

16 October 2014

Mr John Pierce
Chairman,
Australian Energy Market Commission,
PO Box A2449
Sydney South NSW 1235

DISTRIBUTION NETWORK PRICING ARRANGEMENTS (ERC0161)

Dear John

The Energy Networks Association (ENA) appreciates the opportunity to provide this submission in response to the Australian Energy Market Commission's (AEMC) Draft Rule Determination on the Distribution Network Pricing Arrangements Rule change (the Rule change).

ENA shares the AEMC's view of the significance of network pricing reform, in allowing consumers to make more efficient decisions about how they use network services and the technologies they invest in to help manage their use.

In ENA's view electricity pricing reform will be essential to keep downward pressure on electricity costs, ensure fairness and that the electricity grid can accommodate major changes in use.

ENA supports a comprehensive framework for network tariff and enabling metering reforms. This is why the ENA has called for an integrated Road Map for Tariff Reform, which will address the barriers to smarter network tariffs imposed by a lack of smart metering (70 per cent of meters remain simple accumulation meters) and rules imposed by state and territory governments.

While the main barriers to network tariff reform do not lie within the National Electricity Rules (NER) the ENA welcomes a number of the AEMC's proposed changes put forward as part of the Draft Rule Determination. The changes to the NER that ENA considers will make a positive contribution to the implementation of network tariff reform are:

- greater engagement between networks and stakeholders in the development of network tariffs;
- greater transparency of network tariff structures and indicative pricing levels to apply over a regulatory period in a tariff structure statement (TSS); and
- earlier finalisation of network prices in the annual pricing proposal process.

In relation to the regulatory framework governing network pricing, the ENA considers that networks should have the flexibility to design appropriate, more cost-reflective network tariffs in consultation with their customers, stakeholders and with the oversight of the regulator. The ENA welcomes the AEMC's support in the Draft Rule Determination for this objective.

A critical issue in securing the benefits of network tariff reform will be the extent to which network price signals are reflected or “passed – through” into the retail tariffs paid by customers. The outcomes sought by the AEMC proposed rule change are dependent on such a pass-through. Given that there are different incentives faced by network businesses and retailers, the ENA and its member businesses will work closely with retailers to ensure increased alignment of network and retail tariff structures in the interests of customers.

In this submission the ENA raises five issues for further consideration by the AEMC, prior to the Commission making a Final Rule Determination.

- While supporting the inclusion of a network pricing objective in the NER, it is ENA’s view that the wording and scope could be re-considered;
- There is sufficient guidance within the existing principles for networks to set tariffs that promote the efficient provision and use of electricity network services. While the proposed principles have the potential to benefit customers through greater transparency of the trade-offs that are made in setting network tariffs, this greater transparency should not come at the expense of undermining network responsibility for the design of network tariffs. ENA has provided alternative drafting to the pricing principles in the Attachment to this submission that addresses the fundamental conflict between the principles and provides guidance on how these conflicts are to be resolved.
- Changes are required to the proposed regulatory framework for the TSS to ensure that networks are able to introduce changes to network tariffs within a regulatory period, in meaningful consultation with customers and stakeholders. There is a risk in the proposed regulatory framework that by locking in tariff structures and charging (pricing) parameters for five years, the practical ability of networks to manage short term tariff changes in the best interests of customers will be compromised.
- The proposed transitional arrangements do not provide adequate time for meaningful engagement with customers on an initial TSS. Therefore the ENA asks that the AEMC consider deferring the date by six months to 31 December 2015.
- The Final Rule Determination should recognize that fixed charge tariff components are likely to play an important role in improving the economic efficiency of network tariffs that are charged to customers with simple accumulation meters. Given the potential impact of higher fixed charges on vulnerable customers, in ENA’s view this adds to the impetus for governments to review customer hardship programs, and policy consideration of increasing access to interval or smart meters.

The ENA would be pleased to meet with you, your fellow Commissioners and the AEMC staff to clarify or provide further detail on any of these issues. You can contact me on 02 6272 1555 or jbradley@ena.asn.au or Lynne Gallagher on 02 6272 1515 or lgallagher@ena.asn.au.

Yours sincerely,



John Bradley
Chief Executive Officer



SUBMISSION TO THE DRAFT RULE DETERMINATION

National Electricity Amendment (Distribution Network Pricing
Arrangements) Rule 2014

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1. INTRODUCTION

The Australian Energy Market Commission (AEMC) in its Draft Rule Determination, *National Electricity Amendment Distribution Network Pricing Arrangements) Rule 2014* has proposed a “more preferable” rule (the Rule change) in response to rule change requests by the Council of Australian Governments (COAG) Energy Council and the Independent Pricing and Regulatory Tribunal (IPART) of New South Wales (NSW).

In this submission, the Energy Network Association (ENA) considers the benefits of the Rule change with respect to the National Electricity Objective (NEO) which promotes the long term interests of consumers.

The ENA is the national industry association representing the businesses operating Australia’s electricity transmission and distribution and gas distribution networks. Member businesses provide energy to virtually every household and business in Australia.

1.1 ENA SUPPORTS A COMPREHENSIVE FRAMEWORK

ENA’s response to the Rule change needs to be considered in the context of its support for a comprehensive framework for network tariff and enabling metering reforms.

Network tariff reform will provide customers with efficient incentives to make informed choices in their use and generation of electricity. Network tariffs that signal future costs and recover total efficient costs will benefit customers by putting downward pressure on network prices, will minimise unfair cross-subsidies as network uses become increasingly diverse and enable the successful integration of future step-changes in technology into the electricity grid.

More cost-reflective network tariffs

Network tariff design changes are being progressively implemented, within the constraints represented by current metering assets (i.e. approximately 70 per cent of meters remain simple accumulation meters), and jurisdictional policies and obligations. It is these constraints, and not a lack of firm obligations in the National Electricity Rules (NER) that are the main reason that more cost-reflective network tariffs have not been more widely introduced or adopted by customers.

Within the boundaries of these constraints, a range of more cost-reflective network tariffs have already been introduced.

In most jurisdictions almost all large industrial customers, and a significant proportion of commercial customers, receive network charges based on their electricity demand (kilowatts or kilo-volt-amperes), rather than consumption (kilowatt hours). In addition, some networks have introduced critical peak pricing (an energy based tariff) for commercial and industrial users, for example AusNet Services introduced a voluntary critical peak tariff in 2011.

For small customers i.e. residential and businesses below 160 MWh per year:

- » where customers have a simple accumulation meter, reduced reliance on volumetric (consumption) charging has been achieved by gradually increasing the fixed charge component of network tariffs; and
- » where customers have a meter that measures demand (an interval meter or smart meter):
 - time of use network tariffs have been made available in NSW, the ACT (where they have been the default tariff for new customers since 2010), Victoria and Queensland;
 - a number of networks are in the process of progressively introducing demand charging for medium businesses, for example SA Power Networks has required all new customers requiring current transformer metering since 2010 to be on a cost-reflective network tariff.

