Major Energy Users Inc.

## Australian Energy Markets Commission

**National Electricity Rule Amendment**

## Distribution Network Pricing Arrangements
**[Reference No: ERC0161]**

# Response to Draft Rule Determination

## Submission
**by**

## Major Energy Users Inc

## October 2014

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**The views expressed in this document do not necessarily reflect the views of the Consumer Advocacy Panel or the Australian Energy Market Commission. The content and conclusions reached in this submission are entirely the work of the MEU and its consultants.**

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# S1. Summary

The Major Energy Users Inc (MEU) is pleased that the Australian Energy Market Commission (AEMC) is progressing the reform of the National Electricity Rules (NER) with respect to distribution network pricing. The MEU sees this reform as complementary to the recent reforms to the NER regarding the AER's approach to setting the overall revenue allowance for networks as well as being a key first step in the implementation of the long-awaited Power of Choice reforms[1].

The MEU has long expressed its great concern with the processes by which both distribution and transmission networks develop, implement and change their pricing arrangements. Many of the MEU members have suffered considerable financial distress as a result of the seemingly haphazard way significant changes are made to network tariffs and the lack of any meaningful consultation with the members in the process. This was exemplified in the work carried out by MEU in its report to the AEMC in February 2014, "MEU Member issues with network pricing".[2]

The MEU is also aware of the concerns that smaller consumers have had with sudden and/or steep changes in energy prices, albeit they are not always aware that many of these changes are caused by changes in underlying network charges.

MEU members are also frustrated by the proliferation of different network tariff structures and prices across the NEM, seemingly with little reason for such differences. This proliferation adds costs and risks to both consumers and retailers.

The lack of any clearly defined principles and any clear link between prices and costs to provide the services also inhibits the efficient development of cost effective demand-side participation by both large and small consumers. For instance, if the distribution network service providers (DNSPs) across the NEM had introduced interval metering for all solar PV consumers, along with appropriate cost reflective time of use pricing, then there would now be a much better alignment of solar installations and network benefits and costs. As it is, the majority of the solar installations contribute very little to reducing network costs.[3]

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[1] The MEU considers that unless network tariffs refect the costs of providing the service, investment decisions by consumers are distorted.
[2] Available at http://www.aemc.gov.au/getattachment/afb96f8f-37bf-4496-8456-bc11896ce23c/Major-Energy-Users-supplementary-submission-%E2%80%93-rece.aspx
[3] Under standard flat tariff pricing arrangements consumers benefit from solar panels facing north rather than west. However north facing panels contribute little to reducing peak demand during

The MEU therefore strongly supports the general intent of the AEMC's proposed reforms to the NER, particularly where these reforms will produce greater transparency and consistency while contributing to lower network costs in the future.

In general, the MEU considers that the Draft Rule Determination addresses stakeholders' concerns with the lack of transparency in the network pricing process. The reforms proposed in the Draft Rule to engender transparency have greatly enhanced the requirements for consultation through a number of mechanisms including the Tariff Structure Statement (TSS) and the Annual Pricing Schedule.

The AEMC's Draft Rule changes have also reset the timetable for development, approval and publication of network tariffs. This is another valuable reform that will promote better consultation and enhance the capacity of retailers to adjust their retail tariffs to better reflect network price signals.

Similarly, the reforms enhance the opportunity for large consumers to engage with the networks and to respond appropriately to the network price signals, though efficient management of their peak demand are seen as valuable improvements.

The MEU is also appreciative of the additional analysis of tariff principles and structures provided by the AEMC's two consultants, NERA Consulting (NERA) and The Brattle Group. Both studies provide a clearer analysis of the relevant economic and practical issues of tariff reform. Such analysis was lacking in the AEMC's Consultation Paper and the MEU urged the AEMC to undertake further research and tariff modelling in its response to the Consultation Paper. The MEU is therefore pleased to see this additional work has been undertaken by the AEMC's consultants.

Nevertheless, the MEU believes the AEMC has not translated these two important research studies into the Draft Rules in a manner that is in the long-term interests of consumers. The MEU therefore urges the AEMC to reconsider a number of elements of the Draft Rules.

In particular, the MEU is very concerned with the undue emphasis the AEMC has given to the networks' perceived interests at the expense of the clearly enunciated concerns of consumers. The MEU's views on this are summarised

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the system peak period of 5pm to 8pm. Time of use pricing would enable the network to signal the system peak times and provide benefits to consumers who respond to this.

below and pervade much of the MEU's subsequent responses to the AEMC's Draft Rule Determination.

## S2. Flexibility versus Predictability & Consistency – What is in the best interests of consumers?

In particular, the MEU is concerned with the extent to which the AEMC's Draft Rules rely on general principles and provide little specific direction to the distribution businesses.

The MEU understands that there is a spectrum between flexibility and certainty to be considered in establishing the Rules regarding network tariff design. The MEU also understands that the AEMC's preference is to provide flexibility to DNSPs to determine tariffs within the broad bounds of the AEMC's pricing objective and pricing principles. In doing this, the AEMC has stated that it regards it as important for DNSPs to be able to respond to their individual circumstances and to "own" their respective network tariffs.

However, the MEU believes the AEMC has leant too far towards the flexibility end of the spectrum. The MEU is concerned that the AEMC has elected to follow this path even though the arguments provided by the AEMC are largely theoretically based rather than based on the evidence provided by consumers. The AEMC also appears to assume that the DNSPs will use this greater flexibility to promote the long-term interests of consumers. However, based on experience to date, consumers consider that the prime focus of DNSPs is on maximising shareholder profitability. Consumers therefore believe their interests are best served by Rules that provide less flexibility for the DNSPs than that provided to the DNSPs under the AEMC's Draft Rules.

More particularly, the MEU believes the AEMC's decision between flexibility and prescription must be based on the outcomes that **are in the best interest of consumers.** And consumers (including, but not only, the MEU and its members) are clearly stating that more prescription around network tariffs is in their best long term interests.

The logic of this primacy of consumers' interests in more prescription rather than more flexibility is made even stronger given the AER has recently adopted the default position of applying a revenue cap control mechanism. As a result, a DNSP faces no financial risks as a result of any prescriptive requirements on the network tariff design.

Rather, it is consumers who face the risks and costs of different and/or inefficient network tariffs. The MEU also questions whether the scope given networks to provide innovation is offset by the risks that consumers face if networks are able to use tariff development to over-recover efficient revenues should the AER reintroduce price cap regulation.

Similarly, retailers and policy makers face risks that their intended policy reforms will not be realised in a reasonable time-frame if networks have a significant degree of flexibility in the way they assesses input costs (such as the long run marginal cost (LRMC)) and in the design of their tariffs.

The MEU recognises the need for some flexibility to enable DNSPs to respond to changing circumstances. However, regulatory objectives such as 'encouraging initiative' or 'ownership of tariffs' by DNSPs must be considered against the much more important policy objectives of tariff reform; namely ensuring efficient price signals are provided to consumers enabling consumers to respond efficiently in a manner that reduces overall costs.

Persisting with an approach that allows DNSPs to continue to develop their tariffs, within only the bounds of general objective and high level principles, will mean that the plethora of confusing tariffs will continue and that investment by consumers in inefficient outcomes will also continue unabated.

The MEU is also concerned that the AEMC has not responded to alternative approaches that would provide greater prescription to the networks while achieving the stated policy outcomes. The MEU suggested in response to the AEMC's Consultation Paper that the AEMC consider some modified version of the existing transmission pricing rules (in Chapter 6A of the NER). The transmission pricing rules in Chapter 6A allow for signalling of transmission network costs while ensuring that total costs are allocated in a rational and transparent way across the different tariff classes and tariffs.

Similarly, NERA identifies approaches in other jurisdictions that are worthy of further consideration. The MEU particularly highlights the approach adopted by the Office of Gas and Electricity Markets (Ofgem) since 2010, known as the common distribution charging methodology (CDCM), for low voltage customers. This approach provides more direction to the DNSPs on Ofgem's expectations for network tariff analysis and design to promote efficient outcomes based on the LRMC of supply. However, the CDCM also leaves some flexibility for the DNSPs to adapt the general approach to their particular network circumstances.

However, despite the potential consumer benefit that would come from a more common approach to modelling network tariffs (and the lack of risks to DNSPs

under a revenue cap regime in particular), the AEMC does not appear to have even explored this option. In saying this, the MEU notes that it is not specifically recommending the Ofgem option but it does point to the possibility of an approach to network pricing that has more consistency and less flexibility than the AEMC is proposing.

## S3. Summary of the MEU's Response to Specific Issues in the Draft Rule Determination

### S3.1 Stakeholder engagement and consultation processes

The AEMC's intention is clearly to promote much greater consultation between the DNSPs and consumers, retailers and other stakeholders through the tariff development and implementation process.

Under the Draft Rules, the Tariff Structure Statement (TSS) is the primary vehicle for establishing this communication requirement. For instance, the DNSP must demonstrate in its TSS how it has engaged consumers and retailers in the development of its tariff plan.

However, the AEMC does not provide any further guidance in the Draft Rules on what is to be expected in the consultation process or how the AER is to evaluate the effectiveness of the DNSP's consultation process.

The AER has already established a Consumer Engagement Guideline as part of the reform of the network revenue determination. This could well form the basis of the AER's evaluation, although the Guideline itself sets out principles and good practice rather than specific requirements.

In addition, the Guideline does not identify any specific consultation requirements with other stakeholders such as retailers.

What is particularly concerning to consumers, however, is the prospect of a DNSP largely complying with the high level consultation process requirements but ignoring the outcomes of that and/or implementing network prices that do not efficiently meet the policy intent of the rule changes or the expectations of consumers.

The MEU considers such an outcome is quite possible and would largely negate the value of the Rule change process. It would be more useful and the outcomes more certain, therefore, if the AEMC provided some more specific requirements in the Rules, even if the Rules only state that in consulting with consumers and

retailers, DNSPs must be guided by the principles set out in the AER's Consumer Engagement Guideline (perhaps modified?).

The MEU has also provided comments in section 2 below on some other aspects of the broad consultation issues, including the TSS and annual price proposal. They are briefly noted below:

- **Amendments to the TSS**: The MEU agrees with the AEMC that a DNSP's TSS should be binding on the DNSP, particularly given that the AEMC has also made special provisions for amending the TSS if that is required in the interests of consumers. A binding TSS provides some level of stability and certainty to consumers without imposing additional risks on the DNSPs (especially under a revenue cap control mechanism). The MEU therefore rejects the DNSPs' arguments that a binding TSS is too restrictive and inflexible.

- **10-year non-binding strategy document**: The AEMC has rejected the MEU's proposal. However, the MEU believes the AEMC did not properly consider the proposal for a strategy document and how it is designed to support the principle of 'gradualism', as the reform of a network tariff may take place over more than one regulatory period. For the AER to assess whether the TSS proposal accords with the principles, it is important that there is transparency on what is the "end-game" even if this is more than four years into the future.

- **Indicative Pricing Schedule**: The MEU agrees with the AEMC that an indicative pricing schedule should accompany the TSS, and it should be updated each year of the regulatory period, as part of the formal annual pricing approval process. This provides greater transparency on both the direction and quantum of the tariff changes. The MEU considers the concerns raised by the DNSPs that consumers will expect the indicative tariffs will be implemented as proposed are important concerns but can (and should) be managed as part of the process.

- **Content of the Annual Pricing Schedule**: The MEU is pleased that the annual pricing schedule requires an update of the original indicative pricing schedule for all the remaining years of the regulatory period. This provides an additional level of certainty in a difficult and changing environment. However, the MEU would also like to see a requirement for the DNSP to explicitly state how it has varied from the indicative pricing schedule historically as well as its expectations for the future. Historical data, presented in this way, provides much greater transparency and facilitates a more effective communication with consumers.

- **Access to the Limited Merits Review**: The MEU disagrees with the AEMC providing access for the DNSP to seek a limited merits review of the AER's decision on the TSS. The MEU does not see the necessity of this, or the logic of the AEMC's claim that it should be consistent with the existing rights of a DNSP to appeal the AER's revenue determination. The DNSP is not put at financial risk in the case of a regulatory decision on the TSS, it is the consumers' welfare that is at risk. Moreover, the fact that the revenue proposal and the TSS are contemporaneous does not mean they are logically interdependent. The Limited Merits Review process just adds to consumers' risks and costs without a corresponding benefit to consumers.

- **Consultation with Large Customers:** The MEU recognises that this does not require a specific Rule. However, in the past, the networks consultation with large customers about proposed network tariffs has often been extremely poor - most often in the form of "this is what it is and no further discussion is needed". This issue is therefore raised by the MEU as being an important part of the AER's assessment of the consultation process. It is particularly important at this time, as there is a risk that in simplifying other aspects of the tariff reform, additional costs may be allocated to large users. There must be significant transparency in this process.

- **Timing of the network tariff processes**: The MEU appreciates that the AEMC has given much consideration to the timing of the various steps in the process. The Draft Rules provide a reasonable balance between providing information to stakeholders as early as possible (allowing time for consultation with consumers and consolidation in retail tariffs, for instance) and ensuring that a DNSP's cost estimates are not so premature that there will be significant updates and instability in prices (e.g. updates to CPI, or transmission tariffs and settlement residue amounts).

## S3.2. The Economic Assessment of the Network Tariffs

While the MEU is reasonably supportive of the AEMC's Draft Rule Determination in relation to the TSS and related processes and documents, the MEU is much less supportive of the AEMC's approach to the establishment of a DNSP's network tariffs as set out in the Draft Rules.

The MEU accepts the AEMC's pricing objective and the pricing principles establish a high level framework for pricing network services.

