Energy Consumers Australia

Multiple Trading Relationships

Submission in response to Draft Rule Determination

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Energy Consumers Australia
PO Box A2258
Sydney South NSW 1235
ABN: 96 603 931 326

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Introduction

Energy Consumers Australia considers that the draft determination on the "Multiple Trading Relationships" rule proposals does not promote the long term interests of consumers.

The AEMC review of the proposed rule identifies that there are two high value services for which current trading relationships are inadequate.

The analysis identifies ways of achieving trading relationships to provide these services which are preferable to the proposed rule. The AEMC should proceed to making more preferable rules through the current process to achieve these outcomes.

Background

On 19 November the Australian Energy Markets Commission (the AEMC) published its Draft Rule Determination (the Draft) on the National Electricity Amendment (Multiple Trading Relationships) Rule 2015 and the National Energy Retail Amendment (Multiple Trading Relationships) Rule 2015.[1]

On 30 November 2012 the AEMC issued its 'FINAL REPORT Power of choice review - giving consumers options in the way they use electricity'.[2] On 11 December 2012 the AEMC issued its 'FINAL ADVICE Energy market arrangements for electric and natural gas vehicles.'[3] As part of the latter report the AEMC recommended:

> *New metering arrangements that enable the separation of load (or generation) for the purposes of DSP. This should enable efficient EV charging and greater consumer choice. We have specified arrangements for embedded networks, parent/child metering, multi-element meters and situations where there is more than one Financially Responsible Market Participant (FRMP) at a connection point.*

In June 2013 the COAG Energy Council (the EC) asked AEMO to develop a rule change proposal to better allow for multiple trading relationships (MTR) at a single site in the National Energy Market[4]. It was listed as item 11 on the COAG EC Demand Side Participation Program.[5] In December 2014 the AEMO submitted the rule change proposal resulting from the EC. This is the rule change subject to the current Draft.

While the original MTR proposal was not included in the final Power of Choice report, it was developed contemporaneously with it. The AEMC's own Power of Choice web page has listed the MTR rule change consideration as part of the work-stream[6]. The media release accompanying the publication of the Draft stated "The rule change request follows earlier work by the AEMC to develop a new framework to better enable customers to engage with multiple retailers, as part of the Power of Choice review."[7]

The emerging services market

The research conducted by KPMG as part of the consideration of the rule change revealed that there are eight other services besides EV charging for which MTR is an enabler. For both the EV charging and aggregator models MTR is identified as being an essential dependency. (see Fig 1)

