AUSTRALIAN ENERGY REGULATOR

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John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
SYDNEY SOUTH NSW 1235

Dear Mr Pierce John

Submission on distribution network pricing arrangements

Please find attached our submission regarding the Australian Energy Market Commission's draft decision on the National Electricity Amendment (Distribution Network Pricing Arrangements) Rule 2014.

We would be pleased to provide further assistance to the Commission on this important area of reform. If you would like to discuss any aspect of our submission please contact Adam Petersen Director, Network Regulation, on (08) 8213 3458.

Yours sincerely

Chris Pattas
General Manager, Networks
AER

Rule changes—distribution network pricing arrangements

AER Submission to AEMC Draft Decision

October 2014

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1 Introduction

The AER welcomes the opportunity to respond to the AEMC's draft decision on the changes proposed to the distribution network pricing arrangements in the National Electricity Rules (NER). This draft decision consolidates and builds upon proposals from the Independent Pricing and Regulatory Tribunal (IPART) of New South Wales and the Standing Council on Energy and Resources (SCER)—now the Council of Australian Governments (CoAG) Energy Council.

We support the AEMC's draft decision and draft rules, which appears to address the issues expressed in our submission to the earlier Consultation Paper.[1] We consider that this package of reforms when compared to current arrangements, will provide stronger requirements:

- in the NER for network tariffs to, over time, move toward better reflection of the actual drivers of network costs—being the time and location in the network where energy is used. This in turn provides us with greater scope to review tariff structures than we are currently able to do given the largely non-binding nature of the current pricing principles.
- for distributors to consider the impacts of their network tariff strategies and address issues of tariff appropriateness, transition and volatility in a direct, transparent and evolving way. In particular, this new framework for tariff development using a Tariff Structure Statement (TSS) as the focal point and customer impacts principles as the driver, will allow for a tariff dialogue between distributors and stakeholders, and should lessen any potential need for resorting to numerical or arbitrary approaches to manage tariff volatility.

The draft rules balance the need for more specific requirements while maintaining flexibility for innovation on the part of the distributors. We will look to the views of stakeholders on this draft decision to assess whether this flexibility gives rise to any undue uncertainty. This will allow us to determine whether we will need to engage and consult on these issues prior to implementation and distributors preparing their initial TSS.

Our response to the AEMC's draft decision covers the following aspects:

- The economic efficiency and customer impacts pricing principles
- The TSS and annual price review stages of the pricing process
- The transitional rules for implementing the new framework.

[1] Accessible on: [http://www.aemc.gov.au/Rule-Changes/Distribution-Network-Pricing-Arrangements]

Pricing principles

There are a number of competing tensions that arise in deciding how to structure a new set of regulatory principles that are to guide more efficient outcomes in the pricing of distribution networks:

- The reform process that led to this draft decision was predicated on the need to achieve certain broad outcomes by way of better signals of what it costs to provide network services. At the same time, flexibility is important and distributors should have ownership of their prices, and innovate and evolve their approaches over time.
- We also want the impacts, path and speed taken toward achieving these efficiency based outcomes to be considered in a direct and transparent manner guided by the National Electricity Objective. However, these issues also need to be considered on a customised basis and are likely to evolve in response to stakeholder demands.

We consider that the draft decision balances these competing tensions. Our views on the economic efficiency based principles and those designed to manage pricing impacts are set out below.

1.1 Economic efficiency

The draft rules appear to balance the need as we see it for firm requirements for tariffs to be more efficient, allowing the AER greater scope to actively assess tariff structures/strategies, while maintaining flexibility for distributors and the AER in dealing with issues on a case-by-case basis. We support:

- The introduction of an overarching pricing objective that each tariff should reflect the efficient costs of service delivery to customers receiving that tariff. This helps avoid doubt that the key starting point and underlying objective in applying the principles is achieving a closer connection of prices with cost drivers. Further, by stating that this is something that 'should' be achieved, the objective helps reconcile conflicts that could otherwise emerge from distributors needing to depart from or phase-in prices towards efficient levels. The latter could arise from distributors needing to evolve their approaches as more advanced metering becomes available. It could also arise from needing to comply with jurisdictional obligations, that might or might not depart from more efficient pricing, or customer impacts principles that might require a gradual transition to more efficient tariffs. The application principles that accompany the objective also assist here, by clarifying that any such departures from economic efficiency should only be to the extent necessary to comply with these obligations. Describing the effect of such departures could also help quantify the effects of any transition that might occur over time.
- Strengthening the wording of the principles such that these better lock–in requirements to comply with a particular broad economic concept in Long Run Marginal Cost (LRMC). This is the key basis of what should be a more efficient signal for end users than is currently the case for most users. This provides a firmer and enforceable requirement than exists with the current pricing principles. Distributors should be moving toward the signalling of future costs and customers should be actively considering their usage decisions in response.
- Leaving the principles open on the exact method used to calculate LRMC and the way of applying it to tariff structures. Decisions on these matters will likely need to be made on a case–by–case basis. Different LRMC calculation methods and different tariff structures could lead to more pronounced or averaged price signals and deciding between these outcomes will likely depend on how soon network augmentations or replacements might need to be

contemplated and to what size. Importantly these decisions depend on the type of meters available and whether they can record time-interval or real time data.