However, the MEU is disappointed that the AEMC did not consider alternatives to the adoption of the LRMC as the basis for tariffs. The MEU believes different approaches should have been considered including some adaption of the approach set out in Chapter 6A of the NER for transmission pricing (the "cost reflective network pricing" approach). This transmission approach (the modified CRNP) is simpler and could be relatively easily modified to align with the objectives and principles as they apply to a distribution network's pricing.

The MEU's other main concern, as suggested above, is the degree to which the Draft Rules allow flexibility to the DNSPs to set their own tariffs subject only to high level and largely subjective principles, and the requirement to "base" tariffs on the LRMC.

For example, as noted above, the Draft Rules prescribe the use of LRMC as a basis for all tariffs. However, the Draft Rules leave it up to each DNSP to decide what particular approach it will adopt to assessing the LRMC. The studies by both NERA Consulting (NERA)[4] and The Brattle Group[5] indicate how different the outcomes might be depending on the type of analysis used. The table below provides a sample of the different LRMC estimates for two different DNSP regions and the impacts of two different approaches identified.[6]

| Region | LRMC Methodology | Estimate LRMC $/kW/year |
|---|---|---|
| 1 | AIC | $353 |
| | Perturbation | $157 |
| 2 | AIC | $163 |
| | Perturbation | $ 23 |

Note: AIC – Average incremental cost

While NERA suggests that the most practical solution is to use the AIC approach (average incremental cost) to calculating the LRMC, NERA also observes that the perturbation approach is the more accurate. In this example, the perturbation

[4] NERA Economic Consulting, *Economic Concepts for Pricing Electricity Network Services*, A Report for the Australian Energy Market Commission, July 2014. [NERA, 2014, Network Pricing Report].
[5] The Brattle Group, *Structure of Electricity Distribution Network Tariffs: Recovery of Residual Costs*, Report prepared for the Australian Energy Market Commission, August 2014. [The Brattle Group, 2014, Recovery of Residual Costs].
[6] Adapted from NERA 2014, Network Pricing Report, pp 28-30, tables 6.1 and 6.2.

approach also produces a much lower LRMC[7]. This is likely to be the case when a region is characterised by little new growth in demand and capacity expansion.

In addition, as the total cost (not included in the table) is the same for both approaches in each given region, the proportion of total costs explained by the LRMC component will also be very different between the AIC and perturbation methods.

However, under the Draft Rules, one DNSP could choose the AIC approach and another DNSP could choose the perturbation approach, with significant impacts on the tariff allocation of LRMC and residual costs and the design of the tariffs[8]. Either way, the DNSPs would remain whole with regard to their revenues, however, consumers may be significantly affected[9] and the AER would have little basis for rejecting either approach as inconsistent with the TSS principles.

As noted, under the AEMC's Draft Rules, the DNSPs will have considerable discretion, subject only to the high level principles, in choosing:

- The type of LRMC methodology adopted in the cost analysis (as explained above);

- The allocation of the remaining costs (between the LRMC and the total costs, known as the residual costs); the remaining costs are likely to represent a substantial proportion of the total costs to service the consumer in the current market and both NERA and The Brattle Group studies reveal how many options are available to capture these costs while remaining consistent with the pricing principles. However, each choice will have very significant impacts on different customer groups.

- The approach by the DNSP to the pass through of transmission costs (as a special sub-set of residual costs), particularly given these transmission prices also include important signals on upstream network costs, which may be more or less distorted by the DNSP's approach;

[7] The MEU notes that when assessing its rule change on generator market power, the perturbation approach also resulted in lower LRMC assessments implying that perhaps the AIC approach has an inbuilt bias to over-state LRMC assessments

[8] For example, because of the outcomes of the different approaches, if two adjacent networks have different tariffs then consumers at the boundaries would invest to access to the lower priced network - such investment is inefficient but commercially attractive from the consumer viewpoint.

[9] In part, the differential impact on consumers will depend on the proportion of the total costs for that tariff that is recovered by the LRMC. Clearly, if the LRMC made up (say) only 10% of the costs, then the observed differences would be very significant for consumers of the two DNSPs.

- The classification of customers into tariff classes and tariffs within those classes, and the parameters used to define those classifications (location, profile, voltage level, usage similarity etc);

- The structure of the tariffs and their relative price levels; eg whether there is a capacity charge, whether there are one or many steps in the variable component of the price, and so on;

- The rate at which different consumer classes transition to the new cost reflective tariffs.

The MEU has serious concerns as to whether all the DNSPs have the capacity, the will and the incentive to optimise all these factors to achieve the efficient network tariff outcome in the long-term interests of consumers. In addition, the pricing principles set out in the Draft Rules are so general that it will be difficult for the AER to assess compliance and non-compliance with regard to the outcomes sought by the rule change proponents.

The MEU therefore, looks to the AEMC to provide more guidance in the Rules. In the alternative, the AER should be required to provide some more specific guidance in the form of development of a mandatory guideline which is based on the sought after outcomes. At its most basic, consumers and retailers are seeking transparency in the process and some overall national consistency in the outcomes; policy makers are seeking to implement a network pricing regime that delivers cost reflectivity so that the Power of Choice outcomes can be achieved. The AEMC's approach does not deliver either of these outcomes with the level of certainty required by the urgency and importance of the reforms.

Consumers must be able to understand the reasons for and approaches to such significant changes and they are more likely to be able to do that if there is a focus by the rule makers on transparency and consistency. Without this acceptance and understanding, history suggests that the policy outcomes and the substantial long-term benefits of reform will not be fully realised.

The MEU considers that the AEMC's Draft Rule Determination does not deliver these necessary outcomes, and that this arises from the AEMC's undue emphasis on the supposed need for DNSPs flexibility and control, rather than delivering outcomes to meet consumers' interests. To rely on the preparedness of the networks to commit to delivering these outcomes, especially when their core driver is to maximise shareholder wealth, is hardly good rule making!

A firmer hand, committed to facilitating reform of network pricing as quickly and efficiently as possible, is required to meet the original objectives of IPART and

SCER in proposing the rule changes. The AEMC should not shirk this responsibility by introducing largely unenforceable Rules based on high-level generic policy principles.

However, the AEMC is not the only electricity market institution to not deliver on the promise of reform. COAG has been painfully slow to progress these matters, there have been unnecessary delays in the regulatory facilitation of smart meter (or even interval meter) roll outs across each state and DNSPs have also demonstrated a lack of initiative and consumer focus.

Large customers in particular have suffered as a result of a lack of reform focus by many DNSPs, even though there are few constraints on the DNSP to enact efficient tariffs to these consumers. This should be taken as a lesson in the ineffectiveness of leaving reform to the DNSPs when they have little, if any, "skin in the game".

In addition, DNSPs have long expressed concerns about the failure of retailers to pass-through network price signals to consumers. However, retailers have already made it clear to the AEMC that they oppose the development of a plethora of network tariffs that adds to the complexity of what is already in place.

The AEMC has not addressed this important issue that has been raised strongly by the retailers as well as the MEU. Rather, it is likely that the AEMC's approach has added to the problem by providing considerable flexibility to networks to allow adoption of different approaches to setting the network tariffs. This not only adds to customer confusion (as above), but also further complicates the task for retailers to develop suitable products to meet the intent of some of the Power of Choice recommendations and adds another barrier to the entry of new retailers into the market.

# 1. Introduction

The Major Energy Users Inc (MEU) welcomes the opportunity to provide a response to the Australian Energy Market Commission's (AEMC) Draft Rule Determination on distribution network pricing arrangements (Draft Rule Determination).[10]

The MEU is, therefore, pleased that the process of reform of distribution network tariffs is in the final stages, although it is disappointing that it has taken so long to get this far and will take further time before the actual implementation of the reforms to the NER. It is also disappointing that the AEMC has not reflected sufficiently on the Distribution Network Service Providers' (DNSPs) lack of commitment in the past to setting cost reflective prices (where they can) in the long term interests of consumers. Such analysis would have guided the AEMC in its decisions on the level of flexibility or prescription allowed under the Draft Rules.

In this regard, what is overlooked in the AEMC review process of the proposed rule changes is that it is how consumers use the networks that will maximise the economic efficiency of the network. How consumers use the networks is driven by prices set by the DNSPs. For maximum economic efficiency to be achieved, pricing must reflect the costs in providing the service.

The MEU's experience with network pricing for large consumers suggests that generally, NSPs have been reluctant to pursue tariff reform based on consumers' interests, or invest in the systems and processes that would allow this to happen. Rather, the MEU considers past DNSP pricing activities have been too often driven by a desire to maximise revenues, particularly when subject to the weighted average maximum price cap (WAPC) regulatory revenue control mechanism that has prevailed in NSW, Victoria and South Australia.[11]

Further, the observations made by the AER in its assessments of the most appropriate control mechanisms to apply to regulated electricity distribution

[10] AEMC 2014, *Distribution Network Pricing Arrangements,* Draft Rule Determination, 28 August, 2014*,* Sydney. [AEMC 2014, Draft Rule Determination].

[11] Under the WAPC revenue control mechanism, the AER determines the overall revenue, and the average maximum price cap, given the forecast demand. The DNSP develops the tariffs that are (in theory) designed to achieve the overall revenue target in total. The expectation was that this would encourage DNSPs to develop innovative pricing solutions relevant to their consumer base. However, this did not happen. What often happened instead was that many DNSPs consistently recorded total revenues in excess of their allowed revenues (sometimes despite declining energy usage and flat demand) indicating they had used network pricing to enhance their revenues beyond what had been considered by the AER to be efficient.

networks[12] clearly indicate that while pricing is primarily an issue for consumers DNSPs have demonstrated a primary interest in ensuring the pricing delivers the best outcome for the DNSPs rather than the interests of consumers[13].

The AEMC's Draft Rule Determination fails to recognise these realities. The MEU considers that, for all its other merits, the AEMC's Draft Rule Determination allows too much flexibility to the DNSPs and will, therefore, not achieve the aims of promoting the policy objectives of the rule change proposers. Nor will it be in the long-term interests of consumers.

## 1.1 Background

The AEMC has been requested to amend the National Electricity Rules (NER) that relate to the processes and timing adopted by DNSPs to set their annual distribution network prices. The AEMC is also required to respond to the recommendations of COAG Energy Council (CEC)[14] and others on network tariff reform. The Draft Rule Determination is the final stage of AEMC consultation on the proposed rule changes.

The AEMC's approach draws together two separate, albeit over-lapping, rule change requests that proposed substantial amendments to the distribution network pricing arrangements in the NER. These rule changes were, in turn, proposed in response to mounting concerns about the gaps in network pricing regulation and the perception that the current rules were a barrier to achieving more efficient network prices in the future. There was also a concern to see mechanisms in place that facilitated the signalling of efficient network price signals through intermediaries, particularly the electricity retailers, to end-consumers.

The distribution pricing principles and rules are set out in Chapter 6.18 of the NER and include (inter alia) the timetable for providing pricing proposals to the AER, the requirement to define tariff classes in the proposal, pricing principles, side constraints on tariffs, publication of tariffs and the AER's approval of the pricing proposal.

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[12] For example, AER 2012, *Preliminary Positions, Framework and approach paper, Ausgrid, Endeavour Energy and Essential Energy Regulatory Control period commencing 1 July 2014,* pages 81 and 82

[13] See also AER 2014, *Preliminary positions on replacement framework and approach (for consultation) for CitiPower, Jemena, Powercor, SP Ausnet, United Energy for the regulatory control period commencing 1 January 20106*

[14] Previously called Standing Council on Energy and Resources (SCER)

The first rule change request came from the IPART.[15] This request focussed on amending the NER as it applies to the timing and consultation processes undertaken by DNSPs when setting network prices. IPART was seeking changes that would enhance engagement between the DNSPs and other stakeholders, particularly retailers and consumers. IPART was also seeking amendments to the timing of the process to facilitate this enhanced engagement and better enable retailers to incorporate network tariffs in their retail price offers.

The second rule change request was from the SCER (now called CEC) and arose out of the recommendations contained in the AEMC's Power of Choice Review[16]. SCER indicates that its rule change request is designed to: [17]

- Ensure that DNSPs must develop prices based on Long Run Marginal Cost (LRMC);

- Enable the AER to have sufficient time to evaluate DNSP pricing proposals against the pricing objectives and principles; and

- Improve the existing consultation process so that stakeholders have a greater opportunity to influence network pricing structures.

As noted by the AEMC, there is considerable overlap between the two rule change proposals. However, SCER's proposal has an additional emphasis on the economic efficiency of network pricing reflecting its links to the AEMC's Power of Choice Review.

Following extensive consultation, the AEMC has now issued its Draft Rule Determination. In this Draft Determination, the AEMC has adopted a "more preferable rule", but one that the AEMC claims "contains many of the elements proposed by the COAG Energy Council [SCER] and IPART."[18]

## 1.2 Proposed rule changes and issues arising from these changes.

The AEMC summarises the key features of its preferred rule change as follows: [19]

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[15] IPART, *Network price changes, IPART's proposed changes to the National Electricity Rules,* September 2012. [IPART, Proposed Rule Changes].
[16] AEMC 2012*, Power of choice review – giving consumers options in the way they use electricity, Final Report*, 30 November 2012, Sydney. [Power of Choice Review)
[17] See, SCER, *Rule change request - reform of distribution pricing arrangements*, September 2013. p 2. [SCER, Rule Change Request].
[18] AEMC 2014, Draft Rule Determination, p i.
[19] Adapted from ibid.

