30 January 2014

By email: chris.pattas@aer.gov.au

Mr Chris Pattas General Manager - Network Operations and Development Australian Energy Regulator Level 35, 360 Elizabeth Street Melbourne Victoria 3000

321 Ferntree Gully Road Locked Bag 7000

Dear Chris.

Request for a replacement framework and approach paper

Pursuant to clause 6.8.1(c)(1) and 11.60.3(c) of the National Electricity Rules (NER), Jemena Electricity Networks (Vic) Limited (JEN) hereby requests that the Australian Energy Regulator (AER) make a replacement framework and approach paper (new F&A paper) to apply to the distribution determination the AER must make for JEN's 2016-2020 regulatory control period for the matters listed in clause 6.8.1(b).

The primary reason for JEN making this request is that the F&A paper that was published on 29 May 2009 (old F&A paper) is outdated.

In particular, the old F&A:

- 1. Does not deal with the transition into the NER regulatory framework of metering services that are currently regulated by a Victorian Ministerial Order in Council, including the service classification and form of control of those services, nor with the planned introduction of competition for the metering services mentioned above by no later than 1 January 2017—JEN considers that:
 - non-competitive metering services (currently services to small 0 customers) should be classified as Alternative Control Services and a revenue cap price control mechanism should apply, which is conceptually consistent with the current treatment of these servicesa revenue cap is also intuitively appropriate, as tariffs for metering services are not intended to and are unlikely to influence customer behaviour (the decision to have or not to have a meter), and would not therefore affect the efficient use of electricity services
 - o competitive metering services (currently services to large customers, but post 1 January 2017 likely to be all metering services) should be unclassified and unregulated, which is consistent with the current classification of these services.
- 2. Does not deal with a range of matters relevant to the recent changes to the NER—including changes to clause 6.8.1(b) that sets out the matters an F&A paper must address—and the AER's resulting Better Regulation work, which



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culminated in a range of new guidelines being issued in November and December 2013. In particular:

- the application of any potential small-scale incentive schemes (SSIS)
- the application of a capital expenditure sharing scheme (CESS)
- the application of the AER's Expenditure Forecast Assessment Guidelines (assessment guidelines)
- 3. Is not up to date on matters relevant to the application of the service target performance incentive scheme (**STPIS**).
- 4. Is not up to date on matters relevant to the demand management and embedded generation connection incentive scheme (**DMEGCIS**).
- 5. Is not up to date on matters relevant to the application of the efficiency benefit sharing scheme (**EBSS**), in light of recent changes to the AER expenditure forecast assessment approach to operating expenditure forecasts, as set out in the AER's new assessment guidelines.
- 6. Is not up to date on matters relevant to the choice of forecast or actual regulatory depreciation, in light of the introduction of a CESS—JEN considers that forecast depreciation should apply.
- 7. Is not up to date on matters relevant to the AER's Connection Charge Guidelines for Electricity Retail Customers, published in June 2012, and those guidelines' interaction with the Victorian Electricity Industry Guideline 14.

The AER should also carefully consider the price control mechanism or mechanisms to apply to standard control services—the relevant considerations for this are set out in detail in **Attachment 1**. JEN considers that different price control approaches may be appropriate for different businesses, and that the regulatory framework provides for this. JEN believes that, given its strong incentive properties, a Weighted Average Price Cap (**WAPC**) is the most appropriate control mechanism for JEN's standard control services.

JEN would like to meet with the AER for discuss the matters raised in this letter. Anton Murashev will contact AER staff shortly to arrange this discussion. You can reach Anton on (03) 8544 9036 or by email <u>anton.murashev@jemena.com.au</u>.

Yours sincerely

Robert McMillan General Manager Regulation Jemena Limited.

Jemena Electricity Networks (Vic) Ltd

Attachment 1: Control mechanism for standard control services

Public



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An appropriate citation for this paper is:

Attachment 1: Control mechanism for standard control services

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1. SUMMARY

- Under the National Electricity Rules (NER), as part of a distribution determination the Australian Energy Regulator (AER) must impose control mechanisms in relation to prices for standard control services consistent with its position set out in the AER's framework and approach paper (F&A paper). The National Electricity Rules (NER) require the AER to publish a F&A issues paper by 31 May 2014 and its final F&A paper by 31 October 2014.
- 2. Jemena Electricity Networks (**JEN**) has been considering its own position on the most appropriate control mechanism in the context of the Victorian electricity distribution sector, the smart meter rollout and associated pricing innovation, international regulatory developments and thinking, and good regulatory design.
- 3. As a result, JEN has concluded that the AER should seriously and thoroughly consider its current approach to control mechanisms for Victoria in its F&A paper. Further, JEN asks that the AER F&A process provides for different price control mechanisms—for example, a Weighted Average Price Cap (WAPC) or a revenue cap—to apply to the standard control services of different Victorian distributors, and allow for a step in the process for each distributor to express a preference for a particular mechanism. This approach is conceptually the same as determining different service classifications or different ways in which incentive schemes should apply to different businesses, which the AER has previously done in the 2011-2015 price review.
- 4. Below, JEN explains its initial analysis of the control mechanism for standard control services as a basis for discussion with the AER.
- 5. JEN considers that the AER should consider the following factors when forming its view on the control mechanism to apply in Victoria from 1 January 2016:
 - the regulatory framework
 - · the Victorian market context—both historical and regulatory
 - the history of and experience in control mechanisms in Australia, including the AER's own experience
 - · international developments and thinking on regulatory design
 - the principles of good regulation.

2. CONCLUSION AND JEN'S REQUEST TO THE AER

- 6. The decision on the control mechanism for standard control services should not be made in isolation or independent of considering the market and policy context.
- 7. Significant changes are expected in Victorian network and retail tariff structures, as is increased innovation in the products and services offered to consumers as a result of the smart meter roll-out and likely Government policy positions to achieve the benefits from the roll-out. This is a different market and policy context to those in NSW, QLD and SA.
- 8. The unique Victorian market context requires the AER to consider the price control mechanism for JEN (and the other Victorian distributors) anew, rather than simply relying on analysis done for recent determinations in other states.
- 9. In this context, JEN notes that:
 - deriving the benefits of smart meters requires tariff innovation—the incentives for tariff innovation are affected by the price control mechanism
 - a WAPC provides a commercial incentive on JEN to design tariffs based on marginal costs and increase prices for less price elastic customers, while a revenue cap would remove such incentives
 - given the Victorian Government has only recently removed network and retail tariff constraints on introducing new tariff structures and the rollout is only now reaching near completion, the past experience with WAPC is not relevant to ascertaining its future effectiveness.
- 10. Therefore, JEN requests that the AER review the existing price control mechanisms for JEN (and the other Victorian distributors), and that the AER include in its F&A issues paper, and/or draft F&A paper that will apply to JEN for the 2015 distribution price review:
 - two options for the form of control mechanism for standard control services (a sub-set of direct control services), being a WAPC and a revenue cap
 - formulae to give effect to each of these forms of control mechanisms
- 11. JEN (and other Victorian distributors) should then have an opportunity to express and provide support for a preference out of these two options, before the AER finalises its view and publishes a final F&A paper applicable to that distributor.

3. REGULATORY FRAMEWORK CONSIDERATIONS

- 12. Under the NER, the AER must make a distribution determination for each distributor (see clause 6.2.4(a)), following the processes in Part E of Chapter 6. The AER's practices in aggregating guidance documents and decisions (here, all Victorian distributors) should not alter the rights, obligations and interactions of the AER and an individual distributor under the NER.
- 13. The AER is only required to 'have regard to' the matters listed in clause 6.2.5(c). The matters themselves can be mutually exclusive (for example, where previous regulatory arrangements for the relevant distributor (sub-clause (3)) are not consistent with similar services in other jurisdictions (sub-clause (4)).
- 14. JEN believes that the NER do not suggest or require a single form of control mechanism. Chapter 6 contemplates multiple forms of control mechanisms, even within a single distribution determination. For example:
 - Part E includes clauses 6.8.1 and 6.12.1(11) which refer, for each distribution determination and its constituent decisions, to the form of the control mechanisms (i.e. plural) for standard control services.
 - Though a distribution determination itself must impose controls over prices, clause 6.2.5 allows flexibility for the form of control, including combinations of five listed options.
 - Clause 6.5.1(3) refers to a "control mechanism (or control mechanisms) for standard control services."
 - Clause 6.8.1(b) provides that a F&A paper that applies in respect of a distribution determination must set out the AER's decision and reasons, for the purposes of the forthcoming distribution determination, on the "form (or forms) of the control mechanisms."
- 15. JEN believes that the NER allows and contemplates a control mechanism for its standard control services which:
 - has inbuilt flexibility
 - provides for, more than one form of control mechanism to apply within a jurisdiction at the same time.

