20 October 2014

Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Via email to: aemc@aemc.gov.au

Re: AEMC Rule Change on Distribution Network Pricing Arrangements Draft Determination, Project Number ERC0161

The Consumer Action Law Centre (**Consumer Action**), Consumer Utilities Advocacy Centre (**CUAC**) and Victorian Council of Social Service (**VCOSS**) welcome the opportunity to provide input into the AEMC's draft determination on distribution network pricing arrangements.

Consumer Action is an independent, not-for-profit, campaign-focused casework and policy organisation. Consumer Action offers free legal advice, pursues consumer litigation and provides financial counselling to vulnerable and disadvantaged consumers across Victoria. Consumer Action is also a nationally-recognised and influential policy and research body, pursuing a law reform agenda across a range of important consumer issues at a governmental level, in the media, and in the community directly.

The Consumer Utilities Advocacy Centre Ltd (CUAC) is a specialist consumer organisation that represents Victorian energy and water consumers in policy and regulatory processes. As Australia's only consumer organisation focused specifically on the energy and water sectors, CUAC has developed an in-depth knowledge of the interests, experiences and needs of energy and water consumers. In informing these debates, CUAC monitors grass roots consumer utilities issues with particular regard to low income, disadvantaged, and rural consumers.

The Victorian Council of Social Service (VCOSS) is the peak body of the social and community sector in Victoria. VCOSS works to ensure that all Victorians have access to and a fair share of the community's resources and services, through advocating for the development of a sustainable, fair and equitable society. VCOSS members reflect the wide diversity of the sector, ranging from large charities, sector peak organisations, small community services, advocacy groups, and individuals involved in social policy debates.

Overview

Our organisations agree that there is a need to reform the way distribution networks and services are priced, in order to drive greater efficiency of use, avoid unnecessary investment and drive more efficient prices charged to all consumers. We therefore welcome this rule change and support the new network pricing objective requiring Distribution Network Service Providers (**DNSPs**) to charge tariffs that reflect their efficient costs of providing distribution services. If this

is done effectively, it will create great potential for consumers to take better control of their energy consumption and expenditure, potentially allowing many low income and vulnerable consumers to save money on their energy bills.

The change to flexible distribution network pricing will, however, increase the complexity of an already complex market. The potential for consumer disengagement is therefore high, and special attention needs to be paid to the way the changes are communicated to consumers and the structure of new tariffs. We therefore welcome the AEMC's acknowledgement of the importance of the consumer perspective and their ability to engage with flexible pricing.

Consumers' ability to understand the changes and how they are reflected in their energy bills will be fundamental to the success of the reforms. If consumers fail to understand, or actively engage, the market benefits underpinning the reform will not be realised. A critical issue for the success of the reforms is therefore the manner and extent to which energy retailers reflect the changes to network tariffs in their market offerings.

Perhaps more importantly for effective competition, there is also high potential for the reforms to lead to further public backlash and erode trust as some people's bills increase as a result of the reforms, without their understanding or ability to respond.

Currently the rules do not require any consideration of consumers' ability to understand the market or engage with the information that is issued about the structure and level of energy prices (and associated fees and discounts), which has led to poor consumer decision making and ineffective competition. It is essential to the success of this rule change, and other *Power of Choice* reforms, that the consumer impact and their ability to understand the rule changes are properly considered. We therefore encourage the AEMC to use the precedent of consumer impact principles set in this network pricing rule change to apply a consumer impact and understanding principle to all future rule changes. This will greatly enhance the value of the *Power of Choice* reforms in increasing consumer uptake of demand-side initiatives.

Further detailed comments on aspects of the proposed network pricing objective and principles are set out below.

Network pricing objective

The network pricing objective introduced in this rule change is that each network tariff should reflect the efficient costs of providing network services to the consumers assigned to the tariff.

We broadly support this objective, having regard to matters raised below concerning particular pricing principles.