- DNSPs will be subject to a new "pricing objective" that network prices should '"reflect the business' efficient costs of providing services to each consumer';

- The new network tariffs must be based on the LRMC of delivering the network services to various consumers, subject to pricing principles;

- New "pricing principles" will require DNSPs to address the potential impacts on consumers of a transition to new network prices;

- DNSPs will be required to be more transparent and undertake more consultation with consumers and retailers in the development of network prices. The timing of the process will be brought forward to facilitate consultation and adoption to the prices; and

- The structure of the network prices will be developed by the DNSPs and approved by the AER in parallel to the revenue determination process thereby providing a "more integrated process".

The MEU sees that implementation of these key features will provide a benefit to consumers. However, it will be the extent to which the Rules permit flexibility by the DNSPs to decide on how they will be achieved that will determine whether the targeted outcomes will be delivered to consumers in an efficient and timely way.

## 1.3 Developing economically efficient network tariffs to meet the pricing objective

The AEMC has identified several specific requirements to set economically efficient network tariffs which are captured in the new rules. They include:

- The DNSP must be able to recover its total efficient costs as determined by the AER;

- The DNSP must base its tariffs on the LRMC of providing the network services to that tariff category; and

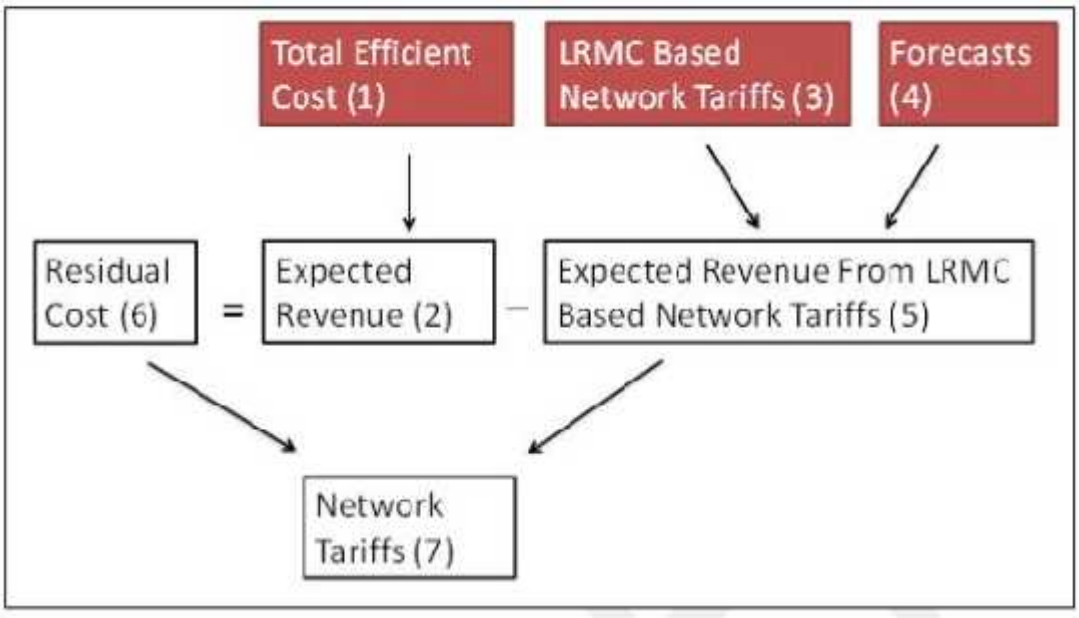
- Residual costs (the difference between total efficient costs and LRMC derived costs) must be allocated to the network tariffs "in a way that minimises distortions to the price signals for efficient usage that would be

set by LRMC based tariffs".[20] The AEMC notes that when demand is flat or falling, allocation of residual costs will be the dominant driver of the overall tariff levels.

The AEMC provides a useful diagram to illustrate the steps that will be taken under the amended Rules. Importantly, however, having undertaken this first analysis, the DNSP may need to adjust the final network prices to take into account other principles. These are also set out in the amended Rules.

**Figure 1: Deriving the efficient network tariffs[21]**

**Figure A3.1 Expected revenue, total efficient cost, marginal cost and residual cost in network pricing**




Again, the MEU supports the requirements that must be addressed but observes that it will be the implementation and the way the DNSPs use the flexibilities granted to them in the Rules that will determine the overall success of the rule changes to achieve the necessary policy outcomes sought by IPART and SCER..

[20] See for example, AEMC August 2014, Draft Rule Determination, p 108
[21] Ibid, p 110.

## 1.4 AEMC's "principles" that must be applied by the DNSP when setting network tariffs

The AEMC's Draft Rule Determination sets out both a new pricing objective (as above) and new pricing principles that a DNSP must comply with when setting tariffs. The principles are listed below (and include the efficiency principles discussed above): [22]

- Each network tariff must be based on the long run marginal cost of providing the service. *However, network businesses will have flexibility about how they measure the long run marginal cost*;

- The revenue to be recovered from each network tariff must reflect the network business's total efficient costs of providing services to the consumers assigned to that tariff. *Network businesses will be able to determine the method they use to comply with this principle*;

- Distribution businesses must give effect to a new consumer impact principle when developing their tariffs. The principle sets out two requirements:

    - minimise the impact on consumers of changes in network prices; and
    - network prices must be reasonably capable of being understood by consumers.

    *DNSPs may depart from the cost reflectivity principles (above) to the extent necessary to meet this consumer impact principle.*

- Network tariffs must also comply with any jurisdictional pricing obligations imposed by state or territory governments. *The DNSPs may depart from cost reflectivity principles to the extent necessary to comply with these obligations, but must transparently explain how they have addressed the obligations.*

The MEU observes that these are very high-level principles. While each DNSP must observe these principles when setting network prices, it will have substantial scope to establish how the principles will be applied and to vary from a principle if it considers that such is necessary in light of the other principles.

[22] See for example: AEMC 2014, Draft Rule Determination, p iv.

Overall, the MEU is very concerned with the flexibility that is being provided to the DNSPs and fears that exercise of this flexibility will lead to a less efficient outcome for consumers, but may provide the DNSPs with an opportunity to increase their profitability as they have in the past.

## 1.5 The Draft Rules define new processes and timeframes for setting network prices.

The AEMC states that the new consultation requirements will "require distribution businesses to demonstrate to the AER how they have consulted with consumers and retailers in developing price structures".[23] The Draft Rules emphasise meaningful consultation processes and transparency around the decisions made by the networks with respect to tariffs.

This is achieved through a new two-stage process set out in the Draft Rules as follows:[24]

- Stage 1: Development, consultation on and approval of a new Tariff Structure Statement (TSS). This is prepared once every five years and must show how the DNSP has applied the pricing principles and indicative price levels for the five-year regulatory period. The TSS is developed in parallel to the development of the revenue proposal and must be approved by the AER. Once approved by the AER, the price structures must remain in place unless formally amended and approved by the AER.

- Stage 2: The DNSP will develop price levels each year based on the approved price structures. The AER will assess whether the annual prices comply with the TSS, the pricing principles, revenue allowance and other rule requirements.

In order to allow for adequate consultation with consumers and retailers and for the review and approval processes by the AER, the AEMC has also amended the timetable for the completion of the annual pricing process. The AEMC claims that this will also facilitate retailers incorporating the network prices and price signals into their retail product offers.

The MEU notes the AEMC observation that prescribing the extent of networks consultation with consumers and retailers could lead to the minimum of consultation (just enough to comply with the rules!). The AEMC considers that

[23] Ibid, p v.
[24] Ibid, pp 55 – 56.

allowing the DNSPs to determine the nature and extent of consultation will lead to a better outcome for consumers.

The MEU considers that this is indeed a "courageous decision" by the AEMC as having no minimum requirement could well result in there being no meaningful consultation at all. The MEU believes that the AER has little real power to reject a TSS under the Draft Rules even if it considers the consultation process is less than good practice.

### 1.6 Other factors impacting on the outcomes of the Rule changes

The AEMC has correctly identified a number of other factors that will influence both the range and structure of efficient prices and the customer impacts. They include:

- The extent to which there is a requirement for new investment in capacity augmentation. Where augmentation is required, tariffs are expected to more closely reflect the LRMC;

- The extent to which advanced metering has been rolled out to small business and residential consumers. The roll out of smart meters will enable DNSPs to introduce more cost reflective pricing based on usage at peak times (for instance);

- The load profile of the consumer's use of energy (for a given tariff in a given region);

- The technology available to consumers, e.g. penetration of solar PV, air-conditioning, advanced control appliances, electric vehicles. The AEMC states that an important secondary principle is that the draft rule is technology neutral and provides sufficient flexibility to result in efficient outcomes for any current or future technology;

- Consumer acceptance of the new tariff arrangements is essential if the full benefits are to be realised; and

- Transitioning to new more cost reflective tariffs will lead to 'winners' and 'losers' although in the medium to long term the overall impact should be positive. The DNSPs are required to manage these transition issues in line with the other consumer impact principles.

The MEU agrees that these other factors will have an impact on the success (or otherwise) of the preferred rule change proposed.

## 1.7 MEU's initial response to the Rule changes – in summary

In the rest of this submission, the MEU considers, the extent to which the AEMC has addressed the key issues facing consumers with respect to the development and implementation of network tariffs, and therefore, whether the AEMC's 'preferred' rule changes better promote the National Electricity Objective (NEO).

In brief, there are many good aspects of the proposed rule changes, such as the requirement for a TSS and for the network to develop prices consistent with the TSS over the regulatory period. This will provide some level of certainty for consumers and retailers over the same period.

However, the MEU believes that some other features of the rule changes will undermine rather than support the achievement of the reform objectives.

In particular, the MEU is concerned with the extent to which the AEMC's Draft Rules rely on general principles and provide little specific direction to the distribution businesses.

The MEU understands that there is a spectrum between regulatory flexibility and certainty regarding tariff design. The MEU also understands that the AEMC's preference is to provide flexibility to DNSPs to determine tariffs within the broad bounds of the AEMC's pricing objective and pricing principles. In doing this, the AEMC has stated that it regards it as important for DNSPs to be able to respond to their individual circumstances and to "own" the tariffs.

However, the MEU believes the AEMC has stepped too far towards the flexibility end of the spectrum. The ultimate criteria that the AEMC should apply, is what is in the best long term interests of consumers. Predictability for consumers and the timely and efficient delivery of the much needed policy reforms which underpin the rule changes proposed by SCER should have priority over concerns for the DNSPs flexibility and "ownership" of tariffs. This is particularly important given the historical tendency for DNSPs to focus on revenue and profit maximisation rather than efficiency and consumer welfare.

These and other issues are discussed in more detail in Sections 2 and 3 below.

# 2. The network tariff setting processes

## 2.1 Stakeholder Consultation & Engagement

### 2.1.1 The MEU's understanding of the NER Draft Rules

The AEMC's proposed amendments to the NER are designed, amongst other things, to greatly enhance stakeholder consultation, transparency and active engagement in the development of the network revenue and pricing proposals. In this discussion, "stakeholder" refers to large and small end-consumers, retailers and other affected parties.

In the case of network pricing, the principal vehicle for this consultation is the development of the TSS and associated pricing schedule that sets out indicative prices for each year of the five year regulatory. The Draft Rules also require the DNSP to prepare an "overview paper" which assists communication with stakeholders by summarising a DNSP's TSS and its consultation processes.[25] Further consultation is required if a DNSP wishes to amend or vary the TSS from the AER approved version.

There does not appear to be any subsequent obligation in the Draft Rules for consultation with consumers or retailers in the preparation of the annual pricing statements, perhaps because this is considered to be more of a compliance process (i.e. compliance with the approved TSS and associated pricing principles).

However, seeking consultation on the annual pricing statement (albeit one not required explicitly by the Draft Rules) would clearly be good practice by a DNSP, particularly if a DNSP plans to make significant changes to tariff structures or if the final network prices differ significantly from the indicative prices in the pricing statement.

The Draft Rules do not set out any specific requirements for a DNSP's stakeholder engagement activities. The AEMC appears to prefer the DNSPs develop their own engagement procedures and programmes. Rather than directly prescribing an engagement approach, the AEMC only requires a DNSP to describe (ex post) how it has undertaken the consumer engagement task. For instance, Draft Rule 6.8.2(c1a) states:

[25] See for instance, Draft Rule 6.8.2(c1) – (c1a), which states that the regulatory proposal must be accompanied by an overview paper, and what this must include

> "The overview paper [that accompanies the regulatory proposal and TSS] must also include a description of how the [DNSP} has engaged with *retail customers* and *retailers* in developing the proposed *tariff structure statement* and has sought to address any relevant concerns identified as a result of that engagement."

In this context, the MEU notes that as part of the 2013 Better Regulation program, the AER published a Consumer Engagement Guideline that provides a broad framework for DNSPs to develop their own effective consumer engagement policies.[26]

The Draft Rules for network pricing do not specifically refer to the AER's Consumer Engagement guideline. However, the MEU presumes the Consumer Engagement Guideline will apply equally to the AER's assessment of the DNSP's consumer engagement processes for the revenue reset and for the development of the TSS and accompanying indicative price schedules.

For the avoidance of doubt, the MEU considers that the consumer engagement expected under the pricing rules should be the same as that required under the AER guideline. The MEU believes that a Rule requirement such as this will provide more direction to a DNSP than a requirement to simply describe what has been done by the DNSP, after the fact.

### 2.1.2 Overview of the MEU's response

In responding to this section of the Draft Rule Determination, the MEU's focus is on the TSS as a central document that a DNSP will use to communicate with consumers, retailers and policy makers of its direction with respect to network pricing. Clearly, however, there will need to be additional components of an overall communication strategy to support consumer acceptance of, and response to, the changes to the network tariffs sought by the Draft Rule change.

