307 Ferntree Gully Road Locked Bag 87
Mt Waverley Victoria 3149 Australia
Telephone +61 3 8540 2300
Facsimile +61 3 8540 2280
ABN 63 061 583 533
www.australianpaper.com.au

12 May 2011

Mr Paul Smith
Senior Director
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Dear Paul

Australian Paper submission on Australian Energy Market Commission's Strategic Priorities for Energy Market Development

Thank you for the opportunity to set out the views of Australian Paper on the recent launch of the AEMC Strategic Priorities for Energy Market Development and we look forward to discussing our views with you in depth at a later date.

Australian Paper is a major energy user being one of Victoria's largest energy users; we are also an electricity generator and Victoria's largest industrial renewable electricity generator. The initial part of our submission will provide an insight into our business in order to frame the context in which we make our comments upon the AEMC Strategy Paper.

Australian Paper

Our Business

In Victoria, Australian Paper manufactures both uncoated printing & writing papers (including copy paper, envelope paper, scholastic paper, printing paper and security papers) and packaging & industrial papers at its Maryvale mill in Latrobe Valley and also at its small specialty papers mill in Shoalhaven NSW from materials sourced predominantly in Victoria. It also manufactures envelopes and other paper-based stationery in Preston, Victoria. Outside of mining and agriculture, the paper industry is one of Australia's few major regionally based industries.

Australian Paper also imports coated paper from its parent company in Japan for resale in Australia and hopes in the future to expand its Latrobe Valley manufacturing facilities to produce this paper in Victoria if this becomes commercially viable.

Employment and Economic Benefit

Australian Paper employs just under 900 people at its Maryvale pulp and paper manufacturing plant in the Latrobe Valley, 191 at its Preston envelopes and stationary manufacturing and office papers distribution business and a further 108 in its sales, marketing and head office in Mount Waverley. This is a total of just under 1,200 direct employees in Victoria, with wages and salaries totalling $150 million annually. In addition, there are a significant number of on-site operations managed and operated by other companies to provide goods and services to Australian Paper and to process by-products from its operations.

Past economic studies have demonstrated a flow on of a further 143% to 188% to household incomes in the community.

Total sales of Australian Paper's Victorian manufacturing businesses are just under $800 million, again with a flow on of a further 120 – 152% to the community, much of this in regional Victoria.

With the completion of its pulp mill redevelopment, Australian Paper is much less reliant on imported pulp for its paper manufacture and therefore a much larger part of the sales revenue remains in Victoria.

Australian Paper's recent Investments in Victoria

Australian Paper's ongoing capital re-investment in its operations in Victoria is around $40 million annually, excluding major expansion projects, with the majority spent within Victoria for labour, local contracts and materials.

The $600 million Maryvale pulp mill redevelopment project (including the repurchase of the new Pederson Group wood yard) to increase Maryvale mill wood pulp self-sufficiency and renewable energy generation was completed in early 2010.

The Business Environment and Competition for Manufacturing in Victoria

A leading private survey has found that the manufacturing sector shrank in March 2011 as the Australian dollar hit fresh records above 103 US cents. The Australian Industry Group - PwC Performance of Manufacturing Index released on 1st April 2011 has slipped 3.2 points to 47.9, below the 50-point level that separates expansion from contraction. Manufacturing industry, Australia wide, is in the red, driven by a strong Australian dollar together with weak domestic demand, rising overseas competition and the increasing cost of raw materials. At the date of this submission, the Australian dollar has risen further in value exceeding 108 US cents. This has a major impact on profitability.

