Australian Energy Market Commission

STAFF PAPER

Distribution Network Pricing Arrangements: Options for a new network pricing process

14 May 2014

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1 Introduction

This AEMC Staff Paper provides an overview of options to improve the current pricing process distribution network service providers (DNSPs) go through to get network tariffs approved and communicated to retailers and customers.

These options are currently being considered as part of the AEMC's assessment of the rule change request on the Distribution Network Pricing Arrangements submitted by the Independent Pricing and Regulatory Tribunal (IPART) and the COAG Energy Council (formally the Standing Council on Energy and Resources). The options have been developed with reference to stakeholder submissions and workshop outcomes.

The options presented in this paper have been developed taking into account stakeholders' submissions and workshop discussions to date. The purpose of this paper is to stimulate discussions with stakeholders at the workshop on 16 May 2014. The approaches in this paper do not necessarily reflect the views of the Commission and the Commission may consider other options as its consideration of the rule change continues.

In designing potential options for a new network pricing process framework, it is important to be clear about what outcomes the framework should support. In workshops to date, there is general agreement from stakeholders that the network pricing process should contribute to the following outcomes:

- DNSPs are able to recover their allowed revenues over the regulatory period through their annual network prices;
- allow verification and oversight by the Australian Energy Regulator (AER) to assess compliance of DNSP proposed network tariffs with the rules;
- DNSPs undertake appropriate consultation with retailers and consumers in the development of their network tariffs;
- adequate notification of approved annual network tariffs; and
- better understanding of the pricing signals network tariffs are trying to send consumers.

The options outlined in this paper for improving the network pricing process seek to support these outcomes

1.1 Overview

In order to achieve the desired outcomes of the pricing process, a key change would be to split the network pricing process into two stages.

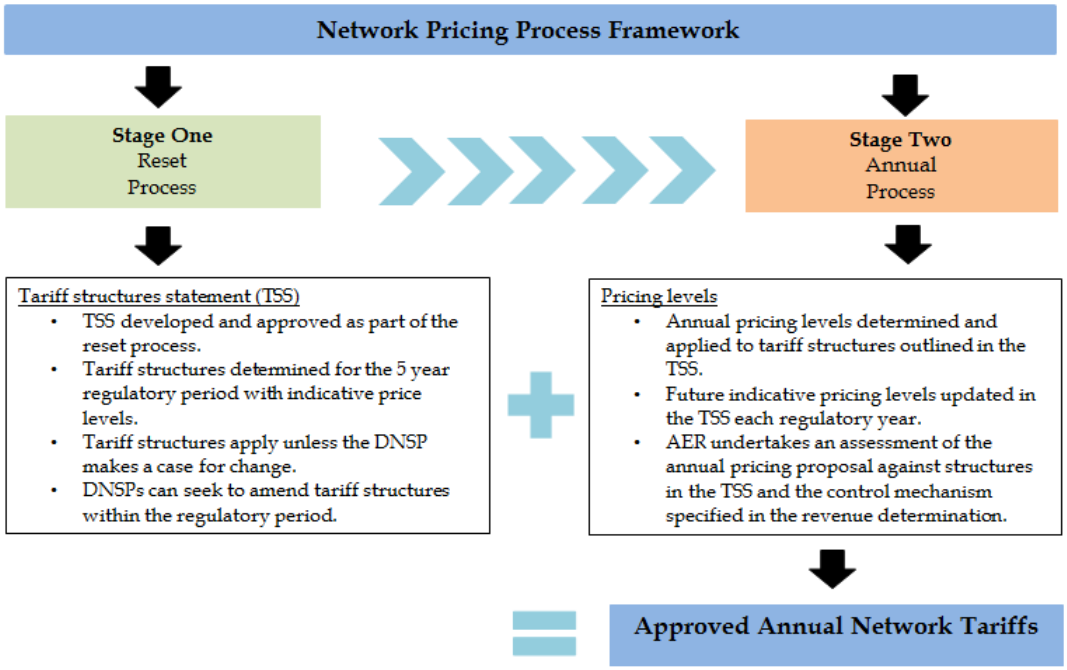
In the first stage, DNSPs would develop a tariff structure statement (TSS) that would outline the tariff structures it will apply over the regulatory control period, which is

typically for five years. This document would be submitted to the Australian Energy Regulator (AER) for assessment against the pricing principles in conjunction with the DNSP's five year regulatory proposal. The AER would approve the TSS if it meets distribution pricing principles and other rule requirements that currently apply.