Long Run Marginal Cost

We support the use of Long Run Marginal Cost (LRMC) as the basis for developing network tariffs. For consumption to occur efficiently, consumers should face prices equal to the costs their consumption incurs. Specifically, economic theory suggests consumers should face costs as if their consumption were the final consumption to be satisfied – their consumption is ‘at the

margin'. When prices are set to these 'marginal costs', a change in consumers' consumption by one unit should alter their costs by the amount it costs to produce (or not produce) one unit.[1]

Marginal cost pricing signals also encourage efficient production, as it aligns the producers' incentives to produce with the consumers' willingness to pay for that production.

LRMC vs. SRMC

When consumption necessitates the construction of long-lived assets, such as electricity distribution networks, the recovery of the costs of those assets from consumers is properly spread over the life of the assets – over the long run.

In the context of electricity distribution networks, discussion has often focused on the long run marginal costs of meeting increased network system peak demand, i.e. the costs, over the life of the assets of expanding the network to supply a maximum instantaneous demand one unit higher than its current capacity. However, consumers should also properly face the LRMC of *maintaining* their current level of consumption – i.e. the cost of replacing assets – and the cost (savings) over the long run of *decreasing* their consumption. Consumers' response to these prices will provide network businesses with signals of what level of future capacity to invest in.

We recognize that networks also face a short run marginal cost (SRMC) of meeting consumer demand,[2] and that SRMCs can provide signals to consumers and producers about efficient consumption and production decisions. The SRMC of electricity consumption will be very high at times when demand is equal to network capacity, as "the SRMC increases to the price level necessary to curtail demand sufficiently so that demand is exactly equal to the available capacity. This means that the SRMC includes the cost to consumers of being unable to use electricity when network capacity is insufficient to meet demand, i.e. a congestion cost."[3] At all other times, SRMC will tend toward zero, reflecting only energy losses.

In the current context of electricity demand in the National Energy Market (NEM), SRMC will be near zero for most of the year and high – potentially tens of thousands of $/megawatt hour (MWh)[4] – during only a few hours.

While SRMC should lead to the same result as LRMC, as a difference between average SRMC and LRMC would be inefficient, in practice, the complex and fluctuating nature of SRMC makes the signals more difficult to respond to, particularly for consumers. Consumers are unlikely to understand or react well to wildly fluctuating prices, and may face payment difficulties. As the Commission notes, "in the short term consumers may be able to switch-off or turn-down some equipment and processes and SRMC will provide stronger signals for this. But larger, longer term responses typically require the user to invest in new equipment. More stable longer term price signals provide a better basis for these decisions."[5]

[1] In standard economic theory, an appropriate return to the producer – profit – is included in the 'costs'.
[2] The threshold between 'short run' and 'long run' is whether productive capacity is held constant (short run) or can vary (long run).
[3] NERA (2014) *Economic Concepts for Pricing Electricity Network Services*, p.6
[4] Draft Determination, p. 90
[5] Ibid, p. 93

The fear of high bills during periods of high SRMC could also prompt some households to inappropriately self-limit their consumption in a way that leads to negative welfare effects, e.g. if older consumers limit their usage of air-conditioning during heat waves and suffer or exacerbate health problems as a result.

For these reasons, we prefer LRMC as a signal of future production costs.[6]

LRMC methodology

The AEMC Draft Determination highlights three different methodologies that have been traditionally used to estimate the LRMC of providing network services: the Average Incremental Cost methodology (AIC); the Common Distribution Charging methodology; and the Perturbation or 'Turvey' methodology.

We do not claim to know which of these methods is the 'best'. The number of fine minds who have considered this question without reaching a conclusive answer suggests that specifying a single approach would lack strong intrinsic justification. Arguments for a uniform approach, such as cross-jurisdictional comparability, have some merit, but as it stands we do not oppose a flexible approach to LRMC methodology.

We also welcome the AEMC's decision to provide LRMC guidance to DNSPs. We are wary of LRMC methodologies becoming as hotly contested a topic as the Weighted Average Cost of Capital (WACC) is. It is important that, whichever method a distribution business chooses to use, its process, claims, and assumptions are rigorously scrutinised by the AER.