Moreover, the MEU agrees with the AEMC that these consultation processes will differ according to the needs of different stakeholder groups. As the AEMC correctly states:[27]

> "Although consultation with retailers and consumers is essential to the success of sending the right network pricing signals, effective consultation

[26] AER, *Better Regulation - Consumer Engagement Guideline for Network Service Providers*, November 2013.
[27] AEMC, 2014, Draft Rule Determination, p 50.

> by DNSPs will need to use different consultation practices to target different stakeholder groups."

The MEU considers the TSS, the overview paper and the annual pricing schedule represent significant advances on the DNSPs' current levels of engagement with their customers (including retailers).

The MEU therefore strongly supports the introduction of a TSS, and also the linking of the timing of the TSS with the network revenue determination process. This parallel timing of the TSS and revenue determinations has several advantages, which the MEU has previously noted in its submission to the AEMC's Consultation Paper.[28] These include:

- It enables a more efficient use of resources for the consultation process benefiting the DNSP, consumers, retailers and the AER.

- It provides an explicit link between the overall revenue determination and the prices that DNSPs will charge for the services they provide. For example, there are close links between the capital expenditure forecasts and the assessment of the LRMC in a DNSP's region(s).

- It ensures that the TSS is a more strategic document, with a minimum of a five-year horizon.

- Similarly, it reinforces to a DNSP that the TSS is a serious document that represents a real and enforceable commitment by a DNSP to consumers, retailers, regulators and policy makers.

- It provides a framework for assessing annual pricing proposals.

- It is a source of information to consumers (and retailers) that can guide their future investment decisions in energy efficiency, demand management, product innovation and the like.

Notwithstanding these potential benefits, the MEU recognises that a TSS will only be worthwhile if, in practice, it has been developed by the DNSP with serious intent to identify and address the underlying network issues and the expressed concerns of consumers. That is, the effectiveness of the TSS will depend on the whether there has been a process of genuine consultation with a wide range of stakeholders, as noted above.

[28] See also, MEU, *Response to the AEMC Consultation Paper on Network Pricing*, December 2013, p 17.

Given the TSS represents a serious commitment by a DNSP to consumers, the MEU would expect there to be significant barriers to any subsequent amendments to the TSS and associated pricing schedule by the DNSP, as discussed below.

### 2.1.3 Amendments to the TSS during the regulatory period

The MEU believes that the TSS should represent a basic commitment by a DNSP to its customers, and should not, therefore, be amended to readily or frequently. When it is amended, it should reflect a transparent and consultative process. The same MEU view applies to the indicative pricing schedules that accompany it. The MEU therefore also supports the Draft Rules that place limits on the rights of a DNSP to vary its TSS without further approval from the AER and after additional consultation with consumers.

The MEU is aware that many of the DNSPs consider the combination of the TSS and the indicative pricing schedule places a 'binding' obligation on a DNSP; a constraint that the DNSPs claim will stifle innovation, reduce flexibility and increase risks to the DNSPs.

The MEU considers these claims are overstated by the DNSPs, and represent a more ideological position than a properly reasoned concern for the risks to their business and shareholders. For example:

- The Draft Rules provide a specific and overt assurance that a DNSP's overall allowed revenue must be must be recovered through the tariffs.[29] Therefore, whether the Rules allow more or less flexibility to a DNSP to set prices, there is no additional risk to the DNSP. However, individual consumers and groups of consumers are exposed to significant risks from a DNSP's tariff decisions [30];

[29] NER Draft Rule, 6.18.5(g)(2) which states that the revenue from all the tariffs must recover the expected revenue allowed under the applicable distribution determination.

[30] The MEU notes that under revenue cap control, there would be no increased financial risk to a DNSP. There could be a financial risk to the DNSP under a WAPC approach but the requirement that the DNSP must recuperate its allowed revenue addresses the DNSPs' concerns. However there are still risks to consumers under either a revenue cap or WAPC approach, albeit somewhat different risks. Under a revenue cap, consumers as a whole may not pay more (or less) than the allowed revenue, but individual consumers or groups of consumers classes could be substantially affected. Under a WAPC, the DNSP can still **over-recover** on revenue (although not under-recover as a result of the overt requirement to recover its revenue) through biasing its tariffs, as currently occurs. Therefore, consumers are at risk both collectively and individually or by group. Either way, consultation is critical to ensure outcomes for consumers are understood and responded to appropriately.

- On the other hand, (other than the ability of a DNSP to recover more than its allowed revenue under a WAPC approach) the financial and operational risks to individual consumers, or classes of consumers, and retailers, is reduced by having more certainty about future energy costs and additional time to adjust to these;

- The TSS can be amended if a DNSP can establish there are special circumstances that are beyond the "reasonable control" or "could not reasonably have been foreseen" by a DNSP at the time the TSS was prepared and would, or would be likely to, "materially better comply with the *pricing principles*…";[31] and

- In any year, with four months notification to the AER, a DNSP can apply to the AER for the introduction of a new "sub-threshold" tariff that need not comply with the pricing principles or the TSS.[32] This provides scope for a DNSP to introduce new prices or conduct trials of different pricing structures if considered to be appropriate.

Overall, the planned restrictions on a DNSP amending its TSS, and the requirement to disclose these amendments and to test them against the pricing principles, will provide greater reassurance to consumers.

The MEU members, for instance, have long promoted the importance of a stable and predictable pricing regime. Too many businesses have been impacted badly by unpredictable but very large changes in the network costs. This in turn leads to a reluctance by consumers to invest in the changes necessary to respond effectively to the network (or even wholesale market) price signals.

For instance, large consumers (including MEU members) will be reluctant to invest in changing processes to manage peak demand at different times of the day, if a DNSP's 'peak period' times are likely to change in a few years.

On the other hand, the MEU does recognise that the energy market has been changing quite quickly and it will be difficult to predict over five years what the direction of key inputs such as the LRMC will be, or what new technologies might quickly introduce significant changes to energy usage patterns. The rapid rise of

[31] NER Draft Rule 6.18.1B (d).
[32] NER Draft Rule, 6.18.1C. The sub-threshold tariff is defined as a tariff not expected to generate more than 0.5% of the total allowed revenue (or, together with other sub-threshold tariffs, generate less than 1% of total revenue). The tariffs are not subject to assessment against the pricing principles or the existing TSS and provide the DNSP with the opportunity to 'experiment' with new tariff structures.

solar PV installations should serve as a cautionary tale to those wanting more rigid compliance with a TSS that will be over 6 years "old" by the end of a regulatory period.

The MEU therefore, supports the AEMC's approach of providing a formal mechanism for amending the TSS (as discussed above), including the requirement for the DNSP to establish that the change will better contribute to the pricing principles. It is hoped that this will result in curtailing relatively frivolous changes while providing some flexibility for the DNSP to respond to changing circumstances.

The use of this TSS change mechanism by the DNSPs, however, must be carefully monitored. The AER's difficulty is that any assessment by the AER of a DNSP's TSS, and of any proposed amendment to the TSS, against the pricing objective and pricing principles, will be largely a subjective process. The AER's decision will in many cases have to rely, not on the law or rules, but on the exercise of regulatory judgement as to how the principles are best interpreted, or more correctly (and even more difficult), how they might be reasonably applied by the AER to a DNSP's TSS. This includes the AER's assessment of what priorities between the conflicting principles should be allowed (or not) in a TSS.

Indeed, much of the TSS assessment, as well as amendments to the TSS, will rely on regulatory judgement – there is no simple right or wrong answer to questions of compliance with principles which can be in conflict or the extent to which one principle is weighed against another over time.[33]

In addition, the Draft Rules imply that the onus of proof sits with the AER. For instance, the Draft Rules state that the AER must approve a TSS unless it is reasonably satisfied that the TSS does not comply with the principles. Moreover, if the AER amends the TSS, the Draft Rules state that it can only do so to the minimum extent necessary for compliance.[34]

Given that the principles in the Draft Rules are set at a high level, the MEU considers the AER will find it difficult to define "non-compliance". Again, it will be consumers who face the costs of uncertainty and flexibility in the Rules, precisely the type of outcome that the rule change proposers were seeking to address.

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[33] For example, the extent to which the cost efficiency principle should be moderated by the principle of managing customer impacts and over what time period.

[34] For example, the NER Draft Rule 6.12.3 (k) states that the AER **must approve** a TSS unless "the AER is reasonably satisfied that proposed tariff structure statement does not comply with the principles…". Similarly Draft Rule 6.12.3 (i)(2) limits the AER's amendment of a non-complying TSS to "only to the extent necessary to enable it to be approved…".

With issues such as these, the MEU considers that the AEMC has failed to recognise the enormity of the impact the amount of flexibility allowed in the Draft Rules will cause.

### 2.1.4 Inclusion of a high-level 10-year non-binding strategy plan

In its response to the AEMC's Consultation Paper, the MEU also highlighted its preference to include a 10-year strategy plan (non-binding) as well as the 5-year binding TSS. This is because the move to cost-reflective tariffs can be very complex, both politically and technologically, and may need to evolve beyond the 5-year timeframes of a regulatory reset process, particularly for small consumers. For example, the Brattle Group noted in their study of total efficient cost recovery, that:[35]

> "…[under the principle of gradualism] if the changes [in the network tariffs] are large, an option for policy makers would be to phase in the changes over a five to seven year period."

The focus of the MEU's proposed 10-year plan would be on demonstrating that a DNSP will deliver over time on the long-term policy objectives such as those set out in the Power of Choice review.

The MEU notes that the AEMC did not agree with the MEU's proposal to require DNSPs to provide a 10-year high-level strategy plan, although the AEMC also noted that there was also nothing to stop a DNSP providing one.

The AEMC argued that a 10-year strategy document is "unlikely to provide stakeholders with any additional certainty beyond the information provided in the TSS…".[36]

The MEU disagrees with the AEMC's position on this. As The Brattle Group has noted (see above), the principle of "gradualism" means that a move towards efficient pricing is likely to take more than five years, and in many cases, only two to three years of the tariff changes might be revealed in the TSS.[37] The MEU asks how the AER can be expected to properly consider whether a DNSP's proposed tariff changes are compliant with the principles in the NER without

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[35] The Brattle Group, *Structure of Electricity Distribution Network Tariffs: Recovery of Residual Costs*, report for the AER, August 2014, p 45. [Brattle Group, Recovery of *Residual Costs*]
[36] AEMC 2014, Draft Rule Determination, Appendix D, p 165.
[37] For instance, a DNSP might propose to change the tariff structures commending in the third year of the regulatory period, so the TSS would only reveal 2 years of the tariff plan.

some sense of the "targeted" outcome of the DNSP's proposal that may not be realised for some five to seven years.

### 2.1.5 Indicative price schedule

As noted above, the Draft Rules specify that an indicative price schedule covering network tariffs for each of the five years of the regulatory period should be attached to the TSS.[38]

The indicative price schedule is not binding, and is updated each year of the regulatory period. However, if there is a material variation proposed from the price schedule, then the Draft Rules require that this be accompanied by an explanation of the reasons for the departure from the original schedule[39] and how this better contributes to the pricing objective.

The MEU understands that the purpose of the indicative price schedule is to give greater transparency and certainty to consumers and stronger indication to a DNSP that its TSS and proposed price schedule are serious documents representing a commitment by a DNSP to its customers.

A number of the DNSPs have expressed concern with the inclusion of an indicative price schedule and prefer to either have no pricing information, or just general directional information provided to consumers, such as "component X of tariff A will increase over three years, but component Y will decrease".

A particular concern of the DNSPs appears to be that the publication of these indicative tariffs will lead to customers regarding the indicative prices as 'firm' pricing commitments by the DNSP.

The MEU agrees that making the price schedule binding on the networks, particularly over a five year period (effectively a six year forecast), would be both too onerous and inflexible, particularly given the uncertainties about the future patterns of energy usage.

However, there is undoubted value in providing consumers with more than just the type of general directional information of the form noted above. The AEMC's Draft Rules, by requiring a DNSP to append a pricing proposal to its TSS, provides more substance and transparency to a DNSP's TSS.

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[38] Draft NER, 6.18.2 (a).
[39] Draft NER, 6.18.2 (7A).

For instance, it might be clear to the DNSP that the fixed supply component of a tariff will have to increase substantially, while the volume component of the price may be subject only to small CPI increases. Directionally, the changes are the same, but they are very different in terms of impacts on different customer segments. The provision of more quantitative information is, therefore, important to both retailers and consumers.

Therefore, the MEU on balance supports the AEMC's approach. However, it is essential that it is made very clear to consumers and retailers that while the TSS is binding, the annual price schedule is not. This is not a simple message, and much thought needs to be given to how this important difference is made clear to all consumers.

### 2.1.6 The content of the annual price schedule

The MEU would prefer that the Rules are more specific about the content of the annual price schedule in order to assist consumers in participating in the tariff development process.

As a minimum, for instance, the annual price schedule should include an assessment of historical trends, such as a year-by-year comparison of the original pricing schedule with the current proposed prices. This will reveal any consistent biases or systematic error in the networks' tariff setting processes.

Such historical information is not only useful to the AER, it will also greatly facilitate consumers ongoing discussions with their DNSP on the direction of tariffs and the ability of consumers to hold the DNSP to account for its approach.

Having said that, the MEU is pleased to see that the annual price schedule is to include not only the proposed prices for each tariff for the coming regulatory year, but an update of the indicative prices (that were initially set out in the TSS) for the remaining years of the regulatory control period.[40]

Combining these projected prices with comparisons of the historical prices (i.e. previous years in the regulatory period) will further contribute to consumer engagement and understanding as noted above.

[40] Draft NER, 6.18.2 (d). The obligation is also extended to Sub-threshold tariffs, Draft NER 6.18.2 (e).