The second stage of the network pricing process would occur in place of the current annual network pricing process. In this stage, DNSPs would develop and submit their annual pricing proposals to the AER. The annual pricing proposals would essentially apply pricing levels to the tariff structures outlined in the already approved TSS. The AER's assessment of the DNSP's pricing proposal would be a compliance check against the approved TSS and the control mechanism as specified in the AER's regulatory determination.

The two stage process is presented at a high level in Figure 1.1 below.

Figure 1.1 Overview of an improved network pricing process framework with two stages



Splitting the network pricing process into two stages provides an important opportunity to improve the timing of the annual network pricing process to achieve earlier notification of network price changes to retailers and consumers.

There are two options to bring forward the timing of the approval of annual pricing proposals:

1. require annual network prices to be approved and notified two months before taking effect; or

2. require annual network prices to be approved and notified one month before taking effect.

Option one is based on IPART's proposed change that would also require transmission network service providers (TNSPs) to publish their transmission prices two months earlier than they currently do. Option two would effectively place firmer requirements around the existing timeframes for DNSPs, but would require TNSPs to publish their prices one month earlier than they currently do.

As highlighted in submissions to the consultation paper, a key consideration for bringing forward the annual pricing process timeframe is the availability of key pricing inputs for TNSPs and DNSPs.

2 Stage One of the Pricing Process

2.1 DNSP consultation

The first stage of the network pricing process would be part of the regulatory reset process.

Under this approach, DNSPs would have a requirement to consult with retailers and consumers in developing their proposed TSS. The intention of such consultation would be to stimulate discussion between DNSPs, retailers and consumers so that DNSPs have the information to develop more robust and suitable tariff structures that retailers can implement and consumers can understand and respond to. This consultation could occur at the same time as consultation on the regulatory proposal.

To encourage DNSPs to engage in meaningful consultation, DNSPs could be required to demonstrate to the AER how they have taken the views of retailers and consumers into account.

This consultation process could also be used as the basis on which the DNSP assesses the impacts of its proposed network tariffs on consumers, consistent with any pricing principle introduced to this effect as proposed by the COAG Energy Council.

There is a question of whether there should be guidance on how DNSPs conduct this consultation. It is important that the DNSPs have the flexibility to adopt a consultation process that suits their needs, depending on the extent of change to their network tariffs.

One solution might be to rely on the existing AER *Consumer Engagement Guideline for Network Service Providers* to provide further guidance to DNSPs on the type and level of consultation expected at a minimum. This was preferred by most stakeholders in their submissions over introducing a requirement for the AER to develop an additional consumer engagement guideline or placing additional requirements in the rules.

Question for workshop discussion

- How could DNSPs be encouraged to undertake meaningful consultation with retailers and consumers on the development of their TSS?

2.2 Submission of the TSS

Following consultation, DNSPs would develop their TSS proposal and submit it to the AER for assessment and approval alongside the regulatory proposal for the revenue determination. Once the TSS is approved, it would apply for the duration of the DNSP's regulatory control period subject to the ability to amend it as discussed in section 2.4.

2.2.1 Content of the TSS

There would be three elements to the content of a TSS. These include:

1. detailed information on the tariff classes, tariff structures and charging parameters to apply to each regulatory year of the regulatory control period, including the assignment and reassignment of customers to tariff classes;

2. supporting material that demonstrates how the DNSP's tariff structures comply with the pricing principles; and

3. indicative price levels for all tariff structures against each regulatory year of the regulatory control period.