Further network tariff reforms are being developed by network businesses, in consultation with their customers, as part of the regulatory proposals being considered for the next regulatory control period.

Dynamic technological change

The future direction for network tariffs is developing within an environment of dynamic technological change. Customers have the opportunity to fundamentally change their load profile and the nature of their reliance on the electricity grid:

- » as the costs of generation and storage technology become more economic, compared with electricity grid supply; and
- » as rising living standards increase the use of energy intensive appliances in the home, including the use of electric vehicles as they potentially become economic in the future.

In this environment of increasingly diverse network uses among the same cohort of customers, network tariffs play a critical role in avoiding increasing cross-subsidies and signalling to customers the actual costs of their use of network services. This could involve both changes in tariff structures to more widespread use of demand tariffs and higher fixed charges, and potential for more geographic differences in network tariffs.

Retailer pass through

There is considerable uncertainty as to whether network tariff signals, intended to incentivise efficient behavioural response, will be 'passed through' into the retail tariff ultimately charged to customers.

In the context of the Rule change it is important to recognise that some aspects of the proposed framework will be undermined, and customer benefits restricted, if network tariff structures are not fully reflected in the structure of retail tariffs.

As recognised by the Productivity Commission:

"Cost-reflective network charges will have little effect on consumers if retailers do not have incentives to pass through at least some form of those time-based charges in their retail offers".¹

In its Draft Rule Determination, the AEMC is of the view that retailers have an incentive to pass through network tariff structures². However, the experience of networks to date is that retailers often do not fully pass through more cost-reflective network tariffs when they have been introduced.

This experience is born out by research findings reported by KPMG in 2008 as part of its assessment of the benefits of smart meters and more recently by the Productivity Commission.

In its study KPMG determined that retailers could be reluctant to pass through price variability in tariffs, because of concerns about the complexity of tariff structures. It reported that when Ausgrid introduced a time of use network charge in 2009

"...of customers with an external retailer, only an estimated half of these faced time of use tariffs from their retailer of choice."³

More recently the Productivity Commission found that a time of use network charge with significant variation in peak and off-peak periods is usually translated into much smaller price relativities at the retail level.

"For example, in New South Wales, Origin Energy's peak retail energy prices for residential customers in the Ausgrid network area are only around four times those of the off-peak rates (Origin Energy 2012). Accordingly, a ten-fold price differential at the network side was more than halved when expressed in retail prices."⁴

There are a number of contributing factors which may mitigate the incentive for retailers to pass through the network tariff, including retailer perception of the customer response to the network tariff signal and differentiation strategies in competitive markets. Additionally, retailers' recovery of input costs on a volumetric basis, and the infrastructure of national billing systems and call centres, all may constrain the pass through of network tariff structures.

Given the different incentives faced by networks and retailers to pass through network tariff structures, the ENA and member businesses will work closely with retailers to ensure increased alignment of network and retail tariff structures in the interests of consumers. However, it is neither possible nor necessary to achieve a "one-size-fits-all" approach, in the form of a single common network tariff structure to apply in diverse jurisdictions with more than 9 million residential and small-to-medium business customers across the National Electricity Market (NEM).

ENA's Road Map for Tariff Reform

The Rule change process has been an important opportunity to advance the case for network tariff reform. ENA welcomes the AEMC support for network pricing reform that results in *"network prices that better reflect the costs of providing network services to individual consumers"* as this will allow *"consumers to make more informed decisions about how they want to use energy services and the technologies they invest in to help manage their use."⁵*

However, in ENA's view the main barriers to network tariff reform are not within pricing principles or the NER. We welcome AEMC's acknowledgement of such influencing factors in the Draft Rule Determination.

¹ Productivity Commission, Electricity Network Regulatory Frameworks, Inquiry Report, Volume 2, p 494

² AEMC, Draft Rule Determination, Executive summary iii

³ Productivity Commission, Electricity Network Regulatory Frameworks, Inquiry Report, Volume 2, p 496

⁴ Productivity Commission, Electricity Network Regulatory Frameworks, Supplement to Inquiry Report, p. 7

⁵ AEMC, Draft Rule Determination, Executive summary, i

To address the challenges facing electricity pricing reform, including network pricing reform, ENA supports an integrated package of five key measures (see Figure 1).

This broader range of issues need to be addressed not only by networks but retailers, governments and energy institutions working together in the interests of customers.

Figure 1: ENA's Road Map for Tariff Reform



1.2 OVERVIEW OF ENA RESPONSE TO THE RULE CHANGE

ENA supports a number of aspects of the Draft Rule Determination, as being in the long term interests of customers, while raising five issues for further consideration by the AEMC, prior to its Final Rule Determination.

Support for aspects of the Rule change

ENA considers that the regulatory framework should allow networks to have the flexibility to design appropriate, more cost-reflective network tariffs in consultation with their customers, stakeholders and with the oversight of the regulator. ENA welcomes the AEMC's support for this objective in the Draft Rule Determination.

"It is important that distribution businesses develop prices that best suit the particular circumstances of their network and their customers, after consultation with consumers and retailers and subject to the oversight of the AER".⁶

In addition, the ENA supports the following aspects of the Rule change.

- » Greater engagement between networks and stakeholders in the development of network tariffs.
- » Greater transparency of network tariff structures and indicative pricing levels, to apply over a regulatory period in a Tariff Structure Statement (TSS).
- » Earlier finalisation of network prices in the annual pricing process. ENA has previously raised a number of issues that need to be addressed in relation to key pricing inputs in the transmission pricing process that could lead to increased volatility for some customers. The ENA is supportive of the timing of the annual pricing process as proposed in the Draft Rule Determination, given the AEMC's judgement that on balance the customer benefits from earlier timing will offset the potential impact of increased volatility.⁷

ENA notes that the earlier publication of transmission network prices, by 15 March for jurisdictions other than Victoria, will have consequences for the timing of the provision of information to co-ordinating network service providers (CNSPs) and for the timing of the AER's decisions concerning annual service target performance incentive

scheme reports. These issues are raised in more detail in the Grid Australia submission to the Rule change.

Issues for consideration

The issues for further consideration are considered in more detail in the remainder of this ENA submission. In summary, the five issues for further consideration are the following.