### 2.1.7 Access to the Limited Merits Review (LMR) process

Given the extent to which decisions to accept or reject/amend a DNSP's TSS and pricing schedule will rely on regulatory judgement, the MEU also believes the Limited Merits Review (LMR) in the National Electricity Law (NEL) should not apply to the AER's determination on the DNSP's proposed TSS.

The AEMC gives scant attention to the issue of access to the LMR process following an AER decision on a TSS. However, the AEMC does propose that the LMR should apply to the TSS approval process because:

(a) It currently applies to the Pricing Approval process for TNSPs (subject to Chapter 6A of the NER);

(b) Because it will be part of the DNSP's revenue determination; and

(c) The importance of the TSS.[41]

The MEU does not accept that the reasons cited by the AEMC justify the risks and costs of extending the LMR process to distribution network pricing and the AER's determination on the TSS.

In the first instance, the MEU is not aware that any TNSPs (which have to prepare a Pricing Methodology as part of their revenue proposal) have ever sought to appeal under the LMR process with respect to the AER's approvals (or otherwise) for transmission pricing methodologies. The MEU considers that this demonstrates the extension of this right to distribution companies is unnecessary because the AER's determinations on pricing proposals have been seen as generally reasonable.

Second, there is no reason why the DNSP's rights to appeal the AER's revenue determination should automatically extend to the quite separate issue of network pricing – the common timing of the revenue determination and the TSS is for convenience, and there is no substantive interdependency between the two.[42]

Third, the TSS is certainly important, but its real and most immediate importance is to consumers not the DNSPs, albeit the DNSPs are responsible for the

[41] AEMC August 2014, Draft Rule Determination, p 64.
[42] That is, the revenue is set independently of the subsequent tariffs. And while the network tariffs are constrained at a very high level by the revenue determination, and the proposed expenditures influence some aspects of the network prices, the process of allocating costs using LRMC (etc) to different tariffs and tariff classes is quite independent of the methodology and process of determining the total revenue allowed.

development of the tariffs. Put another way, if the AER rejected a DNSP's TSS, and (after providing an opportunity for the DNSP to revisit its TSS), the AER remains unsatisfied that the TSS complies with the principles, and replaces the TSS with a complying TSS – what are the risks to the DNSP?

The risks to the DNSP are negligible (other than perhaps to pride), particularly compared to the risks of an extended and expensive appeal process. Given that any such appeal will, in turn, be based on the subjective interpretation of high level principles and on how the AER has exercised its judgement in interpreting these principles, the appeal process itself will prove to be even more challenging than the current appeals by DNSPs on the AER's revenue determinations.

However, in contrast to the revenue determinations, the structure of the network tariffs poses minimal risk to the network's investors, particularly if a revenue cap control mechanism is in place. As the priority objective of the rule change is on the impact of cost reflective pricing on the consumer and the consumers' responses to the tariff 'signals', the consumers should not face the costs and uncertainty created by a DNSP appealing the AER's determination on the TSS.

It therefore makes little sense from either a business or consumer perspective to add a further risk to consumers. Assuming that the AER runs a transparent and independent process in its assessment of the proposed TSS and network prices, the MEU considers that inclusion of a specific right for a limited merits review of an AER's determination on the TSS adds no value to consumers but certainly risks delays and higher costs.[43]

### 2.1.8 Consultation with larger customers

The MEU considers that the TSS should be quite specific about how the DNSP has derived network tariffs for larger customers and the consultation processes it has undertaken with these customers in the tariff development process. Similarly, there should be consultation in the development and/or amendment on the annual pricing schedule.

[43] The MEU emphasizes that it is not challenging the right of DNSPs to access the Limited Merits Review process with respect to a revenue determination by the AER. The outcome of the revenue determination may impact directly on a DNSP's revenue and profits, and it is appropriate for the DNSP to have a right to challenge the decision of the regulator. In the case of the TSS and network tariffs, however, the DNSP's overall revenue is not at risk, it is only consumers who are exposed to the AER's TSS determination.

There is considerable variation and lack of transparency under the current arrangements on how such tariffs are set and/or negotiated with larger customers and what principles are applied in the process.

Larger customers need assurance that they are not subsidising other customer classes[44], and that he tariffs provide the right signals to allow larger customers to efficiently manage their energy usage, including the potential to save costs by reducing demand at the time of system peak.

For example, the MEU is aware of cases where larger contract consumers are charged on the basis of a fixed charge, a capacity charge and a variable charge. However, these fixed charges do not necessarily reflect a customer's direct costs and the capacity charges do not necessarily relate to the peak period of network system (or local area) demand. Customers who have heavy usage over-night for instance (such as irrigators) can be charged the same amount as a larger customer with the same peak demand but where this peak demand is co-incident with the system peak demand. Charging on capacity irrespective of the time of the user's own peak relative to the system peak clearly breaches principles of efficiency and fairness.

Similarly, as larger businesses are generally investing over the longer term, it is useful for the DNSP to understand the nature and intentions of the customer's business and to provide through the tariffs (and effective communication thereof), clear signals regarding locational and timing costs to the networks.

Enhanced consultation and a consistent approach to tariff setting with larger consumers will also facilitate the collaborative development of various demand management options including peak shifting, stand-by generation and so on.

The MEU is not suggesting that the Rules need to be specific about the nature of consultation with larger consumers. However, the MEU does believe that before approving a TSS/pricing schedule (or amendment thereof), the AER should be satisfied that there has been real and specific communication between a DNSP and its larger customers as well as general consultation with a DNSP's mass market customers and retailers.

[44] For example, transmission costs are a larger part of total network charges than for small consumers. This means that larger consumers need to see that they are only paying the passed through transmission costs and not a larger copmponent

## 2.2 The timing of the network pricing process

The MEU appreciates that considerable effort has been made in the Draft Rules to realign the timing of the network tariff process with the broader regulatory timetable. In developing the new 'timetable', the AEMC also had to be aware of the various constraints of data availability and the links to other processes such as the timing of transmission pricing.

The MEU believes that the Draft Rules provide a reasonable compromise between providing additional time for analysis and consultation, while still remaining relevant to the more current circumstances.

# 3. Cost-reflective & efficient distribution network pricing.

## 3.1 The MEU's understanding of the draft rules for setting network prices

The MEU considers it is essential that the it clearly identifies in this submission its interpretation of the rule changes proposed by the AEMC's more preferable rule. This is because the MEU's detailed comments about the various aspects of the proposed rule changes are based on its understanding of the more preferable rule.

The rule change proponents, and the AEMC, have all recognised the need to implement efficient network tariffs, a need made more urgent by the potential for emerging technologies (solar PV, electric vehicles, embedded generation, storage batteries, appliance efficiencies etc) to disrupt the traditional assumptions about the operation of networks, and create revenue volatility for the networks.

As noted in various reports (such as the AEMC's Power of Choice and the 2014 NERA report (op cit)), the importance of efficiently structuring tariffs increases with the degree of price elasticity in the market. The various technological changes described above are providing consumers with increasingly cost effective alternatives to meeting their energy needs. Where once electricity demand was thought to be relatively inelastic, the new technologies mean that this is no longer as realistic as was once held - the picture is changing quite rapidly.

There is also recognition that the current Rules regarding DNSPs' network pricing are not driving efficient outcomes, and the Rules, without change, will become increasingly less viable in delivering efficient outcomes.

The AEMC is proposing a number of important changes to the way DNSPs develop their network tariffs. In developing the rule changes, however, the AEMC has adopted a somewhat different approach (a "more preferable" rule) than those put forward by the rule change proponents.

Nevertheless, the overall intention is still that network tariffs will (progressively) signal the true costs to consumers of their usage patterns, enabling users to make efficient decisions regarding their usage with the full knowledge of the costs that their consumption patterns impose on the network.

NERA states that infrastructure prices that promote efficiency should:[45]

- Enable the recovery of full costs of existing infrastructure assets while simultaneously encouraging the efficient use of the infrastructure; and

- Signal to users the costs of new network infrastructure capacity, so as to encourage efficient usage of and investment in network infrastructure [*the MEU notes this may include investment in demand management]*

The key elements of the AEMC's Draft Rule changes are designed to capture these two elements identified by NERA, and include:[46]

- Inclusion of a specific *network pricing objective* in the NER, namely that network prices charged to each consumer should reflect the efficient costs of providing network services to that consumer.[47]

- Inclusion of a new set of *pricing principles* that the DNSP must address in setting the prices to meet the pricing objective:[48]

    - each tariff must be based on an assessment of the LRMC of supply to that group of consumers;
    - recovering total costs in a way that minimises distortions to efficient usage decisions by consumers;
    - in setting the final tariffs, however, the DNSP must minimise the impact on consumers of changes to network prices;
    - the structure of each tariff must be reasonably capable of being understood by customers; and
    - the DNSP must comply with any applicable jurisdictional pricing constraints and obligations.

- Retention of the existing requirement that for each tariff class, the revenue *must* lie on or between the stand alone cost of serving those customers and the avoidable cost of not servicing those customers in the relevant

[45] Adapted from, NERA Economic Consulting, *Economic Concepts for Pricing Electricity Network Services*, A Report for the Australian Energy Market Commission, July 2014, p 3. [NERA, July 2014, Network Pricing Report]
[46] See for example, AEMC Aug 2014, Draft Rule Determination, p 13.
[47] See Draft NER, 6.18.5(a).
[48] Draft NER, 6.18.5 (b)-(j).

> tariff class[49]. [*the MEU notes the inclusion of "must" in this clause is new*].[50]

The AEMC correctly recognises that there may be conflict between these principles. For instance, the principle of minimising the impact on customers of a change in tariffs may conflict with the principle of cost-reflective pricing, requiring the DNSP to adjust tariffs over a period of time and only after significant engagement with their customers about the change.

The MEU considers that the AEMC's approach to resolving these potentially conflicting objectives is appropriate. The AEMC draft rules state: [51]

> "A [DNSP]'s tariffs may vary from tariffs which would result from complying with the pricing principles (e) to (g) only to the extent necessary to give effect to the pricing principles set out in paragraphs (h) to (j)."

The MEU interprets this to mean the AEMC is giving a priority to cost reflectivity principles ((e)-(g)) and any variation from these principles that arise from the remaining two principles (of minimising impact on customers (h) and complying with jurisdictional requirements (j)), must be by only the minimum amount necessary.

In addition, the TSS must set out where these departures from the economic principles occur and explain how the considerations of consumer impact and jurisdictional requirements have led to these departures.[52] Similarly, the annual pricing statement must identify and explain such variations[53] and how these variations better contribute to the achievement of the network pricing objective.

### 3.1.1 The importance of the long-run marginal costs (LRMC)

The Draft Rules state that each network tariff must be based on the LRMC of providing the service to which it relates. [54] This requirement therefore places the LRMC assessment at the centre of the calculation of the network tariffs.

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[49] The MEU observes that while tariffs should lie within these bounds, the range is extraordinarily wide and the achievement of this requirement is very easy. To a very large degree, the retention of this clause is obviated by the network pricing objective.
[50] Draft NER, 6.18.5 (e).
[51] Draft NER, 6.18.5 (c).
[52] Draft NER, 6.8.2 (c)(7).
[53] Draft NER, 6.18.2 (7)(7A)(8).
[54] Draft NER, 6.18.5 (f).

However, despite the importance of the LRMC, the Draft Rules do not set out a specific definition of, or approach to, assessing the LRMC.

Instead the Draft Rules set out a number of broad requirements for assessing the LRMC, including the following matters which the DNSP must have regard to:[55]

- The costs and benefits associated with using and applying that method as proposed;
- The extent to which retail customers that are assigned to that tariff are able to receive and respond to price signals;
- 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; and
- The location of retail customers that are assigned to that tariff and the extent to which costs vary between different locations in the distribution network.

### 3.1.2 Tariff classes and tariffs

In addition, the Draft Rules require that the expected revenue from *each tariff* must reflect the efficient costs of serving the retail customers on that tariff. In addition, the total revenue from all the individual tariffs must equal the total allowed revenue as approved by the AER.[56]

The emphasis on recovery of costs at the tariff level is new. The previous focus was on cost recovery at the tariff class level. However, as the AEMC correctly highlights, while the total revenue from a tariff class may have been cost reflective, that did not mean that individual tariffs within a tariff class were cost reflective; some may have been, but the great majority of tariffs were anything but.

Classifying consumers and costs at the tariff class level therefore did not drive the networks to develop more cost reflective tariffs. For this reason, the AEMC rejected the COAG proposals that sought cost reflectivity at the tariff class level.

[55] Draft NER, 6.18.5 (f)(1)-(4).
[56] Draft NER, 6.18.2, (g)(1)(2).

### 3.1.4 Minimising distortions

Importantly, the Draft Rules also state that in satisfying the requirements to recover sufficient revenue to reflect efficient costs for that tariff (and overall), it must be done in a way that *minimises distortions to the price signals for efficient usage*.[57]

In effect, this means that the total costs associated with a tariff that are not captured in the LRMC for that tariff (i.e. 'residual costs') must be recovered in a way that best ensures the cost signals embedded in the LRMC are preserved. This requirement applies even where the LRMC analysis recovers only a small percentage of the total costs of supplying that tariff group.

However, while the Draft Rules set out the requirement for the DNSP to use LRMC as the basis for charging, the Draft Rules do not prescribe how the LRMC is to be measured, nor how to minimise "distortions" to efficient pricing. The Draft Rules, instead, rely on a statement of a network pricing objective and the associated network pricing principles to which the DNSP should aspire in setting the network tariff.[58]

The AEMC explains this decision on the basis that "there is no one specific approach that should be applied in all circumstances".[59] The ideal method to minimise distortions for instance, will depend on the "each DNSP's network and consumer characteristics, and the types of price signals being sent".[60]

## 3.2 Overview of the MEU's response

At a high level, the MEU generally supports the approach of setting an overall objective that DNSPs must look to achieve when developing their network tariffs.