Total efficient cost recovery

The Rule Change on Distribution Network Pricing Arrangements does not include in its scope the issue of approved revenue as determined in the AER's distribution determinations. The issue is therefore not what the efficient level of costs is, but how those costs can be recovered efficiently.

However, it is the case that, in some areas, demand has not increased to the extent or in the manner that DNSPs expected. In many areas, demand has decreased. DNSPs' incorrect forecasts have contributed to their investment in infrastructure that has not been needed. While this matter is out of the scope of this rule change, it is strange – even perverse – to consider the efficient recovery of costs of investment that is itself inefficient and/or excessive. For such investment, the relevant question is *why* consumers should pay for it, not *how*.

A portion of what the AER has determined to be a DNSP's total efficient costs (total revenue) will be recovered via the LRMC-based component of network tariffs. This portion will generally be less than 100 per cent – at times, much less: one Victorian DNSP has suggested their LRMC component would recover around seven per cent of their total revenue. The remaining revenue to be recovered is referred to as a 'residual' cost, and can be conceptualised as recovery of past investment or sunk costs.

[6] We note that while e.g. a critical peak pricing approach also involves fluctuating prices, the fluctuations are much less extreme. Our objection is not to fluctuating prices in principle, but to the magnitude, frequency, and predictability thereof.

The efficacy of pricing signals being sent by the LRMC component of tariffs is best maintained by recovering residual costs in a manner that least distorts the actions of consumers. That is, consumers' choices after the recovery of residuals should as closely as possible resemble the choices they would have made before the recovery of residuals, when considering only LRMCs.

The extent to which a consumer group changes – distorts, in this case – their decisions in response to price changes is referred to as their price elasticity. Consumer choices will be least changed (distorted) if revenue is recovered from them in inverse proportion to their elasticity, an approach known as Ramsey pricing.

Ramsey pricing would be an efficient method of cost recovery. However, as noted by the Brattle Group,[7] *efficiency* is not the only relevant principle: also important are the principles of *gradualism* and *fairness/equity.*

We submit that gradualism – the principle of changing prices gradually, so that consumers have sufficient time to adjust and experience no shocks – is important, but will focus in the rest of this section on the principle of equity.

Equity/fairness

Equity and fairness are moral and social concepts, and as such are not strictly defined. Nor can their importance relative to other goals (e.g. efficiency) be objectively assessed, so we recognise that this is one of the more complex areas for regulators to deal with.

As a starting point, the principle of horizontal equity suggests that consumers with the same pattern and levels of energy consumption should be charged equal amounts. Differentiating tariffs by consumer class is an application of this principle – albeit crudely, as for example the 'residential' class of consumers will have significant differences in their usage.[8]

Ramsey pricing, however, contravenes this equity principle: it recovers costs based not on usage, but on price elasticity. Consumers with equal ex-ante usage levels and patterns, but different price elasticities, end up paying different amounts. As the correlation between usage and price elasticity as likely to be limited, Ramsey pricing will result in horizontal inequity. As just one example, a renter and a home-owner with identical usage will exhibit different price elasticities due to the renter's lesser ability to alter their appliances or building shell.

Additionally, Ramsey pricing contravenes the principle of *vertical equity*, a principle that suggests users with greater capacity to pay should pay more. The ability to respond to electricity prices is significantly affected by household income and wealth, with low-income/low-wealth customers, in particular, likely to exhibit lower price elasticity. Ramsey pricing would therefore recover a disproportionately high amount from low income or vulnerable – e.g. requiring life support – consumers and result in vertical inequity.

[7] The Brattle Group (2014) Structure of Electricity Distribution Network Tariffs: Recovery of Residual Costs

[8] In fairness, these differences are, for a network, probably less material than the differences between 'residential' consumers as a class and e.g. 'industrial' users as a class.

A specific example of non-distortionary pricing worth considering is a 'fixed charge', levied independently of consumption levels or patterns. Fixed charges are rarely perceived as fair by consumers, as they are unlikely to understand their rationale and resent being unable to avoid them. Consumers value agency, even if they may be unlikely to exercise it.