Information on tariff classes, tariff structures and charging parameters approved in the TSS would apply to each year of the regulatory control period unless the DNSP makes a case to change them. That is, once tariff classes, tariff structures and charging parameters are approved by the AER as part of its approval of the TSS, these must be applied in the annual pricing proposals unless the DNSP goes through a process to amend them. What this process involves and what sort of threshold must be met in order to amend the TSS is considered in more detail in section 2.4.

DNSPs would be expected to demonstrate how their proposed tariff structures and indicative pricing levels comply with the pricing principles over the regulatory control period in the proposed TSS.

In practice, this may require DNSPs to specify the methodology by which they will calculate network tariff pricing levels in their TSS. This means that while price levels included in the document may be indicative only, DNSPs would need to explain any significant unexpected change in the price levels from one year to the next compared to the indicative information in the approved TSS during the annual pricing process.

The inclusion of indicative pricing levels in the TSS is to facilitate consultation to allow retailers and consumers to gauge the likely impact of changing price levels of different tariffs.

In submissions and the earlier workshop, DNSPs expressed some concerns of having a binding tariff document that requires them to commit to binding pricing levels in advance of the pricing years. However, a TSS that does not provide any certainty on what tariffs will apply will not promote the level of engagement and confidence that would support better outcomes and address retailer and consumer concerns. The TSS tries to strike an appropriate balance between allowing flexibility to adjust pricing levels and providing a significant degree of certainty around pricing structures. This approach also supports a greater level of certainty from unexpected changes to tariff structures at short notice that impacts on retailers and consumers.

Question for workshop discussion

- Would the proposed content of the TSS achieve the right balance between flexibility for DNSPs and certainty for retailers and consumers?

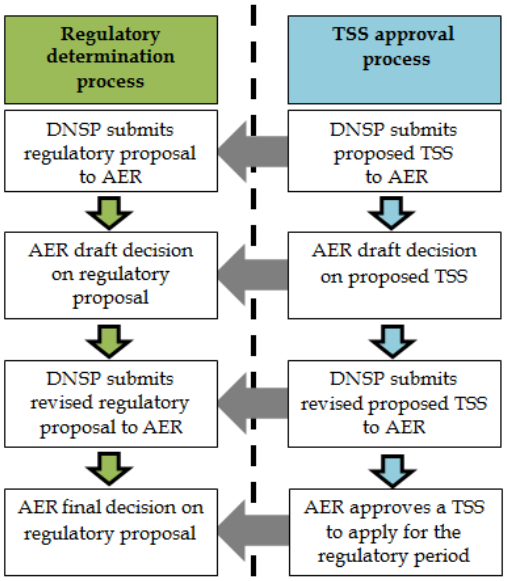
2.3 AER approval of the TSS

The AER would assess the proposed TSS for compliance against the pricing principles and other rule requirements. The AER would need to consider how the DNSP has addressed and applied the pricing principles. This assessment would mainly be focussed on the tariff classes, tariff structures and charging parameters, having regard to the information the DNSP has provided in relation to how it has applied the pricing principles. Undertaking this assessment as part of the 15 month revenue reset process ensures that the AER has sufficient time to properly assess the TSS against the pricing principles.

AER consultation on the TSS would be intended to assist it in its assessment of the TSS. This would be an opportunity for the AER to consider the extent to which DNSPs have incorporated retailer and consumer feedback into their proposed tariffs.

Consistent with the arrangements for the approval of the Pricing Methodology for Transmission under Chapter 6A, the AER would make a draft and final decision in relation to the TSS. If the AER does not approve a DNSP's proposed TSS in its draft decision, it would issue a statement of the changes required. The DNSP would then submit a revised proposed TSS that addresses the issues identified in the AER's draft decision. If the AER is not satisfied that the revised proposed TSS complies with the pricing principles and does not approve it, it would amend the TSS to the extent necessary so that it complies with the pricing principles. This process is illustrated in Figure 2.1 below.