The MEU agrees that this objective of cost efficient tariffs is necessary to achieve optimal efficiencies in the supply and demand for electricity generally, and the investment in and operation of network services in particular.

This over-riding objective also enables the market to respond much more quickly and efficiently to challenges in the future.

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[57] Draft NER, 6.18.2 (g)(3).
[58] Draft NER, 6.18.5 (a)-(j).
[59] AEMC, 2014, Draft Rule Determination, p 121.
[60] Ibid.

For instance, with cost reflective pricing in place, if there is another rapid expansion in peak demand in the future, then the costs of additional infrastructure to supply this peak will be borne largely by those who 'create' the spike. This is in stark contrast to the current situation where those consumers who have caused the growth in peak demand have been subsidised by other consumers, largely because there was no peak demand signal (for small customers) in the tariffs.

Importantly, a failure to establish cost reflective pricing has restricted the development of consumer led demand management and created inefficiencies in the application of technologies such as solar PV.[61]

In addition, the MEU accepts the reality that the impact of tariff changes on consumers needs to be carefully managed – there is no short-cut to cost-reflective tariffs and a failure to engage consumers in the process is likely to provoke political interventions to the detriment of the overall objective.

Given this reality, however, the MEU is pleased that the AEMC's Draft Rules appear to give a priority to those principles that emphasise the obligation to establish tariffs that reflect efficient costs. The MEU also supports the requirement for DNSPs to explain where and how they have amended the cost-reflective tariffs to take account of consumer impacts and jurisdictional requirements. This obligation concerns both the TSS and the annual pricing proposal.

Movement towards cost reflective pricing in the past has been hindered by a number of factors such as retailers reluctance to pass-on network pricing signals, governments' fears of consumer backlash, lack of good information on consumer behaviour and responsiveness to price signals, and the general failure to exploit technological developments such as smart meter/smart grid technology.

The MEU considers that the renewed emphasis on cost efficiency, cost reflectivity and cost savings, as well as consumer consultation provides an opportunity to 'reset the clock' on tariff reform. Consumer impacts are an important consideration, but are no longer an end in themselves or a limiting factor on achieving the policy objectives. The consumer impacts are an input

[61] For instance, where there is a flat or stepped volumetric tariff, consumers with solar PV receive the best return by placing solar panels facing north to maximize total output from the PV system. However, this significantly reduces the benefit to the network in terms of peak shaving. If there was an appropriate time-of-use tariff (for instance), solar PV customers would have an incentive to face solar panels west; overall supply from the PV system would be reduced, but supply at the time when the network reaches peak demand (say 4pm to 7pm on a week day) would be maximized for the benefit of the customer and the network.

(albeit an important input) into the process and influence the outcome but are not the principal purpose of the process.

Similarly, the MEU hopes - and expects – that the transparency required in the TSS and annual pricing statements about the impacts of jurisdictional requirements will pressure jurisdictions to limit their interventions in energy pricing arrangements, and allow the Rules and the regulator to drive reform to achieve an outcome that allows efficient decisions to be made by all parties.

The MEU's experience with direct intervention by jurisdictional governments in energy pricing suggests that this intervention too frequently results in perverse outcomes for consumers.[62] It is also a significant barrier to achieving a more integrated national market. As MEU members have sites covering multiple jurisdictions, they also have significant experience with the costs and inefficiencies created by jurisdictions making energy policy decisions (including tariff issues) without due regard to the benefits of national consistency.

Having supported the overall thrust of the AEMC's Draft Rule Determination, the MEU then takes issue with a number of aspects of the AEMC's Draft Rules. These issues are discussed below.

### 3.2.1 Network tariffs must be based on the LRMC

In its response to the Consultation Paper, the MEU stated that before the LRMC approach was adopted by the AEMC as the basis of network tariffs, a number of issues should be further investigated. These included:[63]

- Analysis of the impact of shifting from current network tariffs to tariffs based on the LRMC, along with greater consideration of how consumers could be transitioned from current tariffs to new tariffs;

- Analysis of the extent to which a LRMC approach would (or would not) capture the total costs of supplying that tariff group (particularly given declining energy usage and flat demand growth);

[62] This is not to say that governments should not set social policy objectives for energy supply and the impact of energy prices on certain sectors of the community (for example). However, this is best achieved through transparent and targeted social payments or other transfers rather then direct price intervention.
[63] MEU, Submission to the AEMC 2013 Consultation Paper, pp 21-22.

- The problem of the allocation of the residual costs to minimise distortion of pricing signals, particularly if residual costs make up the majority of the total costs of servicing the customers on a tariff; and

- Whether there were alternatives that might better address this issue such as the cost reflective network pricing approaches (CRNP or, more relevantly, the modified CRNP) specified in Schedule 6A of Chapter 6A of the NER for the allocation of transmission costs to different services.[64]

The MEU notes that the study by The Brattle Group and the two studies by NERA (op cit), provide considerably more guidance on the potential impact that moving to a LRMC approach may have on different consumer groups. The Brattle Group study also considers the different treatments of residual costs, all of which were consistent with the pricing principles (to various degrees) but which produced quite different costs and benefits to different consumer segments.

While these studies are appreciated and are essential to making progress on the issues, the MEU is disappointed that the AEMC has chosen not to explore the alternative approaches suggested by the MEU or the approaches adopted overseas regulators (such as Ofgem). While the AEMC has noted the MEU's proposal, it appears that neither the AEMC nor the two advisory consultants were tasked to explore this matter further - this lack of further investigation is a matter of extreme concern to consumers.

### 3.2.2 The Cost Reflective Network Pricing Option (as per Transmission pricing, in NER 6A)

To reiterate, the MEU suggested in its response to the Consultation Paper, that the AEMC consider the approach set out in the transmission pricing rules (Chapter 6A of the NER) where the CRNP provides an alternative starting point for developing distribution tariffs. For example, it is an approach that would ensure that capacity and locational signals are captured in the network tariff while also ensuring that the AER's overall revenue allowance will be recovered. Because the proposed allocation of costs is based on the current value of the relevant assets, the CRNP also captures the dynamic aspect of the asset profile.

[64] See NER, Chapter 6A, S6A.3.3, "Modified CRNP [cost-reflective network pricing] methodology – the allocation is based on the ratio of the optimized replacement cost of the asset used to provide the relevant services to the optimized replacement cost of all transmission assets used to provide prescribed transmission services.

Finally, the CRNP approach provides a more consistent and practical approach to allocating costs at the tariff level. For instance, it avoids the theoretical and empirical minefield of determining how to measure the LRMC, and if/how this should vary according to different circumstances.

Similarly, the problem of allocation of residual costs disappears. This is a very important benefit of the CRNP approach in the current circumstances of static or declining demand. As has been noted in the AEMC's Draft Determination, in circumstances of low to negative demand growth, residual costs represent the majority of costs associated with a given tariff.

The MEU also highlights that excess capacity in the network system, as now exists in most areas of most DNSPs,[65] means that there will be little expenditure on increased capacity in the next regulatory periods. The great majority of capital expenditure (which will be much lower than previous periods) will be on replacement expenditure – which is not captured in the LRMC analysis.

The issues of measuring LRMC and allocating residual costs are discussed further below.

## 3.3 Tariff development and flexibility

The analyses by The Brattle Group and by NERA confirm that there are multiple ways of measuring LRMC that may (in a given set of circumstances) result in an efficient cost allocation. Similarly, there are multiple ways of allocating residual costs. As stated by the AEMC in the Draft Rule Determination:[66]

> "The ideal method of minimising distortions to the efficient pricing signals sent to consumers from LRMC based tariffs depends on each DNSP's network and consumer characteristics, and the types of price signals being sent."

As noted above, the AEMC concludes from this analysis that the rules must provide the DNSPs with the "flexibility" to "tailor" their approach to their own circumstances by not requiring a "specific" approach to minimising distortions.[67]

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[65] This excess capacity has arisen as a result of the rapid expansion in capacity over the 10 years prior to 2014 for most networks, while more recent years have seen a decline in energy use and actual demand growth was much smaller than forecast. ,
[66] AEMC, August 2014, Draft Rule Determination, p 121.
[67] Ibid.

The MEU believes that in drawing this conclusion the AEMC has not fully assessed the consequences on consumers of allowing such "flexibility". While clearly there are variations in circumstances facing the DNSPs, it is not in the interests of consumers if DNSPs have such a broad scope of options available to them. The MEU considers that this flexibility may lead to adverse outcomes such as delays to policy implementation and prolonging of inefficient network pricing from a consumer and demand response viewpoint.

In particular, the MEU is concerned that DNSPs may not be motivated by the long-term interests of consumers and will develop tariffs which may minimally satisfy the principles but may not do so in the most efficient way. The Draft Rules do not provide scope for the AER to reject such tariffs (assuming some level of compliance), even though they are not necessarily in the long-term interests of consumers.

### 3.3.1 Impacts of flexibility on retailers and their customers

One of the other major complaints that retailers and their consumers have made about network pricing regards the variety of charging methods across the different network regions; the AEMC's proposed approach to flexibility will ensure that this variation between networks continues into the future. Indeed, it is likely to increase as new options for assessing costs and structuring prices arise including new options for capacity pricing, critical peak pricing and so on..

There is already considerable disquiet about the lack of retailer "buy in" to the tariffs that provide cost reflectivity. Just as DNSPs are obviating the locational signals provided by transmission pricing, retailers can also obviate the tariff signals provided by DNSPs in their network pricing.

However, retailers' reluctance to incorporate network pricing signals in their retail products is not only because of the costs of implementing such new charges. Retailers are often responding to consumer demands for simplicity and the plethora of network tariff arrangements (both within a region and between regions) militates against this simplicity. It also vastly complicates the communication by the retailer of the 'intent' of the underlying network tariff structures to consumers when there are significant variations between networks.[68] Retailers do not want to face the cost of different campaigns for quite different products for each network area.

[68] For example, the MEU understands that the Victorian Government mandated certain common definitions for peak, off-peak and shoulder periods in the network tariffs following the smart meter roll-out, in response to the difficulty of effectively communicating different definitions across the state. It was recognized that change is difficult, and multiple definitions of peak period (etc) would

The MEU notes that retailers have already stated their concerns very clearly to the AEMC on this issue of flexibility and the plethora of existing and potential network tariffs. It is disappointing that the AEMC appears not to have listened to this concern in their approach to the Draft Rules.

More generally, the AEMC has also not adequately considered the impact of this "flexibility" for DNSPs on the development of retail competition. Multiple network tariffs and different times for applications of peak usage within a single jurisdiction and customer type add significantly to the cost and complexity of the new entrant retailer's task. This is already a challenge and will become more so, as opportunities increase under the Rules for many different tariff structures as noted above.

The MEU therefore considers that the AEMC has not considered the wider implications of what this flexibility for DNSPs will result in, or the way network costs will be transitioned to consumers via retailers and what retailers will have to do to respond (if they so elect to do) to this flexibility. Nor has the AEMC adequately listened to the concerns of those most directly affected by it.

Further, the AEMC has posited some reasons why it considers that significant flexibility is needed by DNSPs to have "ownership" of and be responsible for their network tariffs. The AEMC comments that flexibility is needed

> "…to design and implement network tariffs that suit their network characteristics and challenges and the particular circumstances of their consumers" (page 118)

and to allow innovation.

The MEU disputes the strength of these reasons for providing such flexibility when compared to the benefits of greater prescription. As noted above, tariff pricing is essentially to provide signals to consumers about their use of the network. The more flexibility that is allowed DNSPs to set prices, the greater the risk that price signals will be distorted and lose their effectiveness.

Many of the issues causing the need for greater cost reflective pricing are common to all of the DNSPS, including growth in solar PV, electric vehicles,

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simply make the process of consumer acceptance and retail product development even harder. Certainly, the approach by AEMO to clearly define the peak times in a day and year when demand reaches its peak provides a realistic assessment as to when peak demand shifting adds value to the networks. The current definitions of peak times used by networks do little to encourage peak load shifting

reductions in usage, excess capacity in the network. All networks will need to manage these common issues and therefore they should not be a reason for allowing such a degree of "flexibility" in the tariffs as the Draft Rules provide.

Areas where there are significant differences between DNSPs include:

- The extent to which smart metering (or at least, interval metering – Type 5) have been rolled out to smaller consumers;
- The degree to which current tariffs approach cost reflectivity (as defined by the AEMC);
- The extent to which the DNSP supply area includes city, urban or rural areas; and
- Regulatory obligations and constraints.

However, none of these differences should be barriers to establishing more specific tariff pricing requirements in the Rules, particularly given the potential benefits of greater consistency, efficiency and certainty in policy outcomes.

Similarly, a common structure to tariffs will enable (or even drive) retailers to implement retail tariffs that provide not only the price signals that networks need to deliver to consumers but also the price signals provided by the wider market that are currently muted by the multitude of different network tariffs[69].

For example (**and this is *just an example***), the Rules could specify that where smart meters are in place, the networks should work towards network tariffs that include a fixed supply charge, a capacity charge and a variable charge. The fixed supply charge should at a minimum recover the fixed customer related costs while the capacity charge captures the contribution to the regional peak demand of that tariff segment of consumers.[70]

Similarly, where smart meters are not available, the Rules could specify that network tariffs should progress towards a fixed supply charge and a seasonal declining/inclining block charge.[71]

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[69] For example, currently network tariffs in all regions generally determine what are the retailer's peak periods for usage - commonly between 7 am and 10-11 pm weekdays, yet the wholesale market and networks see the peak period for usage is 3pm to 7pm summertime weekdays

[70] The reference to region rather than system-wide is there to allow greater flexibility and differentiation by geographical area.