- » While supporting the inclusion of a network pricing objective, within the pricing principles, it is ENA's view that the wording and scope of the objective should be re-considered.
- » A number of the proposed policy principles are in fundamental conflict. It is ENA's view that drafting changes are necessary to remove conflicts where possible and ensure that there is appropriate regulatory certainty for network businesses as to how they resolve any remaining conflicts. Such guidance is necessary to provide certainty for network businesses around the requirements for the TSS and to make clear the circumstances in which the Australian Energy Regulator may withhold approval for, or amend, a TSS.
- » Changes are required to the proposed regulatory framework for the TSS to ensure that networks are able to introduce changes to network tariffs to signal future costs and recover efficient costs within a regulatory period, subject to meaningful consultation with customers and stakeholders. There is a risk in the proposed regulatory framework that, by locking in both tariff structures and charging (pricing) parameters for five years in the TSS, the practical ability of networks to manage short-term tariff changes in the best interests consumers will be compromised.
- » ENA considers that the proposed transitional arrangements, which require all distribution networks except TasNetworks to submit a TSS on 30 June 2015, do not provide adequate time for meaningful engagement with customers. ENA requests that the AEMC consider deferring the date by at least six months to 31 December 2015.
- » ENA recommends that in the Final Rule Determination report that the AEMC recognise that fixed charge tariff components are likely to play an important role in improving the economic efficiency of network tariffs where accumulation meters are in place. In practice, the primary option for more cost-reflective network tariffs based on accumulation meters is reducing network cost recovery through volumetric usage charges and increasing cost recovery through fixed

⁶ AEMC, Draft Rule Determination, Executive summary vi

⁷ AEMC Draft Rule Detrmination, p. 71

charges. While the Draft Rule Determination notes that cost-reflective network prices under the new principles “do not need to result in higher fixed charges”⁸, the alternative options in the AEMC-commissioned Brattle report focus on sensitively designed fixed charge increases. Given the potential impact of higher fixed charges on vulnerable customers, in ENA’s view this adds to the impetus for governments to review customer hardship programs, and policy consideration of increasing access to interval or smart meters.

⁸ AEMC Draft Determination, p. 39

2. ISSUES FOR CONSIDERATION

2.1 PROPOSED CHANGE TO THE NETWORK PRICING OBJECTIVE

The AEMC has proposed that the pricing principles should include a network pricing objective to guide DNSPs in developing network prices that are efficient and in recovering regulated revenue requirements.

The proposed objective is as follows:

"The network pricing objective is that the tariffs that a Distribution Network Service Provider charges in respect of its provision of direct control services to a retail customer should reflect the Distribution Network Service Provider's efficient costs of providing those services to the retail customer".⁹

ENA supports the inclusion of a network pricing objective within the Rules, as it provides further support for network tariff reform.

However, the ENA has redrafted the AEMC's network pricing objective to change the focus from a process – the allocation of efficient costs – to an outcome.

"The network pricing objective is that the tariffs that a Distribution Network Service Provider charges in respect of its provision of standard control services to retail customers should be set to promote efficient provision and use of electricity network services".

ENA considers that the scope of the network pricing objective is unclear, and seeks clarification from the AEMC, in particular in relation to the following.

- » Consistent with clause 6.18.1 of the NER the scope of the network pricing objective relates to direct control services, which includes both standard and alternative control services. However, there is potentially no additional benefit and only additional cost from including alternative control services within the scope of the objective. ENA notes that:
 - the analysis undertaken by NERA, Brattle and the AEMC was applied to electricity distribution

services that appear to be those typically classified as standard control services;

- it is our understanding that no analysis has been undertaken on the applicability of the pricing principles to alternative control services;
 - unlike standard control services, the long run marginal cost of alternative control services is the same as the short run marginal cost; and
 - the scope of the original Standing Council on Energy and Resources Rule change request related to the delivery of electricity, not the services typically classified as alternative control¹⁰.
- » In ENA's view the the network pricing objective is more appropriately interpreted as applying only to distribution use of system (DUOS) charges. ENA seeks clarification from the AEMC as to the application to network use of system charges (NUOS), and the implications (costs and benefits) of applying the objective to NUOS.

ENA Response

A network pricing objective

ENA supports the inclusion of a network pricing objective within the Rules, as it provides further support for network tariff reform.

However, the ENA has redrafted the AEMC's network pricing objective to change the focus from a process – the allocation of efficient costs – to an outcome.

The network pricing objective is that the tariffs that a Distribution Network Service Provider charges in respect of its provision of standard control services to retail customers should be set to promote efficient provision and use of electricity network services.

⁹ AEMC Draft Rule Determination, p. 15

¹⁰ SCER, Reform of the distribution network pricing arrangements under the National Electricity Rules to provide better guidance for setting, and consulting on, cost-reflective distribution network pricing structures and charges, Rule change request, 18 September 2013, <http://www.scer.gov.au/files/2013/10/Distribution-Pricing-Principles-Rule-Change-Request.pdf>

2.2 PROPOSED CHANGES TO PRICING PRINCIPLES

ENA considers that there is sufficient guidance within the existing principles for DNSPs to set network tariffs that promote the efficient provision and use of electricity network services.

However, the ENA recognises that the proposed Rule change and its principles have the potential to benefit customers through greater transparency of the impacts of jurisdictional obligations on the extent to which network tariffs are cost-reflective, and the extent to which the impacts on customers can be phased in over time. ENA's concern is that such greater transparency should not come at the expense of undermining network responsibility for the design of network tariffs.

In introducing firmer obligations for the pricing principles with the NER, the AEMC has proposed a number of significant changes.

- » Apart from the requirement that revenue must lie between the stand alone and avoidable cost for each tariff class, all principles now apply at a tariff level;
- » The Rule change introduces new principles referred to as the consumer impact principles and the jurisdictional obligations principle;
- » All principles are now mandatory such that each tariff:
 - must be based on LRMC rather than take LRMC into account as previously;
 - must reflect total efficient costs;
 - must minimise distortions to the price signals for efficient usage, rather than minimise distortions to efficient patterns of consumption;
 - must minimise the impact on retail customers of changes in tariffs from the previous regulatory year;
 - must be reasonably capable of being understood by retail customers; and
 - must comply with jurisdictional obligations.
- » The Rule change specifies factors that networks may “have regard to” in complying with the principles.

The AEMC has proposed a structure where compliance with certain principles is mandatory, subject to tariffs being allowed to vary to the extent necessary to give effect to other principles. However, ENA's concern is that there is a fundamental conflict between the principles in the current drafting and a lack of guidance on how conflicts may be

resolved. This conflict would create regulatory uncertainty for DNSPs in compliance and the circumstances in which the AER could withhold approval for, or seek to amend, a TSS and/or an annual pricing proposal.