Figure 2.1 Alignment of TSS approval process with the regulatory determination process



The approved TSS would be used by the DNSP as the basis for its annual pricing proposal developed and approved in stage two of the network pricing framework as discussed in section 3.

DNSPs would have to publish the approved TSS on their websites, updating it each year for indicative price levels, similar to current arrangements. This would give retailers, consumers and the AER access to better information about the likely trajectory of future network tariff price levels. This information would be particularly useful for retailers as evident from their submissions.

Question for workshop discussion

- Should the TSS approval process be similar to the pricing methodology approval process for TNSPs under Chapter 6A, as outlined above?

2.4 Amending the TSS

DNSPs would have the ability to change their approved TSS to deal with significant and unexpected events and/or conditions. As pricing levels in the TSS are indicative only, a DNSP may need to amend the TSS in relation to the tariff classes, tariff structures and charging parameters as detailed in its previously approved TSS.

There are two options for allowing the TSS to be amended during the regulatory control period. The TSS could either be amended with some form of materiality threshold or a higher test of better meeting the pricing principles.

2.4.1 Materiality Threshold

A materiality threshold can provide some transparency in relation to the significance of an event or circumstance that requires amendments to the TSS.

A materiality threshold also provides some certainty to stakeholders that the TSS will only be amended in certain circumstances where it is considered that there is a material reason for such a change.

The materiality threshold would be a numerical value that a DNSP could be required to demonstrate as part of its case for amending its TSS. It could be expressed as a percentage or level of revenue that is at risk unless the DNSP is able to amend its TSS for the remaining years of the regulatory control period.

Further to meeting the materiality threshold, the DNSP would also be required to demonstrate that its amended TSS still meets the pricing principles.

Under the option of no materiality threshold, DNSPs could be required to demonstrate that a revision to some of its tariff classes, tariff strucutres or charging parameters could result in a *better* outcome in terms of the pricing principles. The AER would be required to form a view in relation to whether a DNSP's amended TSS does better meet the pricing principles in order to approve an amendment to the TSS.

If the AER does not approve the proposed amended TSS under either option, the previously approved TSS would continue to apply.

Question for workshop discussion

- Should amending a TSS be subject to a materiality threshold? If so, how should the materiality threshold be defined?

2.4.2 Timeframe for amending the TSS

If a DNSP wants to amend its TSS, this should occur outside the annual pricing process to ensure that the timeliness of that process is not compromised.

Ideally, a DNSP should submit its amended TSS to the AER at least six months before the commencement of the annual pricing process. This would allow sufficient time for the AER to undertake a thorough assessment of the amended TSS proposal. The AER can then also undertake public consultation on the amended TSS before making its decision on whether to approve it or not.

The AER would be required to publish its decision on a revised proposed TSS one month before the commencement of the annual pricing process. This would give retailers and consumers sufficient notification of a change in tariff structures before the change would apply.

Question for workshop discussion

- What is an appropriate timeframe for amendments to the TSS?

3 Stage Two of the Pricing Process

Stage two of the network pricing process would occur on an annual basis. This process would be similar to the existing annual pricing process. However, four significant changes need to be made to incorporate the desired features as described in section 1:

1. DNSPs would develop their annual pricing proposals by applying pricing levels to the tariff structures outlined in the approved TSS;

2. the AER's assessment of the annual pricing proposals would essentially be a compliance exercise of auditing tariff structures against the tariff structures outlined in the TSS and the pricing levels against the control mechanism specified the DNSP's revenue determination;

3. the timing of the annual network pricing process would be moved forward to facilitate earlier assessment and approval of network price changes; and

4. the AER would have a binding timeframe within which to approve annual network prices, with an ability to "stop the clock". A foregone revenue compliance incentive could be introduced to reassign the risk of delays to the finalisation of network prices from retailers to DNSPs.