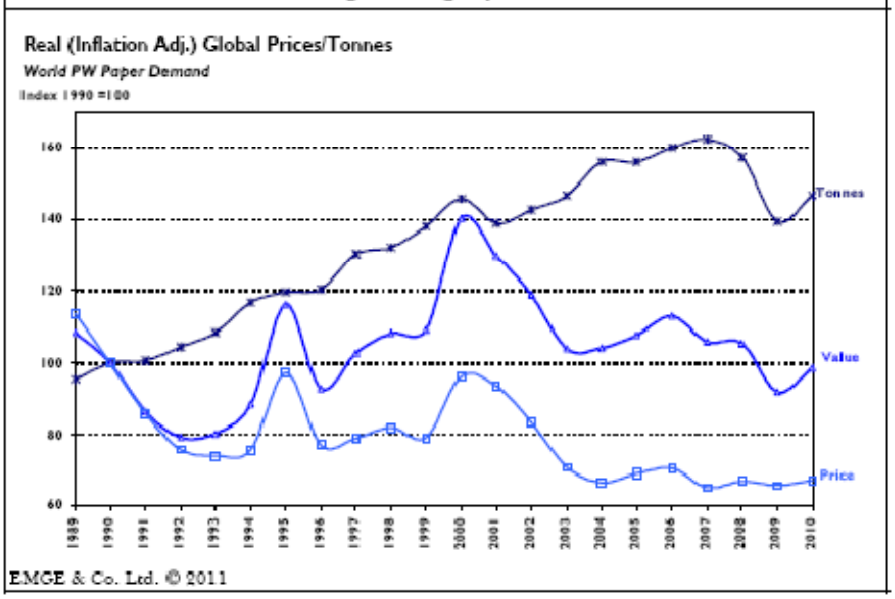
For the paper industry globally, without including the effects of international exchange rate realignments, prices have fallen consistently for many years. The graph below, from EMGE, a major UK-based industry information service, shows that while world paper volumes have increased by 60% over 20 years, the total revenue was essentially unchanged in inflation adjusted terms. This amounts to a price fall of 38% over the same period, or 2.3% per annum. Similar statistics would apply to most manufacturing industries.

Over this time, the products have not been unchanging. Quality and performance of products has improved significantly, as has the quality of service demanded by customers. The ongoing long term price reductions are driven both by increasing scale of operation and by migration of large scale manufacturing from mature, high wage Western economies to emerging Asian economies with limited regulation, low labour costs, rapidly growing local markets and large subsidies from their governments, both in cash and kind.

To survive, Victorian manufacturing industry has needed to achieve cost reductions of a similar order to the price reductions – more than 2% each year in inflation adjusted terms. Some of this has been achieved by increased scale of operation, some by automation, some by head count reductions and some by competitive global sourcing of inputs, but none of these actions can address the costs of escalating Government-imposed regulation, fees and charges and rapidly rising costs from non-import-competing suppliers such as energy, water and other semi-regulated services.

FIGURE 49. REAL PAPER PRICES AND DEMAND

Printing / Writing Papers – Global



In the paper industry, as with most other manufacturing industries, the major competition in the Australian market comes from manufacturers in emerging Asian economies. These manufacturers operate in an environment found recently by the US International Trade Commission to involve a high level of subsidy and to be exporting at prices which are well below those in their own domestic markets (dumping).

In short, the competitive environment in which manufacturing industry operates is one in which prices are continuously falling in real terms at the same time as the quality and performance of both products and services must continuously improve. This competitive environment is similar for other manufacturing industries in Victoria.

In terms of overseas competition, the market is far from a level playing field. Our only available defence against dumped and subsidized product imports is the anti-dumping & countervailing system administered by the Australian Customs Service. Although much improved from the days when two separate bodies were responsible for its administration, this system remains difficult, high cost and unduly onerous, with large delays, both in the time necessary to collect evidence and prepare applications for anti-dumping and countervailing measures and in the time from application to provision of relief from injury.

Australian Paper has made several submissions on this issue to a variety of Federal Government Inquiries, as have other manufacturing industries and industry associations, including A3P which represents our industry.