4. VICTORIAN MARKET CONTEXT

- 16. Victoria will shortly be the only state in Australia that has rolled-out smart meters to all customers. Late last year, the Victorian Government removed constraints on network and retail tariffs that had precluded activities required to realise significant benefits from the smart meter rollout.
- 17. JEN expects that the Victorian Government will take further policy initiatives, given the substantial investment in smart meters across the state.
- 18. Complying with policy requirements and responding to these initiatives requires a significant amount of work and change¹ on behalf of Victorian businesses. Each business's response, and the ultimate outcomes are affected by the policy initiatives and technology, but also by the regulatory framework (which can constrain responses).
- 19. The impact of these policy initiatives is not immediate and businesses expect to evolve their actions in response to feedback and learnings about industry practice, consumer behaviour, etc.
- 20. In addition, in the short to medium term, the likely increased role of distributed generation and battery storage technologies is expected to affect the sector.

4.1 IMPLICATIONS FOR AER'S DECISIONS ON PRICE CONTROL MECHANISMS

- 21. The unique Victorian market context should be taken into account in the AER's decision on price control mechanisms. Specifically, JEN considers the followings points are relevant:
 - a) The emerging market context in Victoria is significantly different to that in other jurisdictions (NSW, QLD and SA); this means that the analysis for other states is not necessarily relevant to Victoria at this time. Similarly, analysis of past Victorian experience is also not necessarily relevant.
 - b) The anticipated changes in the market and associated benefits will occur over timeframes well beyond the forthcoming regulatory period. For example, decisions by JEN to invest in changing network tariffs only make sense by focussing on long term investment. In addition to considering short term incentives, the AER needs to take account of the National Electricity Objective—to promote efficient investment in, and efficient operation and use of, electricity services for the long term interest of customers (emphasis added). Weighted average price caps are particularly well suited to incentivising the efficient use of electricity services by customers, whereas revenue caps are not. While this weakness of revenue caps could be somewhat bolstered by direct regulation of price setting approaches, this will never be as effective as businesses responding to incentives.

¹ The required changes include trialing and deployment of investments in innovative technologies to enable efficient management of peak demand (for example smart homes, smart appliances), retailers investing in developing their understanding of customers and their electricity usage, new network tariffs, retailers developing new time-of-use retail tariffs offers and over time customers developing an improved understanding of opportunities to benefit from more efficient electricity use, and deploying new in home technologies.

5. EXPERIENCE IN CONTROL MECHANISMS IN AUSTRALIA

- 22. Australia was a relatively early adopter of incentive based regulation and price control mechanisms. State regulators and the AER have applied revenue and price capped controls to various electricity, gas, water and other pricing determinations over the years. There appears to be a consensus that all forms of control have their relative merits and problems.
- 23. For the 2001-05 price control period, the Office of Regulator-General regulated Victorian distributors, with that responsibility moving to the Essential Services Commission (ESC) for the 2006-10 period. The National Electricity Code (the Code) in force for these periods required distribution services to be regulated on the basis of CPI-X (or an incentive based variant of CPI-X). However, the Victorian derogations in the Code (clause 9.8.7(d)(1)) also specifically required that the Office of the Regulator-General (and subsequently the ESC) 'must specify explicit price capping as the form of economic regulation'. This reflected the deliberate policy intent of the Victorian Government to adopt incentive regulation in the form a WAPC for network price controls.
- 24. Various options (including WAPC or revenue cap) are now explicitly allowed under clause 6.2.5 of the NER.
- 25. The Report to the Ministerial Council on Energy, April 2006 prepared by the Expert Panel on Energy Access Pricing:

There has been considerable discussion of the relative merits of price versus revenue caps in various electricity distribution and transmission reviews over the past few years. The Panel believes there is now a strong understanding of their relative merits, and considers that the current approaches for gas and electricity, transmission and distribution, and the degree of flexibility afforded under the current arrangements, are appropriate. It sees no need for specific guidance to be given to either the AEMC or the AER on this issue. [pages 114/115]

- 26. In its own point in time analysis² for NSW, QLD and SA on the price control mechanisms for standard control services, the AER has generally concluded that:
 - there is little difference in administrative costs under a revenue cap and a WAPC
 - while consistency with existing regulatory arrangements and consistency between regulatory arrangements is generally desirable, it should not be the primary consideration
 - price flexibility is similar for all forms of control and is primarily influenced by the side constraints and the pricing principles in the NER
 - price instability can occur under both a revenue cap and a WAPC. This is because the NER require various annual price adjustments regardless of the control mechanism.
- 27. In relation to the specific incentive features of the WAPC versus revenue cap, the AER has observed that:
 - whilst in theory WAPC incentivises businesses to set efficient prices, in practice this has not been the case. However, by itself the revenue cap provides limited incentive for distributors to set efficient prices
 - WAPC provides an opportunity for distributors to recover revenue systematically above the AER allowances
 - in the short term, a revenue cap provides an incentive to undertake demand side management.