[71] This tariff structure is not unlike the pricing of gas network and retail tariffs in Victoria. The gas network tariffs vary by season (winter, shoulder and summer) and have up to 4 steps with

An approach, such as that set out above, will still provide some scope for networks to respond to specific circumstances. For example, DNSPs can have some scope in setting the time frame to achieve the cost reflective pricing reflecting differences in the starting point, or the timing of the roll-out of smart meters or regulatory change. Nevertheless, by providing a common set of pricing outcomes, the Rules will facilitate consumer understanding and reduce retailer costs to manage and explain the resulting retail tariffs to consumers.

As explained previously, it is consumer "buy-in" that is critical to achieving the best outcomes (in terms of overall efficiency in energy utilisation) from the tariff changes, and it is consumer interests rather than networks (who remain financially whole either way) that should define the degree of flexibility allowed to the networks under the Rules.

The MEU therefore strongly believes that providing more direction on the structure of efficient tariffs (including allocation of residual costs) is more in the long-term interests of consumers than is allowing DNSPs greater flexibility.

A possible 'bonus' for being more specific in the Rules is that there may be more incentives for policy makers, DNSPs, retailers and/or consumers (as the case may be) to adopt a more proactive approach to the roll-out of smart meters, or at least, type 5 interval meters.[72]

### 3.3.2 Alternative approaches to flexibility and predictability

The MEU notes that Ofgem has addressed the issue of balancing flexibility and certainty by introducing a common distribution charging methodology (CDCM) to apply to distribution charges for low voltage customers. As NERA states:[73]

> "The common methodology was to provide a simple and common framework for distributors to structure network tariffs, and promote more efficient outcomes."

While not necessarily agreeing with all the details of Ofgem's CDCM approach, the MEU believes that it provides a useful reference point for balancing the

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declining rates. Consumers and retailers have been able to manage these types of charges despite their apparent complexity.

[72] The development of communication technology, including HAN, may assist in addressing some of the current limitations of Type 5 manually read meters which currently provide delayed information to consumers. Unfortunately, COAG and state governments have progressed at a 'snail's pace' on the adoption of new metering technology and common communication standards.

[73] NERA, 2014, Network Pricing Report, p 21.

requirements. It is therefore disappointing that the AEMC does not appear to even consider this option, which the MEU considers provides a better balance of interests and risks and gives more certainty to achieving the policy outcomes.

This CDCM approach is particularly useful for developing tariffs for small customers where the trade-offs are different and the need for a relatively low cost and practical approach is greater.

Nevertheless, the MEU would seek greater consistency, if not quite the same level of prescription, in the Rules (or other instrument) for setting the network tariffs for high voltage customers.

The next section further highlights the potential difficulties that may arise if the DNSPs are allowed too much flexibility in the assessment of the LRMC

## 3.4 Assessment of the specific elements

### 3.4.1 Approaches to the assessment of the LRMC

As noted by NERA, an important feature of electricity networks' marginal costs is that "they vary between customers, times of use, location etc." [74] There is no one marginal cost that applies across the provision of all the network services, although such an averaged cost can be calculated in a mathematical sense.

NERA also highlights that marginal cost is a forward-looking concept, ie "it signals the cost of future capacity expansion" and its estimation will be "inherently uncertain".[75] In particular, the LRMC reflects "the cost of an incremental change in demand, assuming all factors of production can be varied".[76]

NERA's analysis above demonstrates the limitations of applying the LRMC approach to network pricing, particularly where there is declining energy use and little growth in peak demand and excess capacity in many regions of the networks. For instance:

- There is an open question as to what level and on what criteria the DNSP disaggregates its customer base. Clearly it is not desirable to have a different network price for each street or even each suburb in a DNSP's

[74] NERA, 2014, Network Pricing Report, p 5.
[75] Ibid.
[76] Ibid, p 6. NERA contrasts this with the short run marginal cost (SRMC) that assesses the costs of an incremental change in demand holding capacity constant.

area, although no doubt these different LRMCs could be calculated at this level.

- There are different approaches to the LRMC calculation that lead to very different outcomes in terms of the LRMC.[77]

  For example, NERA highlights two approaches to the LRMC calculation. They are the "perturbation approach" and the "average incremental cost" (AIC) approach. The perturbation approach provides a stronger signal in terms of understanding the impact of additional demand in an area; the AIC approach provides an output that can be used to set average tariffs across the networks while retaining some price signal of the LRMC.

  NERA provides a number of examples of the different outcomes for LRMC estimation from the two methodologies as summarised in the table below which provides a sample of the different LRMC estimates for two different DNSP regions and the impacts of two different approaches identified.[78]

| Region | Methodology | Estimate LRMC $/kW/year |
|---|---|---|
| 1 | AIC | $353 |
| | Perturbation | $157 |
| 2 | AIC | $163 |
| | Perturbation | $ 23 |

- As the LRMC captures the cost of future expansion, the LRMC will inevitably capture only part of the total of the total costs in most areas. The great majority of the DNSP's costs will be linked to achieving the regulated return on sunk investments in the network system.

The first issue listed above raises questions on how, in a practical sense, consumers can be grouped into tariff classes and tariff categories.

The second issue raises important questions about which LRMC approach to be used in setting tariffs for small and large consumers.

The third point raises the question of how these additional costs should be allocated to minimise distortions in the tariffs.

[77] Ibid, pp 14-16.
[78] Adapted from NERA 2014, Network Pricing Report, pp 28-30, tables 6.1 and 6.2.

Both the NERA report and The Brattle Group report provide some useful concepts and examples of how this might be done and the risks and benefits of different approaches.

Unfortunately, however, the AEMC has decided to leave these decisions in the hands of each DNSP to resolve in the manner each one chooses, subject to some broad objective and principles set out in the Rules. That is, subject to these high level principles, **the DNSP can choose**:

- The type of LRMC methodology adopted in the cost analysis (as explained above);

- The allocation of the remaining costs (between the LRMC and the total costs, known as the residual costs); the remaining costs are likely to represent a substantial proportion of the total costs to service the consumer in the current market and both the NERA and The Brattle Group studies reveal how many options are available to capture these costs (while aligning with the pricing principles) and their very significant impacts on different customer groups;

- The pass through of transmission costs (as a special sub-set of residual costs) which also contain important signals on network costs;

- The classification of customers into tariff classes and tariffs within those closes; and the parameters used to define those classifications (location, profile, voltage level, usage similarity, etc);

- The structure of the tariffs and their relative price levels; eg whether there is a capacity charge, whether there are one to one steps in the variable component and so on; and

- The rate at which different consumers transition to the new cost reflective tariffs.

There is also the opportunity for a DNSP to use different approaches at each revenue reset, further complicating the certainty of achieving cost reflectivity and providing appropriate signals to consumers of their use of the network.[79]

[79] In fact, this is one of the reasons the MEU suggests the Rules include a requirement for the DNSP to public a non-binding 10 year strategy document as a supplement to the TSS.

Overall, there are at least seven 'dimensions' which the DNSP could vary its tariff designs while still satisfying the pricing objective and pricing principles. It is, therefore, also difficult to see how the AER could reject any TSS that is based on any combination of these variables of these, particularly given all the subjective nature of the assessments.

But what of the consumers and retailers?

- Is such a plethora of possible approaches across the different DNSPs in the best interests of consumers?
- Is it likely to improve understanding and acceptance of the efficient tariffs by consumers?
- Is it likely to incentivise retailers to provide bundled tariffs which retain the network signals to consumers?

Experience suggests that the right to use multiple approaches will not deliver the outcomes sought for the reasons outlined above in the sections above.

Of course, in a competitive market, consumers would be able to choose between businesses that offer these various tariff/price options. However, this is not a competitive market and consumers have little choice and no negotiating power.[80]

The questionable benefits of allowing scope in the Rules for DNSPs to 'innovate' or 'own' the tariffs must be set off against the need of consumers for some consistency and transparency in approach as the MEU has highlighted throughout this submission.

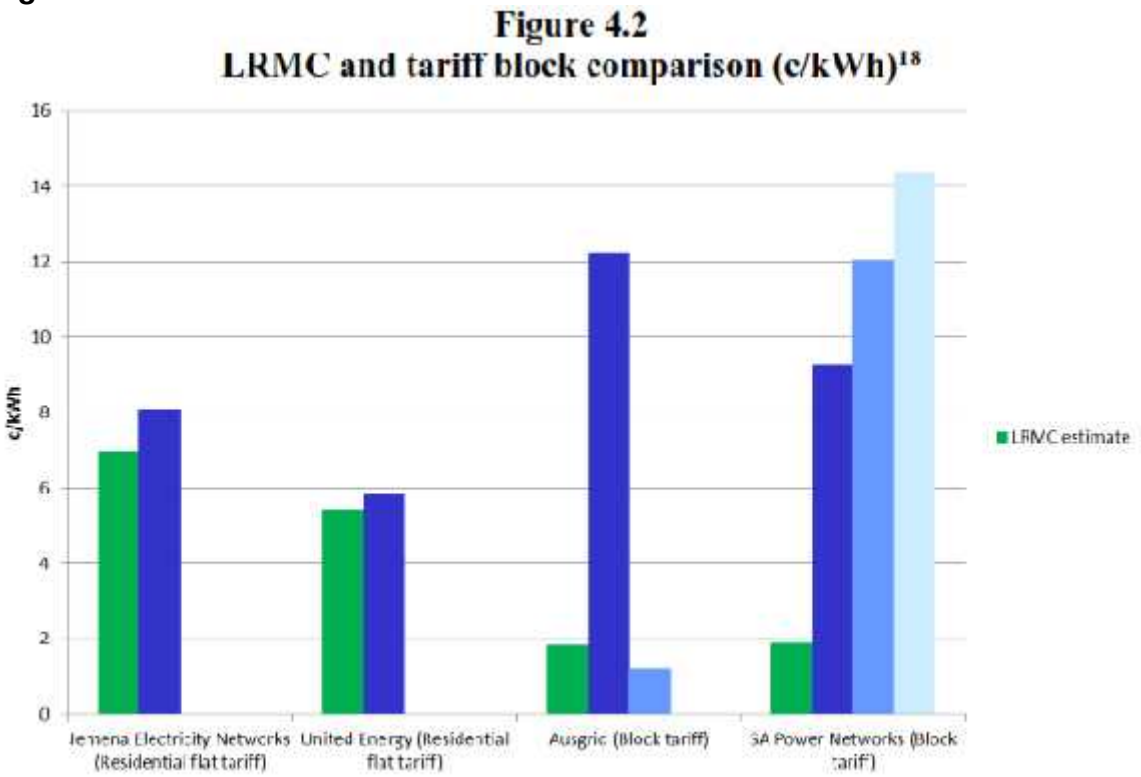
### 3.4.2 The allocation of Residual Costs

The studies by NERA and The Brattle Group illustrate the extent to which LRMC (however calculated) forms only a part of the total network costs to supply a tariff group. In an era of low to negative growth, LRMC will generally recover only a small proportion of the total cost.

NERA provides an example of the different proportions between the LRMC and total costs for different DNSPs, based on the DNSPs' 2013/14 pricing proposals. This is illustrated in Figure 2 below.

[80] The experience of even large consumers is that they have very little negotiating power with a DNSP (or TNSP) unless they are able to by-pass the network.

**Figure 2: LRMC and overall network tariffs[81]**




The relatively low proportion of LRMC of the tariffs for Ausgrid and SA Power Networks (SAPN) probably reflects the very high levels of investment in the two networks in recent years and the resulting excess capacity in the network system such that little new augmentation capital expenditure is required in the next five or so years.

In these instances (particularly Ausgrid and SAPN), the recovery of residual costs can result in the LRMC based price signals being crowded out, and the overall tariff becoming less efficient. The AEMC's Draft rule change attempts to address this by requiring the additional costs to be on the basis that it "minimises the distortion" of the LRMC based allocation of costs.

The suggestion by The Brattle Group and NERA is that this is best achieved by applying Ramsey pricing principles, ie, by allocating the residual costs to the tariff component that is the least elastic. This is because an allocation of costs based on relative elasticity means that there would be minimal distortion of consumer response to the LRMC price signals. In theory, at least, this would mean allocating residual costs to the fixed supply charge component as all consumers

[81] NERA, 2014, Network Pricing Report, p 20.

would receive this additional charge and it would not impact on usage behaviour in the same way as an increase in the variable charge[82].

However, The Battle Group suggests that the common practice in utilities is to allocate the residual costs to the variable charge (whether it is an explicit or implicit allocation).[83] Although in Australia, fixed charges are relatively higher than other countries, it is likely that these charges recover the direct customer related costs but do not recover the residual costs, at least for smaller volume customers. Thus, variable charges are higher, and tariffs less economically efficient, than they need to be given the LRMC.

If, however, the LRMC represents a relatively small proportion of the total costs, the increase in the fixed costs under the Ramsey pricing approach would be substantial and it is doubtful if the community would accept this as being reasonable and fair, particularly to more vulnerable customers. It also encourages increases in usage, which may be efficient from one perspective but would conflict with other policy objectives such as increased energy efficiency and demand management.