It is even possible that the imposition of (perceived) unfair fixed charges could lead consumers to react in a way that damages the structural equity of the entire construct, e.g. by abandoning the network.

We strongly support the principle of ensuring that the price signals received by consumers are not (or only minimally) distorted, as this will only decrease the efficacy of the pricing reforms. However, reduced efficacy must be balanced against considerations of fairness and acceptability to consumers. While equity should be considered at the system level – including government concessions and welfare payments – we have strong concerns about the equity of Ramsey pricing and fixed pricing in the current setting.

Further, recovery of residual costs through fixed charges could blunt price signals, if the relative magnitudes of the costs make the LRMC-based charges appear immaterial. (We note again that residual costs represent up to 93 per cent of costs on some networks.)

We therefore have conflicting views on whether – or to what extent – Ramsey pricing or fixed pricing should be used to recover residual costs. There are clear economic advantages, both for networks and consumers. If consumers' actions won't change the costs they face, why should they change their actions? On the other hand, consumer understanding and acceptance of Ramsey pricing and fixed pricing is very low.[9] In the absence of clearly preferable solutions, we recommend that the AEMC emphasise the importance of the consumer impact principles and consultation requirements in the tariff determination process. Reiterating the earlier point, we anticipate consumer backlash if large components of network prices are fixed, such that changed consumption or usage patterns have limited impact on final bills.

Given that consideration of equity should occur at the system level, we strongly endorse the AEMC's recommendation that a review of energy concessions regimes across the NEM should be undertaken, with a view to adopting best practices.

We further support the proposal by the Public Interest Advocacy Centre in its submission that, as part of the consumer impact principle, the AEMC require DNSPs to consult with consumers on whether proposed tariffs are fair, just, and reasonable.

Consumer Impact Principles

1. Minimising impact

Our organisations strongly support the proposed principle which requires DNSPs to consider the impact of price changes on consumers. This principle should be more broadly applied across all consumer focussed AEMC rule changes. In considering the effects of price changes on

[9] While not specifically related to electricity pricing, history is littered with examples of popular revolts against poll taxes, an equivalent non-distortionary form of revenue collection.

consumers, DNSPs should consult with consumers, drawing on lessons from CUAC's 2013 report, *Meaningful & Genuine Engagement*.

While the list of elements that DNSPs must have regard to in demonstrating they have minimised impact is a good start, it does not go far enough to ensure that DNSPs have truly considered and understood the effect that different network tariffs will have on different demographics of consumer, and particularly on more vulnerable demographics. Certain tariff types may limit effects on consumers better than others.

We therefore believe that, in addition to the requirements outlined in Appendix 4 of the draft determination, DNSPs should be required to provide a detailed assessment of how their proposed tariff structure(s) will affect various categories of consumer - including low income, elderly and vulnerable - in order to justify the application of a given tariff structure. Only by undertaking this analysis can the AER and DNSP be sure that the negative effects on consumers has been minimised.

2. Capable of being understood

We strongly agree with the AEMC's statement that 'consumers will not be able to respond to price signals if they cannot relate price structures to their usage decisions.' Traditionally, consumers' ability to understand and engage with aspects of the energy market that are directly relevant to their ability to make a decision about their energy contracts and usage has not been appropriately considered in the development of the energy market, and consumer engagement has therefore typically missed the mark. It is critical to the effective functioning of the energy market that rule makers and industry participants get a more detailed understanding of how real consumers make decisions, and what information is meaningful to them in that context. Key to that will be retiring the current industry mindset that more information alone will create a more informed and rational consumer.

While our organisations applaud the development of this principle and its application to the current rule change, we believe it needs to go further to ensure that complex tariffs are capable of being understood and acted upon by consumers.

Advice sought by Ofgem in 2011 for communication around energy bills, annual statements and price rise notifications stated that

> *'if we want consumers to understand the energy market sooner rather than later we have to begin by favouring their existing knowledge and existing linguistic practices rather than waiting for them to acquire new vocabulary and linguistic habits that may take years to become established.'*[10]

Nowhere is this more important than in the move from flat network tariffs to flexible tariffs, that bring with them so much potential for consumer detriment and distrust via unexpected high bills.