² AER Stage 1 Framework and Approach – NSW electricity distribution network service providers, March 2013, chapter 2; Preliminary positions paper, Framework and approach for Energex and Ergon Energy, Regulatory control period commencing 1 July 2015, December 2013, chapter 2; Preliminary positions paper, Framework and approach for SA Power Networks Regulatory control period commencing 1 July 2015, December 2013, chapter 2.

28. However, JEN notes that the AER's analysis for NSW, QLD and SA is not in the context of a smart meter rollout to all consumers and the likely government policy positions to deliver the expected benefits from the roll-out.

5.1 IMPLICATIONS FOR AER'S F&A PAPER

- 29. The current consensus is that no one form of control stands out as being universally better and that the incentive properties of different control mechanisms are different.
- 30. In the Victorian context, the AER should start with a clean sheet, recognising the significant structural and policy change happening with the smart meter roll-out. Past experience of tariff structures and consumer behaviour is not necessarily a meaningful indication of what will happen in the future.
- 31. This suggests that maintaining, rather than removing flexibility, is valuable.

6. INTERNATIONAL DEVELOPMENTS AND THINKING ON REGULATORY DESIGN

Internationally, economic regulation in electricity networks and other sectors is continuing to evolve and adjust in response to:

- greater emphasis on customer and broader environmental and social outcomes
- significant and often disruptive technological change, including in relation to data
- respect for different business strategies and the largely unavoidable information asymmetry between businesses and regulators
- efforts to reduce cost, apply market type principles and encourage innovation—to safe guard against the increasing burden of regulation
- maturing regimes, where regulators are consciously looking to learn and evolve (e.g. Ofgem and Ofwat).
- 32. Menu regulation, whereby companies are presented with a choice of regulatory contracts, continues to be discussed and trialled, most notably in the United Kingdom. The rationale for menu type approaches and more individual choice in regulatory arrangements goes to objectives such as:
 - reducing regulatory burden³
 - incentivising information discovery
 - allowing the regulatory framework to dynamically respond to different business strategies and environments.⁴

6.1 IMPLICATIONS FOR AER'S DECISIONS ON CONTROL MECHANISMS

33. Leading economic regulators internationally are taking steps to build flexibility into regulatory instruments, particularly where there is information asymmetry and where taking action to reveal information is deemed beneficial. In JEN's view, the same drivers for emphasising flexibility in regulatory design apply in Australia. JEN considers that the AER should apply the principle of flexibility in developing its position on the control mechanism.

³ See for example, Oxera Agenda, January 2008, Menu regulation: is it here to stay?

⁴ For example, Ofgem's RIIO framework - see, Ofgem factsheet 11, price controls explained.

7. PRINCIPLES OF GOOD REGULATION AND REGULATORY QUALITY AND PERFORMANCE

34. The principles of good regulation are a useful reference point at many stages in regulatory design. The OECD principles of good regulation are set out below.

(i)	Serve clearly identified policy goals, and be effective in achieving those goals
(ii)	Have a sound legal and empirical basis
(iii)	Produce benefits that justify costs, considering the distribution of effects across society and taking economic, environmental and social effects into account
(iv)	Minimise costs and market distortions
(v)	Promote innovation through market incentives and goal-based approaches
(vi)	Be clear, simple and practical for users
(vii)	Be consistent with other regulations and policies
(viii)	Be compatible as far as possible with competition, trade and investment-facilitating principles at domestic and international levels

Table 7–1: OECD principles of good regulation⁵

7.1 IMPLICATIONS FOR AER'S F&A PAPER

- 35. JEN considers that the following principles are particularly relevant to the AER's decision on the control mechanism and should be considered by the AER in its F&A paper:
 - Promote innovation through market incentives and goal-based approaches. In the case of control mechanisms, JEN suggests this principle supports clarity around the goal of the control mechanism, with flexibility for the business to elect how best to meet that goal.
 - Be consistent with other regulations and policies. In this case, the Victorian governments' policy objectives for smart metering are particularly relevant.

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⁵ The Principles for the Governance of Regulators, Public Consultation draft, 21 June 2013, OECD.