAC (b) the networks have been professionally optimised (c) the marketable and non-marketable assets are valued differently. In addition we would expect that all major electricity users would be able to derive their tariffs, based on a fully distributed cost basis (see earlier) to ensure that they can ascertain that their tariffs are efficient, cost based and fair and reasonable.

We draw to the QCA's attention that IPART's Pricing Principles Working Group is currently developing pricing principles for the network businesses in NSW, which have the responsibility for setting and applying network access and usage charges and tariffs, under a revenue cap determined by IPART.

Current activities are based on developing principles whereby:-

⇒ prices are to encourage the economically efficient use and operation of, and investments in, the distribution network and are to encompass both allocative and dynamic efficiency;

⇒ prices are to signal the economic costs of service provision and are to be subsidy free;

⇒ prices are to be developed from an analysis of the costs of service, allocation of existing and future network costs and its translation into service prices;

⇒ public disclosure of information on price levels and structures, underlying costs, price derivation methods and expected future price movements;

⇒ price structures (i.e. the balance of fixed, demand and energy components) should signal at least the economic (i.e. avoidable) costs of additional service networks;

⇒ price discrimination between customers that is not consistent with economic costs is an abuse of market power;

⇒ prices should be competitively neutral;

⇒ prices should discourage uneconomic by-pass;

⇒ information on allocated TUOS charges will be provided on request (INCITEC recommends they be automatically made available to major customers); and

⇒ prices to avoid shocks by means of transitional price options to manage adjustments.

INCITEC reiterates an earlier recommendation to the QCA that it establishes a Pricing Principles Working Group to develop appropriate pricing principles for application in the State, as part of its current regulatory review.

7. SIDE CONSTRAINTS

Providing that the initial tariffs are set fairly and reasonably, we would support the use of side constraints to limit the variation of network tariffs from year to year. Side constraints should only apply to residential customers and could be linked a either to dollar value or a fixed percentage as per the IPART and ORG practice.

8. APPROVAL OF PRICING PRINCIPLES

INCITEC considers that it would be prudent for the QCA to develop the appropriate pricing principles with stakeholders and for annual tariffs to be approved based on those pricing principles (within the revenue caps and any other side constraints). The annual tariffs would be assessed by the QCA on the basis of information disclosed about cost pools, allocation of costs, cost drivers, etc.

We believe that the QCA should also assess the previous year's tariffs outcomes against the pricing principles to ensure proper compliance. A penalty should be introduced for failure to comply.

9. INFORMATION REQUIREMENTS

We believe that the QCA must set out its minimum information requirements in advance. A grading system should be introduced to recognise better performance. Experience in NSW and elsewhere has shown that DNSP's are generally reluctant to disclose information and the quality of information varies substantially.

We support the QCA taking a strong role in requiring strengthened public disclosure of information. The points noted on page 25 are strongly supported, particularly to ensure that prices fall within the subsidy-fee zone, are consistent with economic pricing principles, and that appropriate costs can be properly mapped and prices derived.

10. CONCLUSION AND RECOMMENDATIONS

INCITEC has expectations that network tariffs should fall substantially, as a result of the current review by the QCA. Major electricity users in Queensland look to the QCA to reverse the price disadvantage faced by industry in this State relative to industry in other States.

Accordingly, INCITEC makes the following recommendations with respect to the major issues canvassed in the QCA's Issues Paper on Network Pricing Principles:-

- move in a more economically efficient direction by requiring all generators to bear a fair share of network charges;
- make all subsidies transparent;
- roll-back cross-subsidies and make tariffs more cost reflective;
- enable major electricity users to be able to derive their tariffs to establish that they are efficient and on a fully-distributed cost basis;
- ensure removal of monopoly rents by adopting an initial capital base closer to historical costs;
- adopt allocative efficiency objectives in the top three priority ranking;
- establish a Pricing Principles Working Group to develop efficient pricing principles to guide pricing structures, building on the IPART work;
- side-constraints to apply to residential customers;
- distributors annual tariffs to be approved by the QCA, based on agreed pricing principles; and
- the QCA to take a strong role in requiring public disclosure of information and to specify minimum information requirements.