Response to AEMC Strategy Launch

Electricity Prices and Market Regulation

Transmission and Distribution Networks

Electricity prices have risen by 40% over the past 3 years and, by the AEMC's own submission, are forecast to rise by a further 30% over the next 2 years to 2013. This is an untenable situation and one that will drive manufacturing out of Australia thus exporting jobs and opportunities to our competitors. Historically, Australia has depended to a large extent, upon its relatively low-priced energy as an incentive to energy-intensive industry and this advantage has been used to offset other higher priced cost inputs to make Australia competitive on the world stage: a competitive advantage that is being systematically eliminated.

The argument that the increased costs are justified by the need to invest in electricity transmission and distribution networks is not accepted. As shown above Australian Paper has, along with other companies in the Pulp and Paper industry, made large and significant investments in its business. This has been accomplished against a background of ever falling prices and the need to improve innovation and efficiency in order to remain cost competitive and remain in business.

Whilst an argument may be raised about differing industries having differing economic drivers and not being comparable, Australian Paper would draw the AEMC's attention to the situation in the electricity supply industry in the United Kingdom where transmission and distribution assets have been expanded, reliability levels increased and the real cost to users of this infrastructure is decreasing over time – as it is in the pulp and paper industry. If the Australian transmission and distribution businesses were operating efficiently we should have experienced a similar outcome here.

The Australian Energy Regulator (AER) is tasked with ensuring that the monopoly businesses that comprise the transmission and distribution business do not extract a monopoly rent. The short history of the AER displays a blatant failure of the organisation to execute its role in regard to ensuring that efficient use of the system and efficient costs are being passed on to consumers. No commercial business has the luxury of passing on 100% of input cost increases to its customers as is allowed by the AER. In the commercial world an element of cost absorption and increased efficiency is required as a minimum.

There are two conclusions that may be drawn from the current situation:

1. The AER is failing in its duty to provide effective regulation; or
2. The existing Electricity Rules do not allow the AER to fulfil its obligations.
   This is particularly true of the highly prescriptive rules relating to Chapters 6 & 6A of the electricity rules relating to the Network Service Providers (NSPs)

It is Australian Paper's contention that the existing rules are inhibiting the effective authority of the AER and preventing the AER from fulfilling its obligations, in particular, its role of ensuring efficient use of the system and electricity prices to consumers.

As an example we would highlight the following instances of rules that require closer scrutiny and a revision to the status quo.

- Debt Risk Premium (DRP)
  The existing application of the rules by the AER refers to a BBB+ corporate bond with a 10-year maturity rate. This ignores several anomalies including:
  - There are almost no 10 year BBB+ bonds issued in the Australian corporate bond market hence the benchmark has to be inferred;
  - Australian NSPs raise capital on the international bond markets or through Australian Banks so the benchmark is not relevant;

- The NSPs operate in a risk free market: the AER approves their expenditure and rate of return hence the NSPs, and their lenders, have little in common with the risks lenders bear in loans to other Australian corporates.

The result is additional profit straight to the bottom line of the NSPs plus additional and unwarranted cost increases to consumers.

- Benchmarking
  An application where the rules currently exist but are not fully implemented by the AER. A more precise specification of the rules in relation to benchmarking would greatly assist in achieving an efficient economic outcome in respect of NSP expenditures.

There are many other examples where rule changes would be beneficial but the two demonstrated above would have a significant impact upon lowering electricity costs and ensuring efficient augmentation of the networks.

Infrastructure Development

Carbon Price and Renewable Energy Target

When the National Electricity Market (NEM) was established there was a genuine concern as to how a commercial market being a mixture of privatised and State-owned assets would develop. In formulating the Electricity Rules an emphasis was placed upon establishing an environment that would encourage investment in generation and network assets.

It is Australian Paper's contention that that element of uncertainty has been passed and we now have a mature electricity market operation on the eastern seaboard of Australia.

Indeed, it has become apparent over recent years that the formulation of a competitive electricity market by the splitting of retail, generation, transmission and distribution assets into separate entities and competitive companies has been reversed.