Consequently, the current drafting of the principles could make it practically difficult for DNSPs to satisfy the apparent requirements for separate compliance with each of the principles, and could have the unintended consequence of the AER amending network tariffs. ENA commissioned advice from t Gilbert + Tobine on preferable drafting to achieve the policy intent. The memorandum of advice and preferable drafting changes are included in this submission in the Attachment.

The key areas in which drafting changes have been proposed by Gilbert + Tobin are:

- » clarification of the principles hierarchy;
- » some principles should be expressed as matters which must be taken into account rather than absolute requirements, given the potential conflict between mandatory requirements;
- » reorganisation of the principles to be clear which principles need to be satisfied *in the outcome* and which need to be satisfied *in the process*;
- » clarification of whether a consumer is able to “receive and respond to price signals” is appropriate as a matter to be taken into account in calculating and applying long run marginal cost:
 - ENA's concern is that this provision could be interpreted as a retailer right of veto over network tariff design, rather than being a factor to be taken into account in the costs and benefits of LRMC (and therefore should be part of f(1)) or should more appropriately be included in 6.18.5 (i); and
- » amending the revenue recovery requirement (6.18.5 (g)) which is currently unclear and which could be interpreted as contrary to the AEMC's intent of network responsibility for the design of network tariff structures:
 - amendments are proposed for the requirement for revenue to reflect total efficient costs at the tariff class level, and to minimise distortion to efficient patterns of consumption.

ENA considers that these changes are necessary to achieve the policy objectives, ensuring that networks have the responsibility for setting network tariffs in consultation with their customers. The ENA does not support the proposed Rule Change modification of the existing pricing principles without redrafting to address these strategic issues. The ENA

would prefer to see the existing pricing principles unchanged, rather than see the proposed changes to the NER in the Draft Rule Determination adopted in their current form.

ENA Response

Pricing principles

ENA considers that the changes proposed in this submission (and recommended by Gilbert + Tobin) are necessary to achieve the policy objectives of the Rule change, ensuring that networks have the responsibility for setting network tariffs in consultation with their customers. The ENA does not support the proposed modification of the existing pricing principles in the Rule change without redrafting to address these strategic issues. The ENA would prefer to see the existing pricing principles unchanged, rather than see the proposed changes to the NER in the Draft Rule Determination adopted in their current form.

2.3 PROPOSED TARIFF STRUCTURE STATEMENT (TSS)

Throughout the Rule change process the ENA has supported the proposed TSS as an important vehicle through which DNSPs can engage with customers and stakeholders on the potential pathways for network tariff reform. In recent years many DNSPs have initiated extensive customer engagement processes on network tariff reform, outside of the development of annual pricing proposals and well in advance of the development of regulatory proposals.

Consistent with DNSPs support for meaningful customer engagement on network tariffs ENA supports the proposed changes to the regulatory framework, including:

- » a two stage process for network pricing proposed by the AEMC in the Rule change, requiring submission of a TSS to the AER for assessment against the pricing principles, together with a network's five year regulatory proposal;
- » that there should be sufficient information outlined in the TSS on tariff classes, tariff structures and methodologies to enable the AER to approve the TSS on the basis of its compliance with the pricing principles;
- » that the AER must approve a TSS unless the AER is reasonably satisfied that the proposed TSS does not

comply with the pricing principles or other requirements of the NER.

For networks and stakeholders the period ahead is a learning environment in which each successive change to network tariffs could provide a foundation for the reforms to follow. The regulatory framework needs to accommodate this learning environment and a range of possible pathways for network tariff reform. In this context the ENA requests that the AEMC give further consideration to whether the proposed framework for the TSS could act as a barrier rather than supporting the implementation of network tariff reform.

According to the AEMC, the content of the TSS would outline tariff classes, tariff structures, charging (pricing) parameters for each tariff and the methodologies associated with the pricing principles.

ENA's understanding from the Draft Rule Determination is that the main function of the TSS is

"...to outline tariff structures (and be accompanied by indicative pricing levels) for the five year regulatory control period."

However, the Draft Rule Determination goes beyond this function of transparency, in seeking to provide customers with certainty with respect to how network tariffs will change over time. According to the Draft Rule Determination the TSS will:

"...provide certainty to stakeholders in regards to the network tariff structures and pricing levels that will apply for the regulatory control period so that consumers are given stable, long term price signals that they can respond to".¹¹

The current drafting of the Rule change will provide this certainty by only permitting networks to amend the TSS in limited circumstances within a regulatory period, with approval required by the AER. Under the Rule change, if a network needs to amend a TSS within a regulatory period, they must demonstrate that:

- » there is an event beyond the reasonable control of the network, which could not reasonably have been foreseen at the time the TSS was approved; and
- » that the amendments to the TSS that are proposed in response to this event would, or would be likely to, result in a TSS that materially better complies with the pricing principles and the NER requirements than the current TSS.

¹¹ AEMC Draft Rule Determination, p. 58

There are exceptions made for circumstances where a TSS does not require amendment for a new tariff, specifically:

“...the revenue raised would not exceed 0.5% of the annual revenue requirement, and where the revenue recovered cumulatively from all such tariffs that are not included in the TSS does not exceed one per cent of the annual revenue requirement.”¹²

The limited circumstances for amending the TSS within a regulatory period, and the AEMC’s proposal that charging (pricing) parameters and pricing methodology will be specified in the TSS, would, have the practical effect of locking in tariff structures and relative prices for a five year regulatory period, including potentially in the minds of customers.

In the current environment in which there is considerable uncertainty about the outlook for peak demand, metering, customer use of technology, and customers ability to understand and respond to more cost-reflective pricing signals, locking in tariff structures and relative prices for the regulatory period is not in the long term interests of customers.

Requiring this level of certainty in the TSS has the potential to constrain networks from targeting peak demand constraints as they emerge, and could result in the persistence of inefficient and inequitable cross-subsidies between customers. ENA does not consider that this is consistent with the intent of the Rule change.

In ENA’s view the regulatory framework for the TSS should strike an appropriate balance between giving customers pricing certainty in the short term and providing DNSPs with a reasonable degree of flexibility to reform network tariffs in the long term interests of customers.

ENA is seeking two changes to ensure that networks have the flexibility to introduce new network tariffs, in a timely manner and through meaningful engagement with customers and stakeholders.

The first change is that networks should be able to initiate an amendment to the TSS. A network could inform customers of the reasons why the changes that are needed could not have reasonably been foreseen or that the changes will be a material improvement, but these would not be grounds for the AER to reject an amended TSS. As with an initial TSS the AER must approve an amended TSS unless *“it is reasonably satisfied that the proposed TSS does*

not comply with the pricing principles or other requirements of the AER.”¹³

There appears no basis for the AEMC’s concern that in the absence of stringent requirements for amending the TSS, networks would frequently amend the TSS. Given the significant investment in meaningful consultation required for a TSS, networks interests are aligned with customers and other stakeholders in seeking a TSS that is appropriate for the entire regulatory period.