3.1 DNSP's annual pricing proposal

With tariff classes, tariff structures and charging parameters set in the TSS, DNSPs would apply pricing levels to those elements in the annual network pricing process to come up with the network tariffs to apply for the next regulatory control year. This would form the basis of their annual pricing proposals.

This proposal would be submitted to the AER for assessment as currently occurs. The DNSP would have a set timeframe by which to submit the annual pricing proposal to the AER.

3.2 AER assessment

The AER's assessment of the annual pricing proposal would entail the AER checking that the tariff structures in the annual network pricing proposal are consistent with those outlined in the approved TSS and that the pricing levels are consistent with the control mechanism as defined in the AER's regulatory determination. The AER would also check that the DNSP's proposed pricing levels are broadly consistent with the indicative pricing levels provided in the TSS or that the DNSP has given reasons for any material difference.

3.2.1 Timeframe for AER

The AER would have 20 or 30 business days in which to undertake its assessment of the annual pricing proposal. During this period, the AER would either approve the proposed network prices or it could "stop the clock" on its assessment of the network prices in the allowed timeframe.

The AER would only be able to "stop the clock" in instances where the annual pricing proposal is not submitted on time or where the AER considers that the annual pricing proposal is not compliant with the rules, including where it is not consistent with the approved TSS or the control mechanism. The clock would start from where it stopped each time a DNSP resubmits its annual pricing proposal.

Stopping the clock on the annual pricing process may mean that network prices are not be approved in time for retailers to implement changes to their retail tariffs. This issue could be mitigated by introducing an incentive on DNSPs to submit pricing proposals that can be approved by the AER in the allowed timeframe. The "stop the clock" provision would then only be used where there are serious deficiencies in the pricing proposal that requires further assessment.

Questions for workshop discussion

- What time period should the AER have to assess the DNSP's annual pricing proposal?
- Under what circumstances should the AER be able to "stop the clock"?

3.3 Compliance incentive for DNSPs

If the AER is able to "stop the clock" on its assessment timeframe, it may be appropriate to introduce a mechanism by which DNSPs are incentivised to provide full and compliant annual pricing proposal on time. This would enable timely notification of approved network prices for retailers and transfer the risks associated with any delays in the approval of annual network prices from retailers to DNSPs, where DNSPs cause delays for annual network price changes.

One option to incentivise DNSPs would be to introduce a minimum notification period. This period would be either one or two months depending on the timing option selected as discussed further below in section 3.4.

Under the incentive approach, DNSPs would not be able to charge new prices until the expiry of this minimum notification period. If there are any delays to the approval of network prices, this could mean that network prices do not change on 1 July (or 1 January in Victoria). Any additional revenue that would have been recovered in the period between the start of the regulatory year and the expiry of the minimum notification period would be forgone where there would have been a price increase in network charges.

Such an approach would place a strong incentive on DNSPs to submit a full and compliant annual pricing proposal. However, if prices are to fall in the relevant regulatory year, this mechanism would potentially delay a reduction in network prices. In these instances, the DNSP would be required to refund the amount of revenue that was collected between the start of the regulatory year and the expiry of the minimum network price notification period. In essence, this would be revenue neutral and as such, may not incentivise the DNSPs to provide a full and compliant annual pricing proposal as an instance of rising network prices would.

There is a question as to whether the implementation of this compliance incentive might cause administrative issues for retailers. Under this incentive, the network prices of DNSPs may change on different dates. This may require multiple changes to the billing systems of retailers that could create additional administrative burden.

An alternative to the introduction of a foregone revenue compliance incentive could be to maintain the existing AER powers to amend annual network tariffs to the extent necessary to approve them[1]. This could work in conjunction with giving the AER more time to assess annual pricing proposals.

Questions for workshop discussion

- Is the introduction of a compliance incentive appropriate to ensure that full and compliant annual pricing proposals are submitted to the AER on time?
- How should a compliance incentive work where network price reductions are expected?
- What issues would retailers encounter in implementing network price changes later than 1 July (1 January for Victoria) due to delays to the approval of network prices?