The generation and retail aspects are being re-aggregated with the market being dominated by three major players: AGL, Origin and TRUenergy. Transmission networks are, in the main, still owned by State Governments and pose a conflict of interest in setting efficiency agendas and return on assets to the stakeholder (state government). This can only lessen competition.

It can be argued that the current situation in the electricity generation and supply industry is approaching, and in some instances has exceeded, the levels of concentration that existed prior to reform being implemented. The aggregation that is apparent in the market place today can only lead to a lessening of competition and an unhealthy accumulation of market power. This is contrary to the aims of electricity market reform and the stated top three strategic priorities of the AEMC do nothing to address this situation.

Given the current situation there is no compelling reason to seek to give generators and NSPs an incentive to invest. They are now established businesses and should be run on business lines similar to any commercial operation.

The lack of a cohesive Federal Government policy on carbon and the pricing thereof has led to a hiatus in investment in generation infrastructure due to uncertainty. This is a policy failure on behalf of the Federal Government; it is not a valid reason to focus on electricity rules that are designed to encourage investment that otherwise would not occur. Commercial business is also impacted by the lack of direction on energy policy (by the Federal Government) but is not privy to subsidies or special rules to compensate it for the ensuing uncertainty.

In a similar vein, the Federal policy on the Renewable Energy Target (RET) has resulted in the perverse outcome of significant cost increases to business whilst at the same time removing the incentive to invest in large-scale renewable energy projects.

By splitting the RET into large-scale and small-scale technologies the objective of underpinning the LGC price to encourage investment in large scale projects has not been achieved: indeed the reverse has occurred with a reduction in the LGC price in the market place. For 2011 the LGC price will add $2.16/MWh to a consumers electricity cost.

The small-scale renewable component (SRES) has forced significant price increases onto the electricity consumer whilst having a minimal impact upon reducing greenhouse gasses (GHG). The explosion in photovoltaic roof top systems (PV) has led to a price increase of at least $5.92 per MWh for consumers. The $5.92/MWh figure is derived from the statutory renewable percentage of 14.8% and the set price of $40 for each and every small-scale renewable energy certificate produced. It does not take into account any NSP loss factors that would increase this cost to a consumer, nor does it take into account the potential for a Retailer to charge the penalty rate instead of the standard rate for an STC.

Effectively, Australia already has a carbon price: $8.08/MWh courtesy of the RET. The cost of various state-based schemes should also be added to this price. We must take the AEMC to task in the comments made by Stephen Graham at the policy launch where it was stated that the RET was considered to have had minimal impact upon electricity pricing. The additional cost of SRES alone for 2011 runs into seven figures for Australian Paper, which is roughly equivalent to an 11% increase in electricity costs. This cost increase is not considered to be minimal, nor can it be recovered in increased prices for our product as the market price is dictated by international trading conditions.

Peak Demand and Energy Demand

NSPs would claim that investment in the networks was necessary to meet demand increases and hence the recent price rises are justified. Once again Australian Paper would point to the UK experience where aging assets and investments to meet increased demand have been achieved with a real reduction in costs. This does not suggest there is an efficient outcome in the Australian market.

The figures quoted by the AEMC at the policy launch had historic energy demand for the period 2005-10 running at peak demand increasing by 3.5% and energy demand by 1.2%. However, the forecast demand for the future period was peak demand increasing by 2.6% and energy demand by 2.1% - effectively a balanced demand. One would anticipate that this balancing of peak demand and energy demand was the factor being considered by the AEMC in its planning and not the historical figures. The historical figures have been used as a means of defending past investment in the networks; to use the same figures to support future investments of the same magnitude is double dipping and unsupportable.

Strategic Priority One: a predictable regulatory and market environment for rewarding economically efficient investment.

The AEMC can best provide for this outcome by significantly revising the existing rules to encourage commercial behaviour from generators and network service providers. The existing rules do not encourage such behaviour neither did the presentation made by the AEMC at the policy launch on April 1.