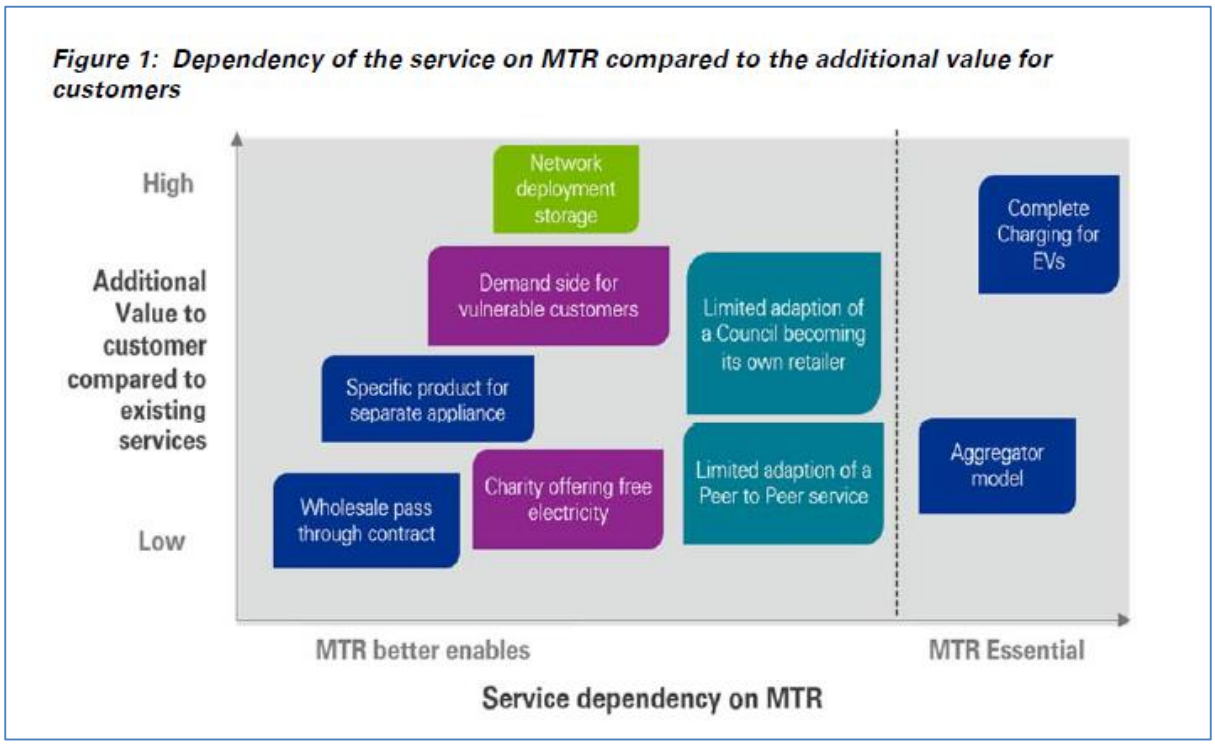


Fig 1: Extract from KPMG Report[8]

The value of specific energy products for separate appliances is under-estimated in the KPMG report.

For example Pooled Energy is a company whose primary product is pool management involving continuous water quality management and consequent incremental chemical addition and controlled pump management. Under current rules, the firm has been required to enter the market as the entire provider of the household energy services integrating the pool management into a total energy offering. Similar value could potentially be created for consumers by other service providers offering control services for other major appliances. Under current rules, the householder will be required to choose whole of household bundled energy providers and will not have the option of choosing unbundled appliance based offers.

The Long Term Interest of Consumers

The Australian energy market arrangements (the Australian Energy Market Agreement and the three Laws introduced as a consequence) have as their stated purpose the promotion of the long term interests of consumers. The guiding principle is that monopoly elements will be separated from potentially competitive elements, that competition is promoted in those markets where it is viable and that “best practice” economic regulation will be applied to the natural monopoly elements.

A characteristic of effectively competitive markets is that they promote innovation. This point was well made by the Review of Governance Arrangements for Australian Energy Markets (see Box 1). The degree of innovation actually occurring is a good proxy measure of the effectiveness of competition in promoting the long term interests of consumers.

Box 1: Extract from the Review of Governance Arrangements[9]

The overall objective for the energy sector in Australia is that the long-term interests of consumers are efficiently served. In a dynamic environment this requires, among other things, that the constant search of market participants and potential participants to discover new and better ways of doing things is not materially impeded. It also calls for a degree of adaptability in the market rules as contexts change, although balance is required here insofar as rules also need to be reasonably stable and predictable over time if they are to serve their purposes—unpredictability in rules, sometimes called 'regulatory uncertainty', tends to degrade effectiveness.

The Panel considers that it is important to recognise the fundamental purposes of the existing governance structures because there are ever-present pressures to seek to use institutional structures as instruments to achieve specific, short-term market outcomes, usually because particular market outcomes would better serve the interests of a particular group that are not aligned with the long-term interests of consumers. These pressures can emanate from many sources: politicians, sellers, buyers, bureaucrats, intellectuals and so on. Effective governance depends on establishing and maintaining institutional structures, including market rules, which are relatively robust in the face of these pressures.

While the promotion of the long term interests of consumers is the objective across the energy market value chain, consumers themselves are only actively involved in choice in the retail market place.