3.4 Timing of the annual network pricing process

Splitting the network pricing process framework into two stages offers significant scope to improve the timing of the annual process to facilitate earlier approval and notification of new network prices.

Timing of the existing annual network pricing process is in part determined by the availability of certain key inputs that go into finalising transmission and distribution prices.

There are two viable options for the timing of the annual pricing process:

1. network prices to be approved and published two months before taking effect; and
2. network prices to be approved and published one month before taking effect.

1 NER clause 6.18.8(b)(2), NER clause 6.18.8(c)

Most submission supported moving forward the approval and notification of annual network pricing process, with retailers seeking two months and many DNSPs expressing support for moving approval forward by one month.

3.4.1 Option for two months notification of network price changes

IPART has proposed that DNSPs' network prices be set two months before taking effect.

Under this option, transmission prices would be published by 15 March, two months earlier than under the current arrangements. As 15 March is the date on which inter-regional TUOS charges will be published from 2015 and the date on which quarterly inter-regional settlement residue auctions proceeds are currently published, TNSPs would either have to use forecasts instead of actuals for these inputs or the timing by which these inputs become available would need to be adjusted.

DNSPs would be required to submit annual pricing proposals to the AER one month earlier than they currently do. For all jurisdictions but Victoria, this would mean that DNSPs would submit their pricing proposals to the AER by 31 March each year. In Victoria, DNSPs would submit their pricing proposals to the AER by 30 September each year.

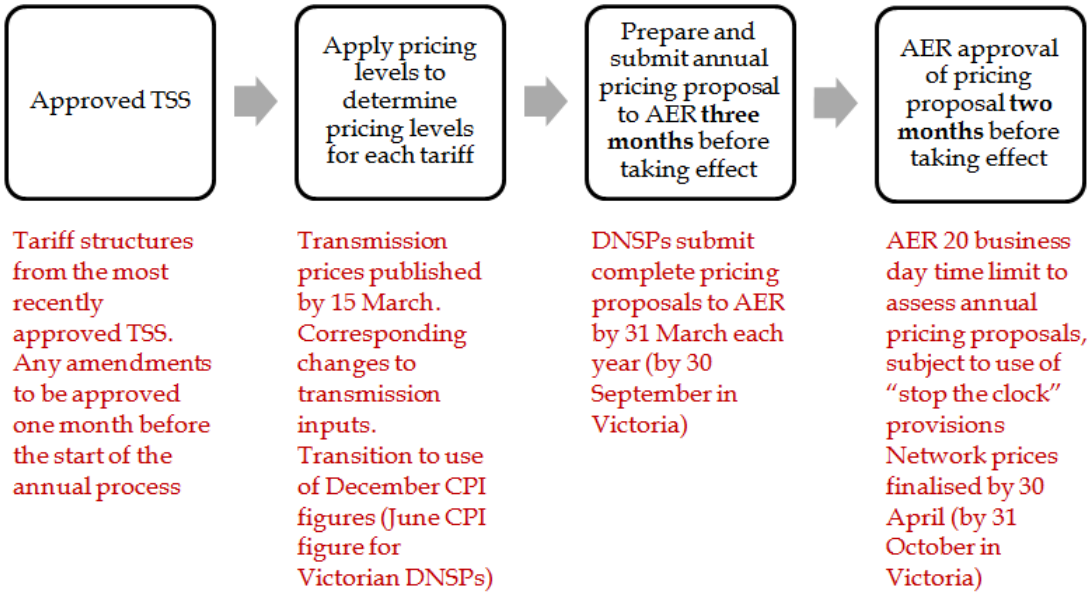
The AER would have 20 business days in which to assess and approve network prices. This would be subject to the AER's use of a "stop the clock" provision. If the AER does not need to use its ability to "stop the clock", network prices would be finalised by 30 April (or by 31 October in Victoria).

This option would give retailers two months notification of the final network price levels.