In framing the original rules and subsequent amendments, the emphasis has been upon generators and network service providers; consumers and the impact upon consumers have not been addressed on an equal footing. In considering further changes the interests of consumers and the cost impact of proposals should be taken into consideration. There is little

point in having a large generation and supply network if business has been driven off-shore by poorly conceived and implemented policy.

The current focus of the AEMC would appear to lie in creating a favourable climate for generators to assist in future investment and refinancing of current debt levels. Adding this to the increasing concentration of generator power and vertical integration occurring in the market place it is extremely difficult to envisage an efficient and cost-effective outcome. Rather the reverse: greater concentration of vertical integration, reduced competition and higher prices to the consumer.

Indeed, a review by the Australian Bureau of Statistics concluded that there had been a dramatic deterioration in Australia's productivity over the past decade. The utility sector has played a major part in this outcome: from 2001 to 2010, the utilities sector (electricity, gas, water and waste water) had the most rapid decline in multi factor productivity – about 3.7% per year – of all 12 industry sectors examined by the ABS (Eslake & Walsh 2011 pp 4 & 23).

Revenues collected by government owned distributors in New South Wales and Queensland have grown far faster than privately owned distributors in Victoria and South Australia. The biggest increases have occurred after the AER's regulatory decisions in 2009 and 2010.

In 2007 government owned distributors regulated assets were returning 30% more per customer than the privately owned distributors. By 2014, using the forecasts of the AEMC and AER, the result will be 300% more per customer for the government owned assets compared to the privately owned distributors. (EUAA research).

Strategic Priority Two: Building the capability and capturing the value of flexible demand.

Large business users have been subjected to time of use tariffs for some considerable time but the opportunities to actively participate in demand side management (DSM) are few.
With the move to vertical integration there is little incentive for a gen-tailer to compensate a consumer for active DSM. Periods of high demand, and consequently high market prices, provide the perfect opportunity for a gen-tailer to load up a peaking plant and capitalise on the market conditions. This is particularly the case where a gen-tailer is long in the generation market and thus can profit from rising prices in the market place.

In the past Australian Paper has been among the forerunners in trialling DSM and seeking commercial agreements with a retailer for mutual participation and benefit. In recent years this has not been a viable option and there is little appetite amongst retailers to provide such a service.

Australian Paper would welcome DSM initiatives but would also wish to see NSP tariffs that reflected load profiling. Currently a business with a relatively flat load profile is penalised by not receiving any discount or recognition for that flat profile. Conversely, a business with a peaky load profile is, effectively, being subsidised.

In the launch presentation, both generators and retailers made reference to peak load and payment for demand levels, a comment that was echoed by the AEMC. In considering any such scheme it is essential that consumers with "good" load profiles are rewarded and not subjected to a "default" price that does not recognize the contribution made to minimising peak demand constraints.

In this respect NSP's are remiss in not providing load related tariffs to consumers that accurately reflect demand and load profile. In contrast, the NSP's tend to produce a raft of time dependant tariffs that have no relation to an individual's demand profile. This could rightly be viewed as a revenue grab by the NSP's and has justifiably been put on hold by the Victorian governments moratorium on the utilisation of SMART meter tariffs.

It is clear from the market response to DSM that the NEM incentive framework is not encouraging NSP's to take an appropriate active role in marketing DSM services. If the DSP3 initiative merely encourages more of the existing status quo then the initiative can only be considered to be a manifest policy failure.

In respect of SMART meters and household consumers there are some important issues to be resolved in respect to privacy concerns and intellectual property. The consumer or customer should have the final say in whether or not they consume energy. Similarly all information collated in respect of load profiles and consumption should be owned by the consumer. In this respect, commercial and industrial loads should share the same privileges: the consumer should hold the IP for all load and consumption data and have free access to it. If a NSP wishes to collate or market this information then they should be obliged to seek permission from the consumer and pay a reasonable fee for the use of this information.

Strategic Priority Three: Ensuring the transmission framework delivers efficient and timely investment.