A consumer's ability to understand a network tariff (or indeed any energy product or service) is based on the effectiveness of the price signal, the volume of information presented, the form in which it is communicated and the language that is used. To maximise consumers' ability to understand flexible tariffs and the need for them, rule makers and DNSPs must:

[10] https://www.ofgem.gov.uk/ofgem-publications/39652/laweslanguagereport.pdf

- Ensure that the price signal established by the tariff does not get obscured by any increase in fixed charges or retail margins;
- Prioritise the communication and realisation of consumer benefits over market benefits, understanding that market benefits will not flow if consumer benefits are not the focus;
- Be consistent across the industry about the terms that are used to explain the new network tariffs, and ensure that the terms are simple and meaningful to real consumers; and
- Be flexible about how prices are applied so that consumers don't get locked in to products or price levels that do not suit their changing needs, while recognising that tariff structures need to be reasonably constant over time within a network area to assist familiarisation with the product.

Importantly, we believe that any increase in fixed charges to recoup residual costs after LRMC is unlikely to satisfy this principle, as consumers will expect that reduced usage will mean reduced charges.

Tariff Structure Statement

We support the proposals that DNSPs develop a Tariff Structure Statement (TSS), and be required to describe how they have consulted with retailers and consumers during their network pricing processes.

It is important that consultation not be tokenistic, and CUAC's 2013 report *Meaningful & Genuine Engagement* offers principles and guidelines in this matter. In particular, as DNSP consultation will involve discussing relatively complex and unfamiliar matters with consumers, care must be taken to not introduce bias or omit relevant information when simplifying.

Conversely, DNSPs may decide it is too difficult to simplify the material for residential users and consult chiefly with commercial users, industrial users, and consumer advocates. While we are happy to be involved in the consultation process, more frequent and complex consultation will place greater pressure on consumer advocates' limited capacity. How will this additional workload for consumer advocates be funded?

Further, assessing DNSPs' consultation will require additional work of the AER. As the Public Interest Advocacy Centre notes in its submission to this rule change, while the AER is the appropriate body to carry out such functions, it is vital that the AER be properly resourced to carry them out.

We therefore submit that where increased requirements are imposed, AER resources be increased accordingly. While this is a matter for Australian governments, who we note are proponents of this rule change, we recommend that the AEMC note the funding imperatives as part of its final determination.

Other issues

The prices that consumers face – and will therefore respond to – are not network prices: they are the prices set by energy retailers. The success of these reforms therefore depends on the

extent and manner in which energy retailers pass through DNSPs tariff structures. We appreciate that this issue is beyond the scope of the rule change, but encourage the AEMC to monitor retailer behaviour and consider further actions should the benefits of this reform be lost in the passage through the retail space.

Conclusion

The change to distribution network pricing has great potential to improve the efficiency and equitability of the NEM, introducing cost reflective pricing and removing cross-subsidies. However, in the quest to improve efficiency, we should not forget the importance of other goals.

The CEO of the AER, Michelle Groves, recently spoke of integrating the consumer voice into the regulatory process.[11] Similarly, the consumer voice must be integrated into the network tariff determination process. That this poses great difficulties in a complex market simply means that special attention must be paid to the way changes are communicated to consumers and the structure of new tariffs. Meaningful and genuine consumer engagement is vital.

Our organisations broadly support the new network pricing objective and use of the long run marginal cost as the basis for developing network tariffs, together with the Tariff Structure Statement process. However we strongly believe that the process must be very closely guided by the principles of consumer protection and be closely scrutinised by the AER.

Additional complexity is introduced by the transformation of network tariffs to retail tariffs, which is unlikely to be 1:1. It is therefore unclear how consumers will respond to these reforms. In order to maximise the benefits of these reforms, and achieve consumer understanding and engagement, it is likely that the consumer protection principles will need to go further and that the AEMC will need to monitor the pass through of undistorted tariffs by retailers.

[11] http://www.aer.gov.au/node/27697