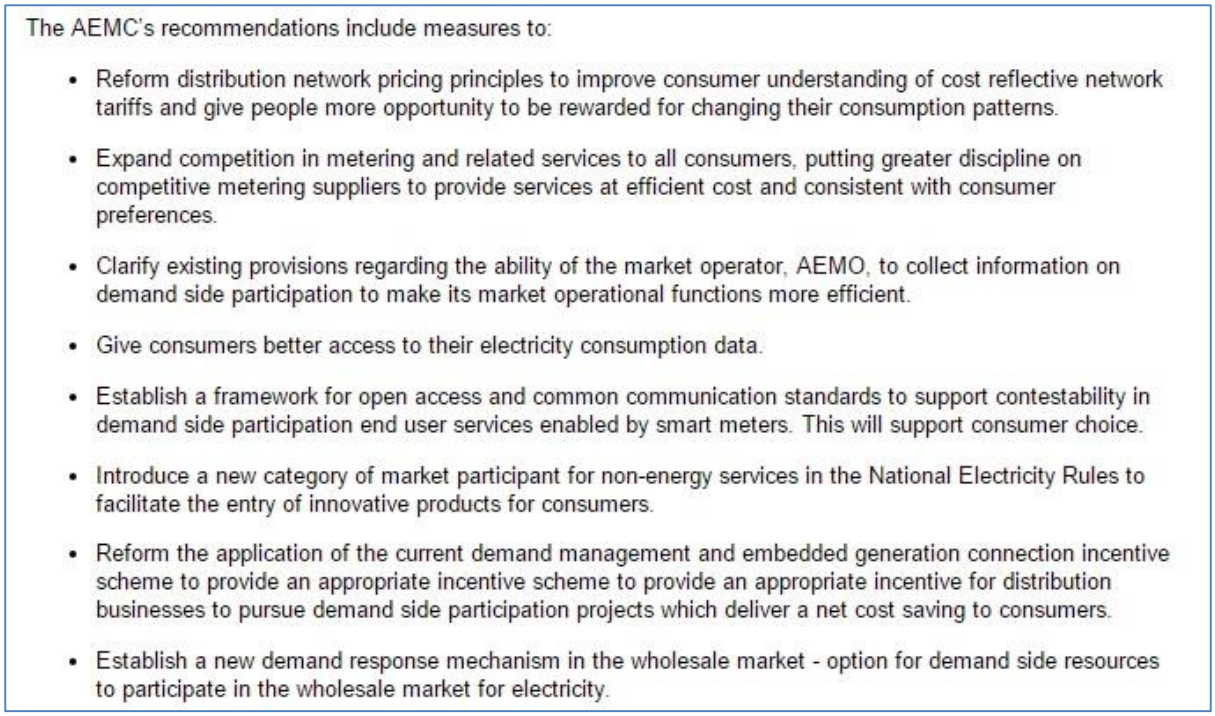
Electricity consumers have been faced with electricity prices that increased by up to 80% from 2007. There has been some recent moderation in these prices but nothing to match the original size and pace of the increases.

Consumers have also been faced with ongoing uncertainty about climate policy and the approach to distributed PV generation. A significant part of this uncertainty has been the arbitrary structure of feed-in tariffs.

The response to consumer concern about many of these issues has been that the work program encompassed under the heading "Power of Choice" would deliver on the promise of the final report's sub-title - "giving consumers options in the way they use electricity."

Three years into that work program there is little substantive outcome from the perspective of consumers. They are still paying high prices and have few tools to manage their use. There are few new innovative competitors and competition is based on price discounting rather than new products and services.

The AEMC's webpage for Power of Choice lists reform of network pricing and metering contestability as the first two of the recommendations. (see Fig 2)


The AEMC's recommendations include measures to:

- Reform distribution network pricing principles to improve consumer understanding of cost reflective network tariffs and give people more opportunity to be rewarded for changing their consumption patterns.
- Expand competition in metering and related services to all consumers, putting greater discipline on competitive metering suppliers to provide services at efficient cost and consistent with consumer preferences.
- Clarify existing provisions regarding the ability of the market operator, AEMO, to collect information on demand side participation to make its market operational functions more efficient.
- Give consumers better access to their electricity consumption data.
- Establish a framework for open access and common communication standards to support contestability in demand side participation end user services enabled by smart meters. This will support consumer choice.
- Introduce a new category of market participant for non-energy services in the National Electricity Rules to facilitate the entry of innovative products for consumers.
- Reform the application of the current demand management and embedded generation connection incentive scheme to provide an appropriate incentive scheme to provide an appropriate incentive for distribution businesses to pursue demand side participation projects which deliver a net cost saving to consumers.
- Establish a new demand response mechanism in the wholesale market - option for demand side resources to participate in the wholesale market for electricity.

Fig 2. Extract from AEMC's Power of Choice webpage[10]

The program for cost reflective pricing has reached the stage of proposals from networks, but there is no indication on how these initiatives will be reflected in the only market in which consumers directly engage in choice – the retail market.

Metering contestability does not commence till December 2017, and the consultation on rule changes for the 'B2B framework' has only just commenced.