In ENA’s view a TSS is more likely to remain appropriate for an entire regulatory period if there is a clear separation between information that is relatively more certain (tariff structures) and information that is indicative (relative prices and pricing levels) and subject to change. Networks could provide information on what factors might lead to change within a regulatory period, and provide a customer consultation plan, within the TSS.

Network experience suggests that a dividing line can be drawn between the tariff classes and tariff structures to apply within a regulatory period, and charging parameters that could be subject to change within a regulatory period if they are to efficiently signal network costs. The need to change charging parameters (such as the definition of time periods or whether rates will be in kilowatts or kilo-volt-amperes, or kilowatt hours) and the impact on revenue raised by such changes depend on factors outside of the DNSPs control. For example:

- » a network may seek to implement KVA pricing but depends on the transmission network to implement KVA pricing also;
- » a network may initially set the time period for monthly maximum demand, but the customer response to the tariff may support a change to a different time;
- » a network may introduce a critical peak price, but weather events may change the timing of the critical event days, within a regulatory period;
- » there is uncertainty over the revenue forecasts which reflects uncertainty over the number of customers that could take up a new network tariff such as time of use, and the extent to which customers are willing and able to respond to the price signals in a new tariff;
- » changes in technology on a given network could change the responsiveness of customers to changes in the level and structures of tariffs. This change in responsiveness could be changes in price elasticities (movements along the demand curve) or a shift in the demand curve because of changes in the take-up of

¹² AEMC Draft Rule Determination, p. 67

¹³ AEMC Draft Rule Determination, p. 63

solar PV, change in income, changes in the cost of fuel alternatives such as gas.

ENA proposes that in the initial TSS submitted with the regulatory proposal that a network should outline the tariff classes and tariff structures, and that these would be binding.

In the initial TSS provided with a regulatory proposal a DNSP could provide details of the initial charging parameters for each tariff, and describe the factors that could potentially lead to variations or changes in these parameters within a regulatory period. The charging parameters would not be binding. However this approach would ensure that customers were explicitly aware of, and in a position to provide feedback on, those areas in which change may occur.

Networks could be required to provide details of the proposed consultation that a network would undertake in advance of the annual pricing process. The AER would approve the pricing proposal on the basis of different parameters to the TSS, provided there has been the consultation with customers in advance as provided for in the TSS. This is similar to the AER consideration in the annual pricing proposal of changes in the indicative pricing levels.

With respect to the content of the TSS proposed in the Draft Rule Determination, the ENA proposes that the following information in the TSS would not be binding:

- » the charging parameters for each proposed tariff, including whether charged on the basis of kilowatt hours, kilowatts, or kilo-volt-amperes, time periods, and thresholds;
- » pricing policies;
- » procedures for assigning and reassigning customers from one tariff to another, (except for the standard procedures that are specified in regulatory determinations);
- » the pricing methodology that will be used to set each tariff in the annual pricing proposal;
- » the methodology for calculating the transmission charges that may be disclosed for large customers (as provided for under clause 6.23 in the NER¹⁴); and
- » a pricing schedule (covering the Network Use of System charges) that sets out the indicative price levels for each tariff.

For provisions that are non-binding ENA is concerned that the allocation of designated pricing proposal charges and jurisdictional scheme amounts should not be binding, although could be disclosed in the TSS. While they could be disclosed in the TSS these costs are not part of the efficient costs of networks in providing either direct or standard control services.

A further consideration in drawing a structural separation between binding tariff classes and structures on one hand, and indicative charging parameters and pricing levels on the other is the interaction between the development of the TSS and a DNSPs regulatory proposal. As the regulatory proposal goes through each approval stage, to arrive at an approved revenue in the final determination, this could require the indicative revenue and pricing information in the TSS to be updated. This has the potential to create confusion for customers if the content of the initial TSS that relates to revenue recovery and pricing were to be binding.

¹⁴ This issue is discussed in more detail in the Grid Australia submission on the Rule change.

ENA Response

Regulatory framework for the TSS

Networks should be able to initiate an amendment to the TSS. A network could inform customers of the reasons why the changes that are needed could not have reasonably been foreseen or that the changes will be a material improvement, but these would not be grounds for the AER to reject an amended TSS. As with an initial TSS the AER must approve an amended TSS unless *“it is reasonably satisfied that the proposed TSS does not comply with the pricing principles or other requirements of the AER.”*

ENA proposes in the initial TSS submitted with the regulatory proposal that a network should outline the tariff classes and tariff structures, and that these would be binding. All other content of the TSS including charging parameters, policies and procedures, pricing methodologies and the pricing schedule would not be binding.

In the initial TSS provided with a regulatory proposal a DNSP could provide details of the initial charging parameters for each tariff, and describe the factors that could potentially lead to variations or changes in these parameters within a regulatory period. The charging parameters would not be binding. However this approach would ensure that customers were explicitly aware of, and in a position to provide feedback on, those areas in which change may occur.

2.4 PROPOSED CHANGES TO THE TRANSITIONAL ARRANGEMENTS

Many DNSPs will have either commenced or will shortly commence their regulatory determination process by the time of the Final Rule Determination. Given that this is the case the AEMC has provided for transitional arrangements that will enable the new rules to be implemented progressively between 2015 and 2017 in all jurisdictions.

ENA's concerns with the transitional arrangements as proposed by the AEMC are that there will be insufficient time for meaningful consultation with customers on the initial TSS under the new rules.

The AEMC has proposed that all networks except Tasnetworks will be required to submit their initial TSS on 30 June 2015.

The problem arises in the transitional arrangements because of the interaction between the development of a network's TSS and decisions in the regulatory determination process. Many DNSPs have commenced consultation with customers on network tariff structures that could apply in the next regulatory control period. However, the capacity to consult on final tariff structures and indicative pricing schedules will depend on the timing of the most recent decision on in the regulatory determination process.

- » In NSW and the ACT, the TSS submitted on 30 June is assumed to be required to be based on the final regulatory determination made on 30 April 2015.
- » In Queensland and South Australia, the TSS submitted on 30 June 2015 will be based on the AER's draft decision on 30 April, but could subsequently be amended to conform with the revised regulatory proposals submitted by the DNSPs.
- » In Victoria, the TSS submitted on 30 June 2015 will be based on the DNSPs regulatory proposals.

Given that in effect, in jurisdictions except Victoria there is a two month consultation period (between an AER decision and submission of the TSS), delaying the initial TSS to 31 December 2015 in all jurisdictions could support more meaningful consultation on the initial TSS under the new rules. The extension to 31 December would mean that in Victoria, DNSPs could update their consultation with customers on the basis of the AER's draft decision on regulatory proposals after 31 October 2015.