There are alternative approaches to pricing that address some of these issues. The introduction of capacity charges for all consumers is one such option. Others include critical peak pricing, time-of use tariffs, declining/inclining block tariffs. For example, with a declining block tariff structure, the residual costs can be allocated to the first block(s), perhaps transitioning to higher fixed costs at some later date.[84] Alternatively (or in addition), governments can provide explicit subsidies to particular customer segments to mitigate their exposure to fixed charges.

The central point, however, is that all these approaches will have significant impacts on different customer segments – there will be winners and losers depending on the level of usage, the profile of the usage and the tariff category and the allocation of the residual costs.

As an example, NERA provides the following illustration (in Figure 3 below) of the impact on a typical residential customer bill of a **time-of use network tariff**

[82] Such an approach could result in inefficient consumer responses too. A very high fixed charge is more likely to result in consumers exiting the market rather than more modestly reducing their demand. Whilst the loss of a consumer might achieve the short term need not to augment the network, it would also mean all other consumers would have to pay higher fixed charges to compensate for the loss of the consumer. This is not an efficient outcome or in the long term interests of consumers. This "threat" is becoming increasingly real given the growth in alternative local forms of generation and network bypass opportunities.
[83] The Brattle Group 2014, Total Efficient Cost Recovery, p 42.
[84] Ibid, p 45.

relative to a flat tariff. Similarly, Figure 4 illustrates the impact on a typical residential bill of a **peak capacity tariff** ($/kW). It is clear from these examples that:

- the allocation of residual costs has a significantly different impact on a customer's bill depending on their level of usage; and

- the impact will vary depending on the type of network tariff the residual cost allocation is applied to.

The reason why the MEU emphasises this issue is because the DNSP's decisions on the allocation and tariff structure have very significant social and economic policy implications that will need to be proactively addressed as well as the potential that the very reason for implementing the change in pricing (ie to provide better signals to consumers) will be so muted as to be lost.

However, allowing the networks the flexibility to choose between the many different combinations of these options greatly complicates the development of an efficient policy response that will be effective both within and between jurisdictions.

For instance, should a government rebate for low income households be fixed or variable? The former would be more appropriate if the residual costs are allocated to the fixed charge, while a variable energy use rebate (such as currently applies in Victoria) would be more appropriate if the residual cost is allocated more to the variable component of the tariff. This policy response difficulty is clearly compounded if DNSPs in the same jurisdiction exercise their flexibility and apply very different approaches, albeit consistent with the pricing principles.

**Figure 3: Change in Customer Bills (Time-of-Use tariff) by Residual Cost allocation[85]**

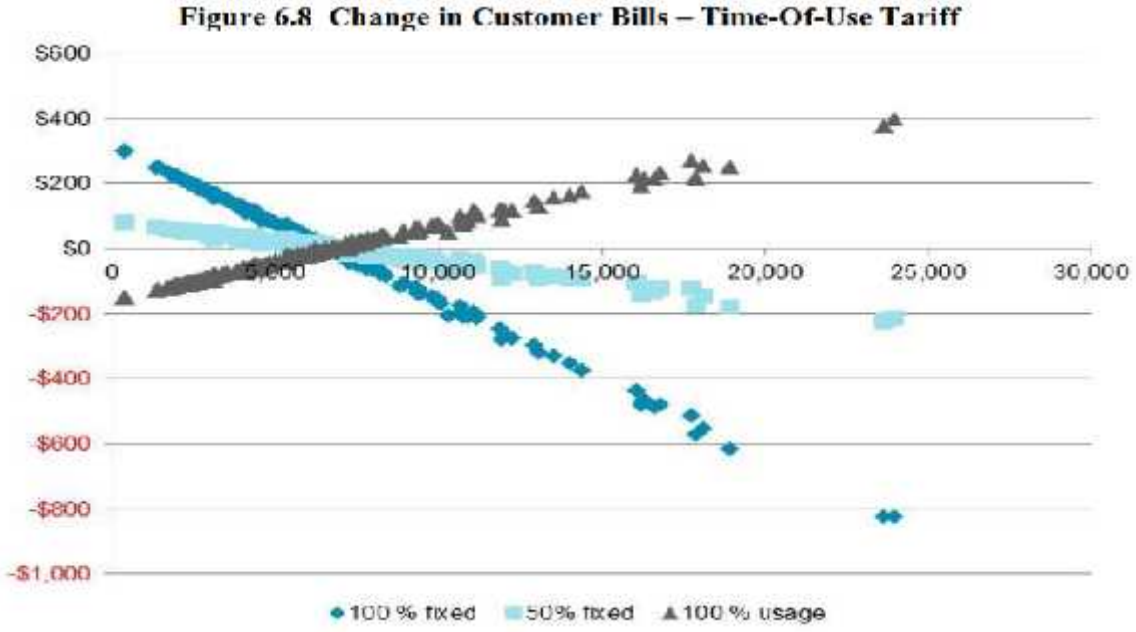
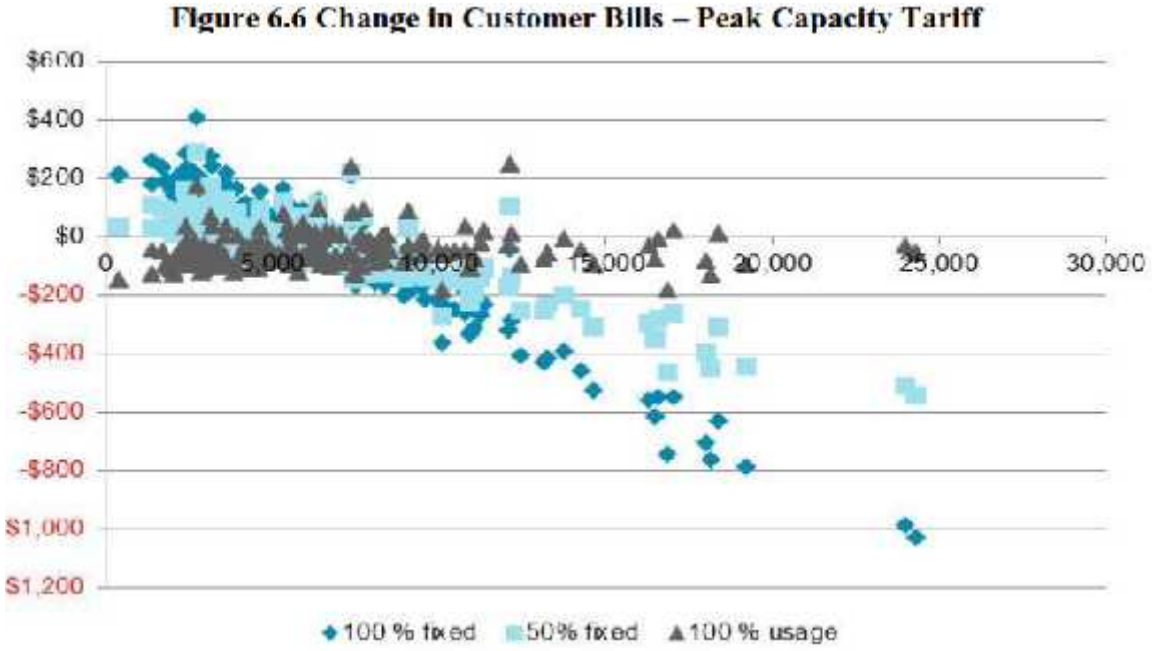



**Figure 4: Change in Customer Bills (Peak Capacity Tariff) by Residual cost allocation[86]**




[85] NERA 2014, Network pricing report, p 39. This assumes that the retailer passes through the network tariff structure in its retail pricing offers.
[86] Ibid, p 35.

### 3.4.3 Pass-through of transmission costs

In its response to the Consultation Paper, the MEU emphasised the importance of having a coherent and consistent approach to the allocation of transmission costs as part of the final network use of system tariff (NUOS tariff).

This is not such an issue for the very largest customers as transmission charges are separately identified and "passed through". However, even with this ability to directly pass through transmission charges, the lack of consistent definitions of (for example) peak capacity charges between the transmission and distribution charges, is a source of frustration and yet another barrier to effective demand-side actions.

For medium to large businesses, transmission costs are an important component of their overall network price, but the process the DNSP uses to allocate these within the NUOS tariff lacks any transparency or, seemingly, much relation to the transmission tariff itself. Thus, the DNSP is able to undermine the pricing signals and therefore, the effectiveness and efficiency of transmission pricing.

The MEU remains concerned with this issue and believes the AEMC has not taken the opportunity to explicitly address this issue as part of the Draft Rules Determination.[87] For example, in its response to the MEU's submission to the Consultation Paper expressing these concerns, the AEMC responds as follows:[88]

> "Transmission charges are an input into the services that DNSPs provide to consumers. As part of the development of cost reflective network tariffs, DNSPs should treat transmission charges similarly to other costs that they incur in providing network services."

The MEU interprets this to mean that the transmission costs will form part of the residual costs, which are then allocated in different ways to different tariff components for different tariff groups.

However, the risk is that, in doing so, the important price signals embedded in the transmission tariff are lost. If this is the case, it would be a most unfortunate outcome as the MEU noted in its response to the Consultation Paper.

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[87] The MEU does, however, recognise that the AEMC has addressed other aspects of the integration of transmission pricing into the NUOS charge, and in particular, the timing of the publication of transmission tariffs has been adjusted.
[88] AEMC 2014, Draft Determination, Network Pricing Rule Change, p 168.

This issue was also identified by Grid Australia in its response to the Consultation Paper. Grid Australia noted that Chapter 6A of the NER requires the transmission service provider to develop cost reflective tariffs and highlighted that there are relatively prescriptive rules about how the cost reflective tariffs should be calculated and designed. Grid Australia also states:[89]

> "The absence of a requirement in the NER to pass on these pricing signals in an efficient, cost reflective manner leaves open to the DNSP how to recover transmission charges from customers. This runs the risk that distribution customers [specifically, larger customers] may not see locational pricing signals, and could therefore be prevented from making efficient locational and consumption decisions."

The MEU absolutely agrees with Grid Australia on this issue and finds the limited and somewhat dismissive response from the AEMC quite concerning. The MEU therefore strongly suggests that the AEMC provide more specific guidance on this issue and also require through the Rules more transparency by the DNSP in setting out its approach to transmission cost pass through. For example, a DNSP's TSS could include a section on how it will allocate transmission costs in the NUOS charge.

### 3.4.4 Capacity Charges

Capacity charging (ie charging for peak demand) in various forms has long been a feature of DNSPs' pricing to larger customers, particularly customers with annual usage over 160 MWh/year. In addition, there is little regulatory or practical constraint on DNSPs developing cost reflective tariffs to apply to larger consumers using efficient capacity charging approaches, along with fixed and variable tariff elements.

There is now a rising interest in developing capacity charges for smaller volume tariff customers as a preferred way of removing cross subsidies and achieving more efficient prices, albeit such a development will require upgrades of meters in many jurisdictions.

As NERA and others note, the principal driver of a DNSP's costs is increased maximum demand at each node. NERA correctly restates this as follows:[90]

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[89] Grid Australia, *Response to the Distribution Network Pricing Arrangements Rule change consultation paper*, December 2013, p 6.
[90] Ibid, p 11-12.

> "Given that the practical cost driver is therefore average maximum demand within period when it is more likely that the network node will be constrained, the relevant demand is only during those periods, and in those locations where this brings forward the need for reinforcement network investment."

The MEU agrees with this, and encourages the move towards capacity charging (in addition to fixed costs per customer and variable usage charges) based on the contribution a tariff customer group makes to the peak system demand in an area.

However, the MEU also believes the Rules should provide more specific guidance on the capacity charge. The MEU members, who have had many years of experience with capacity charges set by different networks, believe that to date networks have failed to utilise these signals as effectively as they can be.

This, in turn, has substantially hindered large customers in managing their load efficiently (from both the customer and network perspective) and providing effective demand management services to support efficient investment in the network.

For example, some DNSPs set the capacity charge on the basis of maximum demand without regard to the time of day, the day of the week or the period of the year.

In these instances, there is no attempt by the DNSP to align the capacity price with the likely network or regional peak[91] *even though there is no practical or regulatory barrier to the DNSP doing so*.

The corollary of this is that there is no signalling through the network capacity charge to the consumer of the benefit of managing their load to reduce demand at times of system/local peak, even though this might lead to substantial reductions in the DNSP's infrastructure investment requirements in a particular area.

DNSPs are often not motivated to achieve such efficiencies when the regulatory determination of the overall revenue rewards actions that increase the value of

[91] The argument is sometimes put that this is because the capacity charge must fund the infrastructure that is installed to meet the customer's peak demand. However, customer specific infrastructure should be captured in the fixed supply charge and/or in the initial connection charges. Capacity charging is then related directly to contribution of the customer's actual demand to the overall system, regional or local peak.

the RAB (by augmentation or replacement) rather than the efficiency of utilisation of the assets that make up the RAB.

These experiences by MEU members and other large consumers, is one factor in the MEU's rejection of the AEMC's proposed approach. The second is that the issue of misalignment in capacity tariffs has been around for some considerable time. For example, the MEU stated in 2012 in response to the AEMC's review of demand side management, as follows: [92]

> "The MEU considers that network supply tariffs should reflect usage at the time when there is the most stress on the network...there needs to be an incentive (by lower network charges) for those consumers who maintain or reduce their demand when the network demand is otherwise increasing."

MEU also notes that the DNSPs themselves have not pursued cost reflective pricing principles with respect to capacity tariffs although there are no regulatory barriers to doing so. The MEU is, therefore, not convinced that relying on a broad pricing objective and a set of high-level principles in the Rules (or mandatory Guidelines) will achieve the desired policy outcomes within any reasonable time frame.

[92] MEU, *AEMC review of demand side participation (DSP3), Response to the Draft Report,* October, 2012, p 5.