The CPI figure used by TNSPs and DNSPs would need to change to the December quarter CPI, which becomes available in late January. As the AER is able to specify which CPI figure applies to the TNSP or DNSP in its regulatory determination, this could be amended for future determinations. A transitional arrangement may need to be put in place for existing determinations.

How this timing would work in practice is shown in Figure 3.1.

Figure 3.1 Annual pricing process with two months notification of network prices



3.4.2 Option for one month notification of network price changes

This option would apply firm deadlines to the indicative timeframes already within the rules.

Under this option, transmission prices would be published by 15 April, one month earlier than under the current arrangements. This is after the date by which inter-regional TUOS charges will be published and the date on which quarterly inter-regional settlement residue auctions proceeds are currently published, so TNSPs would be able to incorporate actuals for these inputs in their annual transmission prices.

There would be no change to the date by which DNSPs are required to submit their annual pricing proposal to the AER under this option. In all jurisdictions but Victoria, DNSPs would submit their annual pricing proposals to the AER by 30 April. In Victoria, DNSPs would submit annual pricing proposals to the AER by 31 October.

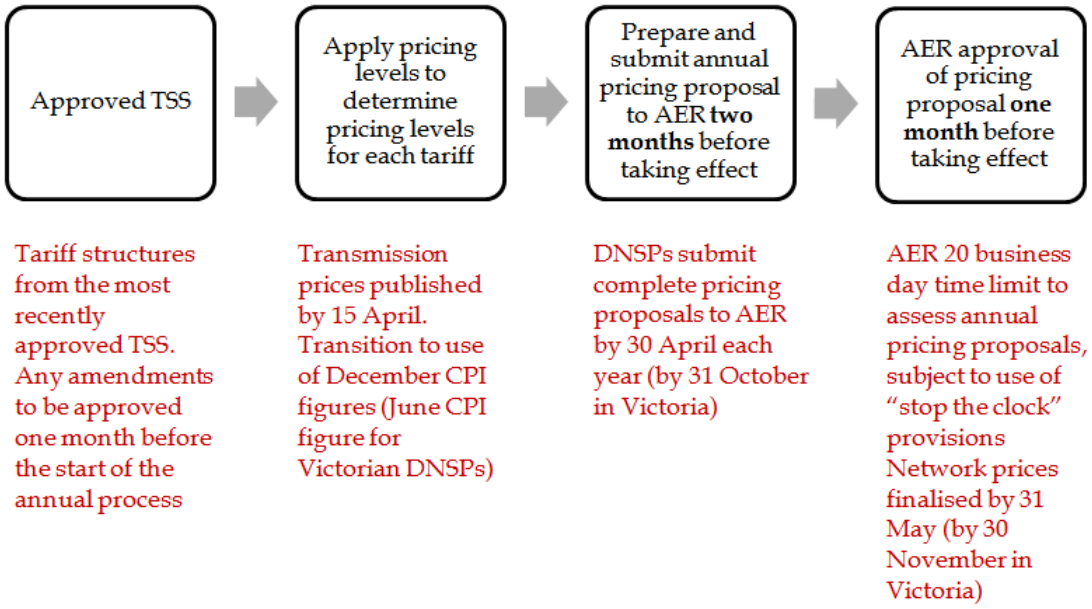
As under this option, the AER would still have 20 business days in which to assess and approve network prices, subject to the use of the "stop the clock" provision. If the AER does not need to use its ability to "stop the clock", network prices would be finalised by 31 May (or by 30 November in Victoria).

This option would give retailers one month notification of new network price levels.

Again, TNSPs and DNSPs would need to be able to use December CPI in the development of annual prices.

How this timing would work in practice is shown in Figure 3.2.

Figure 3.2 Annual pricing process with one month notification of network prices



Questions for workshop discussion

- Are there significant additional risks created by moving the timeframe forward by two months in comparison with risks created by moving forward one month?
- What additional benefits are gained by moving the timeframe forward by two months?