ENA Response

Transitional arrangements

ENA proposes that the date for the submission of the initial TSS under the transitional arrangements be extended to 31 December 2015.

2.5 RECOGNITION OF FIXED CHARGE OPTIONS

Fixed charge tariff components are likely to play an important role in improving the economic efficiency of network tariffs where accumulation meters are in place.

While interval meters or smart meters support smart tariffs that signal the costs of electricity demand at peak times, most residential and small-to-medium businesses outside of Victoria have a simple accumulation meter.

For these customers, more cost-reflective network tariffs will necessarily involve an increase in the fixed charge component, reflecting the fact that network costs are largely fixed and do not vary with consumption.

The report prepared by the Brattle Group for the AEMC on the recovery of residual costs has identified that there are a number of options for the way in which fixed costs might be recovered, in the absence of a more advanced meter. These include postage stamp pricing which applies a uniform fixed charge across all customers or a declining block tariff that assumes that price elasticity is higher for customers with higher consumption.

ENA supports consideration of the potential options for managing the impact on vulnerable customers of higher fixed charges, including the gradual phase-in or reduced fixed charges in special circumstances. However, in ENA's view the potential for higher fixed charges to impact on vulnerable customers, provides further impetus to the policy consideration of access to smart meters.

The issues of metering are being addressed outside of the Rule change, through the consideration by the AEMC of contestability for metering services and through the COAG Energy Council's consideration of market-led roll out for smart meters and the potential for changes to new and replacement meter policies.

In the broader context of tariff reform, the ENA supports a balanced framework for metering that achieves the fastest economic roll-out of smart meters to benefit all customers.

ENA Response

Recognition of fixed charge options

ENA recommends that in the Final Rule Determination report that the AEMC recognise that fixed charge tariff components are likely to play an important role in improving the economic efficiency of network tariffs where accumulation meters are in place.

ATTACHMENT

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15 October 2014

To Energy Networks Association
From Luke Woodward and Geoff Petersen
Matter No 1024244
Subject **Distribution Network Pricing Arrangements Draft Rule**

1 Overview

The Australian Energy Market Commission (**AEMC**) is currently considering a rule change request lodged by the Standing Council on Energy and Resources (**SCER**) which proposes amending the distribution pricing principles set out in clause 6.18.5 of the National Electricity Rules (**NER**). The proposed amendments flow from prior AEMC reviews (including the Power of Choice review) which recommended a greater role for long-run marginal cost (**LRMC**) based pricing.

The AEMC has now published a Draft Rule and Draft Rule Determination in response to the SCER request.¹ The AEMC proposes that there be guidance within the NER, in the form of a distribution network pricing objective, a set of principles and factors that must be had regard to in relation to the principles in the network tariff setting process.

The Draft Rule Determination identifies a number of policy objectives which the AEMC has sought to accommodate in the Draft Rule.² However in some cases, certain of the policy objectives identified by the AEMC may be in conflict. For example, a desire for network prices that send efficient future cost signals to consumers may be inconsistent with a desire to minimise the impact on retail customers of changes in tariffs, or with existing jurisdictional requirements.

Therefore a key issue for the drafting of amendments to the NER is to remove conflicts where possible, and ensure that there is appropriate guidance as to how to resolve any remaining conflicts. Such guidance is necessary to provide certainty to businesses around the requirements for tariff structure statements (**TSS**), and to make clear the circumstances in which the AER may withhold approval for a TSS.

The Draft Rule seeks to accommodate the various objectives by adopting a structure whereby compliance with certain principles is mandatory, subject to tariffs being allowed to vary to the extent necessary to give effect to other principles. We consider that given the prospect of conflict between competing policy objectives, it is appropriate that the framework allow for certain principles to give way to others in certain circumstances.

¹ AEMC, *Draft Rule Determination: National Electricity Amendment (Distribution Network Pricing Arrangements) Rule 2014*, August 2014 (**Draft Rule Determination**)

² These include: a desire for network prices that send efficient future cost signals to consumers; a desire to minimise the impact on customers of changes in tariffs; and the need for businesses to comply with existing regulatory obligations.

However, we do consider that aspects of the current drafting, as summarised below, are likely to undermine the achievement of those objectives including by making it practically difficult for the DNSP to satisfy the apparent requirement for separate compliance with each of the principles. This could have the unintended consequence that the AER is required to determine the TSS by default. We consider the drafting should be revised to better organise the principles and importantly to clarify the circumstances in which deviation from the primary principles is permitted.

Our recommended revisions are intended to resolve conflicts within the operation of the principles.

The key areas in which we think the drafting should be improved are:

- **Clarification of the principles hierarchy.** Based on the Draft Rule, there would appear to be significant scope for conflict between certain of the pricing principles. Further, there is some uncertainty as to how conflicts between pricing principles are to be resolved. In particular it is not clear whether and to what extent tariffs *must* deviate from the cost reflectivity principles (proposed paragraphs (e) to (g)), in order to give effect to other principles. For example, it is unclear to what extent a DNSP would be required to deviate from cost reflectivity, in order to minimise the impact on consumers of a change in tariffs.
- **Likely conflict between mandatory requirements.** The Draft Rule expresses each of the pricing principles as a mandatory requirement – for example the revenue expected to be recovered from each tariff *must* reflect the DNSP's total efficient costs, a DNSP *must* minimise the impact on retail consumers of changes in tariffs, and so on. This means that conflict between the various pricing principles is highly likely, since it would seem almost certain that an outcome complying with one mandatory requirement will be in conflict with another.
- **Use of mandatory outcome requirements and process requirements.** While the policy intent that the principles are mandatory is clear, they differ in nature between requirements which are outcome orientated and requirements which are process orientated. There is scope to better organise and clarify the principles as to whether they are principles that need to be satisfied in the outcome (i.e. compliance with floor and ceiling and total cost recovery principles) or are requirements as to the process by which tariffs are to be formulated (i.e. that they be based on LRMC).
- **Some principles do not appear appropriate as absolute requirements.** For example, we consider that the requirement to *minimise* customer impacts is likely to conflict with other principles. Therefore we recommend that these be expressed either as normative requirements or as matters which must be taken into account, rather than absolute requirements.
- **Clarification of matters to be taken into account in calculating LRMC.** It is unclear why the second factor in proposed paragraph (f) – the extent to which consumers are able to receive and respond to price signals – should be relevant to the method for calculation or application of LRMC. While it may be relevant when considering to what extent tariffs should be based on LRMC (and thus it may bear on application of the consumer impact principles), it would not appear relevant to the method of calculating costs. It also unclear how DNSPs would practically gauge the extent to which retail customers assigned to a particular tariff are able to *receive and respond to* price signals. We would therefore recommend that this second factor be removed from proposed paragraph (f) and moved to paragraph (i).
- **Clarification of the efficient cost requirement.** We consider that drafting of proposed paragraph (g) is currently unclear and may be interpreted in a way that is inconsistent with the AEMC's intent. We recommend that this paragraph be amended.