- The AEMC's inclusion of factors for distributors to consider in deciding how to calculate and apply LRMC. This provides high level guidance, helping to avoid the potential for differing interpretation in reviewing tariff structures, that could result from a less guided approach on LRMC calculation and application.

  The factors that we consider key to enabling the application of the LRMC principle to achieve the overarching pricing objective are the need to reflect the peak demand and location based drivers of network costs. Given their importance, we suggest that the AEMC consider if the wording of these should be firmer such that distributors must consider the ability to move toward greater reflection of peak demand and location drivers, rather than having regard to these factors. As there is no direct lineage between the calculation of LRMC and its application to a tariff structure that signals peak demand, more explicit wording here would help make these factors enforceable. This would reinforce the pricing objective's reference to tariffs being linked to costs. For example, if an issue of peak demand and a likely network constraint is able to be identified via available metering, and there is customer willingness to have a tariff that targets this issue (e.g. a time-varying tariff) then proposing a tariff that charges instead on a flat basis would not serve to achieve the ultimate objective of better aligning prices with costs. Firmer wording of the rules here could assist with our ability to assess tariff strategies over time.

- Having a firm requirement that total costs be recovered in a way that minimises distortions to the LRMC based signal, but leaving it open as to how that should be achieved. Here too, the method of recovering costs residual to LRMC calculations i.e sunk costs will depend on factors such as the ultimate magnitude and impact of these costs. These will vary by distributor and within a given network where peak demand constraints might be more or less pronounced. Further, deciding whether to recover these costs in multiple part or singular tariffs, or trying to apportion these costs to some customers over others will also depend on available metering. This was acknowledged in the Brattle report prepared for the AEMC.

1.2 Managing impacts

The draft rules also appear to effectively balance the need for firm requirements for distributors to consider the impacts of their tariff strategies, but with flexibility for distributors to develop and evolve their approaches via a dialogue with stakeholders using the TSS as a focal point. We support:

- The requirement that distributors minimise the impact on customers of changes in tariffs from a previous year by considering; the need for a transition path, whether customers can respond and mitigate the impacts of tariffs, and, if they understand the tariff options. This explicitly requires distributors to directly address issues of tariff volatility and appropriateness of tariff options, as an accompaniment to the firmer requirements to move to greater efficiency in their tariff strategies. These rules also provide greater focus and meaning to the consultation that occurs in developing the TSS, and allows issues of tariff volatility to be considered in a more customised and evolving manner than via numerical limits on tariff level movements.

- Requiring that tariff structures be reasonably understandable, having regard to the type and nature of customers and the information provided in consultation. This requirement provides an appropriate avenue for stakeholders to raise concerns should they consider the distributor's customised approach to its TSS to be inadequate.

We encourage the AEMC to further consider the intended application of the rule requiring distributors to have regard to the extent to which customers can choose the tariff to which they are assigned, noting the following issues:

- What would be expected if a distributor deems a customer able to respond to a particular tariff signal, but offers the option to not take up this tariff—would any alternative tariff still be in compliance with the pricing principles?
- The intended interaction between this rule and jurisdictional obligations that might impose location equalised i.e. 'postage stamp' pricing. For example, should customers be given the opportunity to opt–in to a non-postage stamp price and would this still be in compliance with the pricing principles?

2 Pricing process

We support the AEMC's draft decision with respect to the two aspects of the new distribution pricing process—the development of the TSS and the annual price review. Our views are set out below.

2.1 TSS

The introduction of requirements to prepare a TSS document significantly improves the network tariff development framework. When combined with the pricing principles to consider tariff impacts, the development and consultation on a TSS appears to provide a key focal point for the development and implementation of new tariff approaches. We would expect that this dialogue based framework would effectively bring distributors together with those affected by their tariff decisions, namely consumers and their representatives, retailers, and perhaps intermediaries managing consumer loads on their behalf. We support:

- The AEMC's decision to only specify a base set of requirements on what to include in a TSS and to not require the AER to develop a guideline that would specify matters up front. The dialogue based framework implemented by this rule change package appears to be a more favourable model than trying to be pre-emptive in the rules or any regulatory guideline at this time. This new model is adaptable in response to stakeholders raising concerns about the information provided:
  - the pricing principles require that distributors seek to address these concerns.
  - if concerns are not adequately addressed, the AER will then be able to assess any such issues in a targeted way when the TSS is submitted for our review.
- Bringing the TSS review into the revenue determination timeframe, providing us with an extended timeframe to consider the complex issues of reviewing tariff structures, their impacts and associated consultation efforts, and do so as a package together with the broader expenditure and investment proposals. This also appropriately separates these complexities from the more mechanical exercise of reviewing annual prices.
- Requiring the AER to review and approve a TSS and how a distributor has in its design of tariff structures, demonstrated its application of what will be more explicit and enforceable pricing principles than currently exist. This provides the AER with a new and more explicit role in reviewing tariff structures.
- The AEMC's inclusion in the base set of TSS requirements of information on how distributors will assign or reassign customers between tariffs and not just <u>tariff classes,</u> as is currently the case. This should help mitigate a present source of concern expressed to us by customers. That is, as the current rules only refer to movements between tariff classes, there has been less than adequate information on why customers might have been assigned to tariffs that charge in a significantly different way, while remaining on the same tariff class.
- The inclusion in the TSS of the methodology used to set each tariff, but that this should not be too formulaic in its approach such that a distributor might be constrained to the tariff levels that might be determined via this methodology. A methodology should provide understandable information for stakeholders and the AER, and some degree of certainty over, how distributors plan to apply the pricing principles for the regulatory period. We appreciate that this rule may be open to interpretation and support the AEMC's intention as suggested at its September public forum, to clarify the issue via a possible workshop with industry. Broadly, we suggest that the methodology should seek to explain how a distributor has, for example:

    - sought to identify its forward looking costs and any residual costs.
    - applied these types of costs to the particular formula it selected to calculate LRMC.
    - taken these calculations and applied the costs to actual tariff structures.
    - identified peak demand and locational drivers and aligned its identification of costs and tariff structures to these, as much as possible, or otherwise explained why this cannot be done.

- Requiring distributors to submit a schedule of indicative prices together with the TSS, to be annually updated, and to provide examples of reasons why prices could divert from these indicative levels. This would usefully accompany a dialogue on tariff structures, providing broad expectations on likely tariff quantum movements and factors that impact on these.

- Binding distributors to the tariff structures in their TSS for the 5 year regulatory period as a starting point—improving stakeholder certainty on intended tariff strategies.

- Not constraining distributor innovation in response to changing circumstances by supporting:

    - The ability for distributors to change their TSS during the regulatory period, should significant issues arise that were unforseen and beyond their reasonable control. Further, any changes proposed to accommodate these issues should result in a TSS that materially <u>better complies</u> with the pricing principles. This qualitative threshold approach proposed by the AEMC appears reasonable to allow us to assess the merits of any proposed re-opening of the TSS mid-period.

    - In principle, the ability for distributors to by-pass the TSS process if they propose introducing small scale tariffs that might be in the form of trials, and which are below a revenue based threshold of 0.5 per cent (individual) or 1 per cent (cumulative). Where tariffs are of limited scale and there is consumer (and AER) notification and consent, avoiding the lengthy process of putting these through the TSS appears reasonable. However, some consideration might needed on how to deal with situations where a tariff might be have a small impact on overall revenues for distributors but the impact might be large for certain types of customers. In particular, whether the AER should be able to quickly assess this potential impact before allowing any TSS by–pass.

- The ability for the AER to amend the TSS to the extent necessary should any proposed TSS or revised proposal be deemed to insufficiently comply with the pricing principles, as an ultimate safeguard in this likely rare circumstance. This allows us to ensure that an initial TSS is in place if any revised proposal is deemed to not comply.

2.2 Annual pricing

We support the draft rules that achieve more timely outcomes in the network pricing process, effectively concluding this process six weeks before prices take effect. This should positively contribute to the ability of retailers to incorporate network tariff outcomes in their offerings and of businesses in undertaking financial year planning. On more specific changes to the timing of the annual pricing process, we are comfortable with the requirements on us to:

- Comply with a 30 business day requirement to assess and decide on annual prices.

- Publish annual transmission business Service Target Performance Incentive Scheme (STPIS) reports by early March so that relevant data is included in annual transmission prices in time.

- Examine the CPI that we use in our subsequent regulatory determinations to accommodate the earlier proposed timeframes of network pricing proposals.

2.3 Transitional rules

While we consider it crucial that the process of consulting and reviewing a TSS be undertaken in parallel to the timing of our regulatory determinations as explained above, we support transitional rules that will separate these processes for the initial round of TSS implementation for most distributors. This will be inevitable given that many of these determinations would be significantly progressed by the time this rule change concludes. It will also allow the new pricing framework to be implemented prior to the commencement of subsequent regulatory periods. As noted by the AEMC at its public forum in September, the exact timing of the transitional rules might require further refinement to accommodate more upfront time for consultation among the sector in the lead up to distributors submitting their initial round of TSS'. We welcome further engagement in refining these transitional rules, but broadly these should maintain:

- Sufficient time for the AER to adequately review and undertake our own consultation on proposed TSS documents.
- Sufficient time for distributors to consult with stakeholders and with the AER in preparing what will be a very different approach to tariff development. We will have regard to the views of stakeholders in response to this draft decision as to the nature of any further consultation that stakeholders might require in preparing these initial TSS'. While there would be insufficient time for the AER to prepare a formal pricing guideline in this period, it does not appear to us that such a guideline would be required in the short term, given that the rules appear sufficiently informative or otherwise flexible where appropriate. The merit of a formal or non-binding guideline might be reviewed at the subsequent regulatory period, after having observed what will, under the transitional model be around 2–3 years of actual practice with implementing these new pricing rules.