In the midst of this turmoil the AEMC has assessed the rule change proposed by the AEMC for Multiple Trading Relationships and concluded that:[11]

> *If implemented, the rule change request would benefit only a small number of customers who wanted to set up MTR arrangements. However, it was also likely to require retailers and distributors to make extensive changes to IT systems and other processes. The costs of doing so could increase retail electricity prices for all customers, not just those who wanted to establish MTR arrangements.*
>
> *In addition, the proposal could increase the complexity faced by customers in electricity retail markets, which may make it harder for customers to engage effectively in the market. It may also create risks for vulnerable customers.*

There are reasons to question the validity of these conclusions which will be discussed in the next section of this submission. However, the overarching concern is that the proposed response by the AEMC seems to be to terminate the consideration of the rule request without identifying what further work could be done to develop a preferable rule. .

The media release issued with the draft stated "Since the AEMC's initial work was completed, other Power of Choice reforms have been progressed that provide similar benefits and reduce the need for this new framework."

This does appear to be in direct conflict with the KPMG assessment which was that MTR continues to be essential for two services.

In the Draft the AEMC considers the ATA and CUAC proposed "single meter model." This model was a simpler version than full MTR that had the particular advantage of enabling PV generating households to sell to someone other than their supply retailer. This would be a solution to the aggregator model and does not appear to be a benefit delivered by any other PoC work.

The AEMC notes that "The Commission has carried out some initial investigation of the single meter model to better understand how it might operate. This initial work indicates that the single meter model has the potential to provide efficiency benefits for some customers." The Commission notes that additional work would be required to deliver the model and that other "stakeholders indicate that there may be alternative versions of the ATA and CUAC's single meter model that could also be validly considered as part of any further investigation of a single meter model".

In the more detailed consideration of the model at Appendix A the AEMC notes:

> *An initial, high level review of the single meter model suggests that these issues are likely to be extensive and complex. As such, it would be more appropriate for the assessment of the ATA and CUAC proposal to take place as a stand-alone rule change process. If stakeholders consider there are potential benefits associated with the single meter model as proposed by ATA and CUAC, they may develop the concept into a rule change request to be submitted to the AEMC.*

The long term interests of consumers is not well served by this approach. The agency responsible for market development provided advice to the COAG Energy Council that new arrangements are required to facilitate the retail market (MTR), but three years later that agency is deciding not to pursue that change to completion.

The AEMC has formed the view that the rule proposed by the AEMO is defective but that also a revised rule proposal could achieve the desired outcome. It is unclear why the AEMC is not proposing a more preferable rule.

It is an inadequate position for the AEMC to determine that it and/or AEMO do not have the responsibility for completing the work they initiated, and instead propose that "stakeholders" develop the proposal further. As will be discussed in the next section the dominant stakeholders – incumbent retailers and distribution network service providers (DNSPs)- have demonstrated that they are unwilling participants to a proposal that promotes retail competition.

Deficiencies in the AEMC analysis

The AEMC is dependent on stakeholders in determining the costs and potential benefits of a rule proposal. In considering the extent to which a proposal promotes the long term interests of consumers it is important that the counterfactual to the proposal isn't merely the *staus quo* but is instead the set of future changes that will occur.

It is not surprising that retailers would not keenly embrace proposals that would increase competiveness in a highly concentrated retail market. It is also not surprising that DNSPs are not embracing changes that require more complex relationships with retailers.

As a consequence the submissions of these stakeholders can be expected to understate benefits and overstate costs.

The most significant case of the latter is in the consideration of the system upgrade costs that would be incurred by the networks and/or retailers. In particular the AEMC wrote:

> *Implementation of the rule change request would require retailers and distributors to update their IT systems and operational processes, the costs of which would be passed on to customers as increased electricity prices. This means that while there may be some direct cost savings for a small subset of customers, all other customers would be likely to face an increase in retail electricity prices but receive no benefit.*

The ongoing development of the energy market is going to require the update to these IT systems. Many of these updates will be occurring as a result of other changes, including metering contestability. To proceed with a full set of changes in one stage rather than two or more can be a net saving not a net cost. In the case where this doesn't apply, the real cost to the firm is the cost of bringing forward an expenditure from a date in the future to today.

In short, the strategic choice is not between updating systems or not updating systems, it is only the timing of the update.

In considering the potential demand for new services for which MTR is a required input the AEMC report relies primarily on the opinion of the existing incumbent retailers…the very businesses most at competitive threat from new services. The AEMC notes:

> *Stakeholders broadly agreed with the KPMG analysis that the ability of a customer to engage with multiple FRMPs* [retailers] *at a premises was not critical to enable most of the identified new services.*

The conclusion that MTR was not an "essential" enabler to **most** of the new services is not the same as it not being essential for **any** new service. As mentioned above, the KPMG report[12] considered nine services for their dependence on MTR and the additional value to consumers, and found MTR essential for two of them.