Each of these issues is discussed in detail in section 3 below. Suggested amendments to the Draft Rule are set out in the Attachment.

2 Key provisions of the Draft Rule

Under the Draft Rule, DNSPs will be now subject to:

- an overarching pricing objective that network prices should reflect the business' efficient costs of providing services to each customer (proposed paragraph (a));
- several new pricing principles relevant to determining the structure and level of their network prices (proposed paragraphs (e) to (j)); and
- rules relating to the application of the new pricing principles (proposed paragraphs (b) to (d)).

The network pricing objective is intended to guide how DNSPs apply each of the pricing principles and exercise the flexibility and discretion that they have under each principle.³

The pricing principles include the following:

- for each tariff class, expected revenue must lie between the avoidable and stand-alone cost of serving customers assigned to that class (proposed paragraph (e));
- each network tariff must be based on LRMC of providing the service (proposed paragraph (f));
- the revenue to be recovered from each network tariff must reflect the network business's total efficient costs of providing services to the retail customers assigned to that tariff (proposed paragraph (g));
- DNSPs must minimise the impact of changes in tariffs on retail customers from the previous regulatory year and ensure that tariffs are reasonably capable of being understood (proposed paragraphs (h) and (i)); and
- network tariffs must also comply with any jurisdictional pricing obligations imposed by state or territory governments (proposed paragraph (j)).

The Draft Rule Determination refers to the principles in proposed paragraphs (e) to (g) as the 'cost reflectivity principles', while those in proposed paragraphs (h) and (i) are referred to as 'consumer impact' principles.

The Draft Rule states that a DNSP must comply with the pricing principles in paragraphs (e) to (g), subject to tariffs being allowed to vary from those that would result from complying with these principles to the extent necessary to give effect to those in paragraphs (h) to (j).

In terms of practically applying the pricing principles, the AEMC propose the following:

- as a "first step" tariffs should be calculated on the basis of LRMC;
- the difference between LRMC based prices and the DNSP's expected revenue as determined under its distribution determination must then be recovered in accordance with the principle on recovery of total efficient costs; and
- the revenue recovered by each tariff class must also fall within the avoidable and stand-alone cost bounds.

The AEMC consider that there should be no conflict in applying the above three pricing principles.

³ Draft Rule Determination, p 20.

DNSPs are then allowed to depart from prices based on these three principles to the extent necessary to meet the pricing principles on customer impacts and any jurisdictional obligation. DNSPs will have to transparently explain any basis for departure, and only depart from prices based on the first three principles to the extent necessary.⁴

The Draft Rule also prescribes that DNSPs must develop a TSS which will outline the tariff classes, tariff structures and the methodologies associated with the pricing principles that it proposes are to apply for the next regulatory control period. This will be accompanied by a schedule of indicative price levels. The TSS will be consulted upon, and be assessed for compliance with the pricing principles by the AER in conjunction with the DNSP's regulatory proposal.

3 Assessment of the Draft Rule

3.1 Structure of the Draft Rule

The structure of the Draft Rule seeks to accommodate the various policy objectives which are reflected in the proposed set of pricing principles (paragraphs (e) to (j)).

We note that in some cases, certain of these objectives may be in conflict. For example, basing prices on LRMC may be inconsistent with a requirement to minimise the impact on retail customers of changes in tariffs, or to comply with existing jurisdictional requirements.

The Draft Rule seeks to accommodate the conflict between the various policy objectives by adopting a structure whereby compliance with certain principles is mandatory, while other principles identify a 'starting point' for tariff determination, with departure from that starting point permitted in certain circumstances.

We consider that in general, the framework adopted in the Draft Rule is appropriate. Given the prospect of conflict between competing policy objectives, it is appropriate that the framework allow for certain 'starting point' principles to give way to others in certain circumstances.

However, we consider that the drafting should be improved in some areas in order to clarify the circumstances in which deviation from the starting point principles is permitted, and to ensure that the policy intent is properly given effect to in the final rule. These are discussed below.

3.2 Network pricing objective

The network pricing objective is that tariffs that a DNSP charges in respect of its provision of direct control services should reflect the DNSP's efficient costs of providing those services to the retail customer.

The network pricing objective aligns closely with the stated objective of the rule change, as set out in the Draft Determination.⁵

However, we note that the drafting of this objective may require clarification, in relation to:

- whether it is intended to apply to charges for standard control services only (it currently refers to direct control services); and
- whether it is intended to only apply to distribution use of system (**DUOS**) charges.

We also note that there may also be some debate at a policy level as to whether this is in fact an appropriate objective. We do not address such policy issues in this memo.

⁴ Draft Rule Determination, p 19.

⁵ The stated objective of the rule change is to ensure that network prices better reflect the costs of providing network services to individual consumers (Draft Rule Determination, p i).

3.3 Scope for resolution of conflict between principles

In our previous advice to the ENA (which was submitted to the AEMC⁶) we noted that the drafting proposed by the SCER potentially gave rise to conflicting requirements. On one hand DNSPs would have been required to base the calculation of tariffs on LRMC, while on the other hand DNSPs would have been required to comply with jurisdictional requirements which might have required tariffs to be based on something other than LRMC. Our previous advice noted that it would be preferable that the drafting clearly deal with how any conflicts are to be resolved.

The Draft Rule seeks to address potential conflicts through a set of rules for application of the pricing principles (proposed paragraphs (b) to (d)). Of particular importance is paragraph (c), which states that a DNSP's tariffs may vary from those that would result from complying with the first three pricing principles (referred to as the cost reflectivity principles), only to the extent necessary to give effect to the last three pricing principles.

In our view, the way in which the Draft Rule addresses potential conflicts between pricing principles should be improved. Based on the Draft Rule, there would appear to be significant scope for conflict between certain of the pricing principles. Further, there remains some uncertainty in the Draft Rule as to how conflicts between pricing principles are to be resolved.

Scope for conflict arises because each of the six pricing principles (including the two customer impact principles) uses mandatory language. Further, in most cases, these mandatory rules are expressed in terms of tariff outcomes, rather than the process for determining tariffs. For example, the proposed principles require that (inter alia):

- revenue expected to be recovered from each tariff *must* reflect the DNSP's total efficient costs of serving retail customers assigned to that tariff;
- a DNSP *must* minimise the impact on retail customers of changes in tariffs;
- the structure of each tariff *must* be reasonably capable of being understood by retail customers assigned to that tariff; and
- a tariff *must* comply with applicable regulatory obligations.