This, of all aspects of the AEMC priorities, is the challenge for a unified national approach to regulation and investment. The aim should be to provide a holistic and comprehensive approach to tackling transmission issues with the aim of providing an efficient and national transmission network. Of particular import here are the recommendations of the Parer and ERIG review that have yet to be embraced and acted upon in their entirety.

In support of the criticism of the existing framework, one could point to the shortfalls of the RIT-T and its predecessors over the past 10 years. The AEMC rightly states in its policy release that the RIT-T has been in operation for a short time. However the fact that it is a fourth iteration of a process that has been in continual operation for almost a decade is not disclosed.

In particular, the tests applied in evaluating RIT-T should take into account the impact on regional generation and the consequent flow-on to prices that consumers will be exposed to. This in turn raises the question of market power of generators and the efficiency that can be gained by increasing the load flow between NEM regions.

Conclusions

There has been an abject failure of the AER, and by inference the AEMC and MCE, to effectively regulate the energy supply industry and provide an efficient and cost-effective service. We can but echo the words of Mr Milo Foster (KCA) and Mr Roy Adair (Hydro Tasmania) in their contention that the AEMC are out of touch with consumers and the AEMC top 3 priorities do not address the concerns and fears of consumers in the market place.

NEM reform has never been completed and is still, at best a work in progress or, more realistically a work abandoned. The original reform agenda envisaged competition from multiple Generators, Distributors and Retailers: this has not happened. In reality we have a reformation of vertical integration and an aggregation of market share amongst an elite few. It can be argued that the collective market share of the Big Three is now greater than any market share enjoyed by the old state-owned businesses.

Passing reference was made by Minister Ferguson to reform commencing some 18 years ago with Hilmer and Parer. It was disappointing, but no surprise unfortunately, to hear that there was no reference to the fact that reform had not been completed nor that only selective parts of the Hilmer and Parer reviews were acted upon. Coincidentally, the parts that have been acted upon are to the advantage of generators and NSP's.

More recent reports: ERIG; Parry-Duffy and Garnaut update No.8 all support the notion that reform is far from complete, regulation of the industry is inadequate, existing rules are inadequate and consumers are not getting a fair deal. These are all aspects that should figure highly on the AEMC's action list.

Whilst allowing that expenditure is required to replace aging assets and augment the networks, we would reiterate the UK experience where such acts are and have taken place against a background of increased service provision, increased reliability and reduced network prices to consumers. This is the model to which the Australian industry should aspire rather than the existing experience of ever increasing prices for, effectively, the same service.

We would be remiss in not commenting on the asymmetric application of the appeals process associated with the regular AER determinations. Not only are the NSP's allowed to cherry pick elements of the AER decision that they wish to appeal, they are also able to mount considerable resources in staging an appeal and then pass this cost on to consumers. Australian Paper applauds the AEMC for tackling the appeals issue and urges the formation of an appeal fund whereby consumers with a genuine concern can access funding to mount an appeal appropriate to the resources utilised by the NSP's. We further believe that an appeal by the NSP's should automatically open up the whole of the AER's determination to review: in other words remove the cherry picking ability. This would be in line with appeal mechanisms in other countries.

Our response has concentrated on the electricity businesses but we also have real concerns for the gas industry. The AEMC have touched upon LNG projects and the potential for eastern seaboard prices to approach international pricing. This is a concern and highlights the necessity of a national energy strategy that takes into consideration the needs of the energy producing businesses and commerce and manufacturing. There is a need, one could say necessity, to consider the value of our manufacturing base and figure that into an overall energy strategy thereby ensuring a supply of affordable energy for commerce and manufacturing.

The challenges ahead are immense and should not be underestimated. Australian Paper would welcome the opportunity to discuss our concerns with you in more detail and to participate in any industry forums that may be envisaged.

Any questions about our submission should be addressed to Brian Green, by email to brian.green@australianpaper.com.au or by telephone on (03) 8540 2384.

Yours sincerely,

Jim Henneberry
Chief Executive Officer
Australian Paper