The two services for which MTR was regarded as essential were charging options for electric vehicles (the starting point of the whole proposal) and the generation aggregation model. Two of the four consumer advocates who submitted on the question of demand are responsible for the submission of an alternative proposal that would still meet the needs of the generation aggregation service (the single meter model).

The third element the AEMC relies on for rejecting the proposed rule is the availability of a substitute by the use of a second (or multiple) connection point. As submissions noted widespread use of second connections is non-trivial. However, the solution is potentially viable in the near term

for higher value services, in particular EV charging. Further, the wide spread use of multiple connections may require rule and system changes.

The approach of favouring a second connection is, however, grounded in two errors. The first is the methodological tendency to analyse issues through the lens of infrastructure rather than services. The long term interest of consumers is promoted through the development for the emerging services market.

The second is a confusing question of cost comparison. The system wide cost of the use of multiple connections versus the cost of developing MTR may be lower while there are only a few customers utilising the relevant services, but over time the relative proportion changes.

What the cost equation looks like for the individual consumer depends on how the costs of implementing MTR are passed on to consumers. If the costs are averaged across all consumers the individual trade off favours the pursuit of MTR over second connections. (For an interesting comparison see Box 2)

Box 2 – Case study of the ULL

When access to the Unconditioned Local Loop was introduced in telecommunications regulation, Telstra incurred extra costs to develop IT systems to make this service available. Telstra argued that these "ULL specific costs" needed to be recovered from only those customers acquiring the ULL. Service acquirers argued that this was an unavoidable cost of Telstra providing copper services to itself and others in the context of the regulatory environment and that the so-called "ULL specific costs" should be recovered across all copper services. The ACCC and subsequently the ACT agreed that the latter interpretation promoted the long term interest of end users.[13]

However the claim by DNSPs that charging for two sets of fixed Distribution use of System (DUOS) charges is a fair reflection of costs is a straight-forward misapplication of the pricing principles. The LRMC of the second connection is close to zero if the customer is simply distributing their existing load across the two connections. It is correct to state that the "cost reflective" component of the connection should be based on the aggregate of the two services, but the one household should not pay a residual twice.

In a very simplified case let's assume that the network charge is based on a cost reflective "capacity" charge (some kind of variable peak usage charge) and a residual cost recovered as a fixed fee per household. The household peak should add the two capacity charges together (note in most models separately billing the two connections would achieve that) but there is no basis on which the extra connection can be said to have increased the total residual system cost.

If second connection is to be the recommended solution to high value applications of choice of supplier then the DNSPs need to consider the approach to tariffs for second connections as part of their future Tariff Structure Statements. It may be desirable to make a specific rule change to ensure that customers choosing a second connection are not charged second fixed charges and to enable aggregation of data.

As the extract from the governance review included in Box 1 noted, "there are ever-present pressures to seek to use institutional structures as instruments to achieve specific, short-term

market outcomes, usually because particular market outcomes would better serve the interests of a particular group that are not aligned with the long-term interests of consumers."

The theory of regulatory capture as outlined by George Stigler takes this observation to its ultimate conclusion.[14] The effort placed on obtaining specific outcomes by a few organisations with a lot at stake will exceed the effort exerted by a disperse group of individuals with little at stake. As a consequence regulatory outcomes will favour the few organisations with a lot at stake at the expense of the diverse population that will benefit by a small amount. Stiglitz proposes the general hypothesis that "every industry or occupation that has enough political power to utilise the state will seek to control entry."

It is a responsibility of the AEMC to be alert to the risk of perceived or actual capture. Clear and vigilant focus on the **long** term interest of **consumers** is the best mechanism for avoiding this risk.

Regulators also face an information asymmetry challenge, regulated firms have more information than the regulator. Where stakeholders make statements without providing evidence, then the regulator should make the regulatory decision as if the statement is untrue thus requiring the firm to either reveal the information or accept the consequences. (see Box 3 for an example)

Box 3. Case Study of Mobile Number Portability

Under the telecommunications regulatory environment the ACCC can make a direction that a class of numbers be portable, but before doing so they need to be advised by the industry regulator (the ACMA, but previously the Australian Communications Authority) that it was technically feasible.

In 1999 the ACA was asked for this advice in relation to mobile number portability. They had a consultant's report identifying significant benefits. Incumbent mobile providers argued the ACA could only make the recommendation if they could demonstrate these benefits outweighed the costs. Only the incumbents could cost a portability solution.

The Authority determined that in the face of the information asymmetry it would presume the costs were lower than the benefits because, if they were higher the networks would have provided them.

Conclusion

The long term interest of consumers is served by competitive retail markets that encourage innovation. The Power of Choice program has tended to make the assumption that the retail market is effectively competitive and that the delivery of the benefits merely requires upstream action.

It is disappointing to see in the summary of the reasons for rejecting the proposed rule a concern over complexity for consumers of choice:

> *Adopting the proposed framework included in the rule change request could also increase the complexity of retail arrangements for customers, resulting in higher search and transaction costs. It is likely that new customer protection mechanisms would be needed to address these risks and maintain adequate overall consumer protections.*

There can be no doubt that the provision of choice can increase the search and transaction costs for consumers. However, the response is not "consumer protection" but market design rules that utilise the insights of behavioural economics to guide consumer participation.

In the consideration of the rule change regarding the application of "fixed terms" in retail contracts the AEMC took a distinctly different view. In lieu of a clear consumer protection the AEMC made a "more preferable rule" that had the consequence of simply requiring the provider to make the consumer read more.

Were this concern about the complexity for consumers to have been the only basis for the AEMC's rejection of the proposed rule this precedent should have resulted in the AEMC simply adding additional retail rules as part of a more preferred rule.

The AEMC has not proposed to consider a more preferable rule but simply to not approve the rule. This is despite the AEMC being the originator of the whole work-stream and the acknowledgement in the draft that:

a. There are two high value services for which the ability to have multiple relationships is essential – the "aggregated model" and "EV charging";
b. That one of these was the original motivation for the combined effort of the AEMC, EC and AEMO in developing the proposed rule;
c. The identification that a simple single meter strategy could meet the requirements of the "aggregated model"; and
d. The identification that a second connection can meet the needs of very high value services such as "EV charging.

The correct response from the AEMC to these conclusions is to move to make a "more preferable rule" to incorporate the needs of delivering the single meter model and facilitate second connections.

That will require the AEMC facilitating work across stakeholders to develop the more preferable rules. An environment in which CUAC and the ATA are expected to go off and refine their proposal before initiating a further rule change request creates extra delay and includes the risk that the proposed rule will also fail. There is no incentive for other stakeholders – especially the DNSPs and incumbent retailers to assist them.

The AEMC should consult with stakeholders to develop more preferable rules that deliver the outcomes initially sought by the AEMC and potentially realisable through the initiatives identified in the draft.

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[1] http://www.aemc.gov.au/getattachment/456bbc5e-578f-4caa-a78d-7d9007c280b5/Multiple-Trading-Relationships-draft-rule-determin.aspx
[2] http://www.aemc.gov.au/getattachment/2b566f4a-3c27-4b9d-9ddb-1652a691d469/Final-report.aspx
[3] http://www.aemc.gov.au/getattachment/156e3de1-9068-4502-a786-5bf68e642b80/Final-Advice.aspx
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[6] http://www.aemc.gov.au/Major-Pages/Power-of-choice
[7] http://aemc.gov.au/News-Center/What-s-New/Announcements/Multiple-Trading-Relationships-News-Release

[8] KPMG http://aemc.gov.au/getattachment/0299bffe-193c-4c82-b8d3-36930f578fc6/Report-to-AEMC-KPMG-New-Energy-Services.aspx

[9] Michael Vertigan et al 2015 *Review of Governance Arrangements for Australian Energy Markets: Final Report* Pp22-23 (https://scer.govspace.gov.au/files/2014/12/Review-of-Gov-Arrangements-for-Energy-Markets-Final-Report-Jan-2016-PDFTAG.pdf)

[10] http://www.aemc.gov.au/Major-Pages/Power-of-choice

[11] http://aemc.gov.au/News-Center/What-s-New/Announcements/Multiple-Trading-Relationships-News-Release

[12]KPMG http://aemc.gov.au/getattachment/0299bffe-193c-4c82-b8d3-36930f578fc6/Report-to-AEMC-KPMG-New-Energy-Services.aspx

[13] See http://www.accc.gov.au/system/files/Final%20decision%20-%20ULLS%20and%20LSS%20monthly%20charges%20undertakings%20-%20December%202005.pdf P 45 and following.

[14] Stigler, G 1971 'The economic theory of regulation' *Bell Journal of Economics* 2:3-21