We note that all of the requirements in proposed paragraphs (e) to (j) of clause 6.18.5 come under the definition of 'pricing principles for direct control services', and therefore a TSS would be required (under proposed paragraph 6.18.1A(b)) to comply with each of these requirements.⁷

In terms of resolving conflict, the Draft Rule states that a DNSP's tariffs *may* vary from those that would result from complying with the cost reflectivity principles, only to the extent necessary to give effect to the last three pricing principles. However it is not clear whether and to what extent tariffs *must* deviate from the cost reflectivity principles, in order to give effect to these other principles. For example, it is unclear to what extent a DNSP would be required to deviate from LRMC, in order to minimise the impact on consumers of a change in tariffs.

In our view, a critical problem with the current drafting is that proposed paragraph (c) of clause 6.18.5 expressly acknowledges the scope for conflict between principles, but does not resolve it. Proposed paragraph (c) expressly contemplates that tariffs may need to vary from those which would result from complying with paragraphs (e) to (g), in order to give effect to paragraphs (h) to (j).

In this respect, proposed paragraph (c) is directly inconsistent with proposed paragraph 6.18.1A(b), which would require a TSS to comply with the pricing principles (that is, all of the pricing principles, as set out in clause 6.18.5). On the one hand proposed paragraph 6.18.1A(b) requires the DNSP to

⁶ Gilbert + Tobin advice to the ENA dated 18 December 2013 (Attachment A to the ENA submission to the AEMC dated 19 December 2013).

⁷ The proposed definition of *pricing principles for direct control services* refers to "the requirements set out in clause 6.18.5".

comply with each of the pricing principles, while on the other hand proposed paragraph 6.18.5(c) contemplates that a departure from certain principles may be necessary in some cases.

A further issue arises in relation to the proposed AER decision rule (proposed 6.12.3(k)), which allows the AER to withhold approval to a proposed TSS where it is satisfied that it does not comply with the pricing principles. Where two or more of the principles are in conflict at least one of the principles must be breached, thus allowing the AER to reject the TSS and substitute its own wherever such conflict arises. This would appear contrary to the stated policy goal of ensuring networks have strong ownership and control of their tariffs.

In our view, proposed paragraph (c) does not properly allow for resolution of conflicts, and does not resolve the associated issues around ensuring TSS compliance. Proposed paragraph (c) does not override the requirement for a TSS to comply with the pricing principles.

We consider that there is scope to better organise and clarify the principles, so as to reduce scope for conflicts and provide DNSPs with a 'roadmap' to ensuring compliance. Specifically, we would recommend that:

- there be some re-ordering of the principles, to distinguish those that need to be satisfied in the outcome, from those that are requirements as to the process by which tariffs are to be formulated. Specifically, we propose that the three principles which we understand to be mandatory in terms of tariff outcomes – i.e. that across all tariffs there must be an expectation of recovering the revenue requirement, that for each tariff class expected revenue must lie on or between avoidable and stand alone cost, and that jurisdictional obligations must be complied with – be placed first. These mandatory outcome principles would then be followed by the mandatory process principles, including the requirement to start with LRM and the requirements to have regard to consumer impacts;
- proposed paragraph (c) be moved and amended to make clear that what is allowed for is a departure from the LRM 'starting point' in certain cases. That is, it is not a departure from the pricing principles that is permitted, since this would be in conflict with other provisions of Chapter 6 which require a TSS to comply with the pricing principles. Rather, what is permitted under the pricing principles is deviation from the LRM starting point in specific circumstances;
- the consumer impact principles (proposed paragraphs (h) and (i)) be separated out from the core pricing principles, and framed as matters which a DNSP may have regard to in considering whether to deviate from LRM under the pricing principles; and
- certain principles – in particular the consumer impact principles – be expressed either as normative requirements or as matters which must be taken into account rather than absolute requirements. This will reduce the scope for conflict between these and other principles.

Specific drafting and consequential amendments to give effect to these proposals is set out in the Attachment.

3.4 Applying the LRM standard

It is clear from the Draft Rule Determination that the AEMC intends that LRM be the 'starting point' or 'first step' for determination of tariffs.⁸ The AEMC considers that an important element of meeting the network pricing objective will be to set network prices "that send efficient future cost signals to consumers", and it takes the view that LRM is the most appropriate measure of future cost signals.⁹ However the AEMC also acknowledges that there may need to be some departure from the LRM

⁸ Draft Rule Determination, pp 103-104.

⁹ Draft Rule Determination, p 16.

starting point in order to allow for recovery of total efficient costs and/or to comply with jurisdictional pricing obligations or the consumer impact principles.¹⁰

We note that there may be a policy debate as to the appropriateness of LRMC as a starting point for tariff determination. However we do not address this policy issue here. Rather, taking the AEMC's policy position as given, we have assessed whether the Draft Rule gives effect to this intent.

The Draft Rule states that the method of calculating LRMC, and the manner in which that method is applied, is to be determined having regard to:

- the costs and benefits associated with calculating, implementing and applying that method;
- the extent to which consumers are able to receive and respond to price signals;
- the additional costs likely to be associated with meeting demand at times of greatest utilisation of the relevant part of the distribution network; and
- the location of consumers that are assigned to the relevant tariff and the extent to which costs vary between different locations in the distribution network.

In our view, based on the AEMC's reasoning for inclusion of these factors in the Draft Determination, all but the second matter would seem relevant and appropriate to consider when calculating LRMC. We understand the third and fourth points to be referring to temporal and locational considerations which may impact on the calculation of LRMC, while the first point is seeking to promote a practical approach to the method of calculation.

However it is unclear why the second factor – the extent to which consumers are able to receive and respond to price signals – should be relevant to the method for calculation of LRMC. While it may be relevant when considering to what extent tariffs should be based on LRMC (and thus it may bear on application of the consumer impact principles), it would not appear relevant to the method of calculating costs.

It is also unclear how DNSPs would practically gauge the extent to which retail customers assigned to a particular tariff are able to *receive and respond to* price signals. To some extent, the ability of retail customers to *receive* price signals is dependent on retailers effectively passing through DNSP charging structures. The ability of retail customers to *respond to* price signals will potentially depend on a range of factors, including the nature of appliances in the retail customer's home.

On one interpretation, this second factor may be seen as inhibiting the implementation of LRMC-based tariff structures, if it appears that retail customers will not *receive* the relevant price signals (perhaps because a retailer is unwilling to pass through the change in tariff structure). This would seem contrary to the policy intent.

Therefore this second factor potentially creates some uncertainty for DNSPs, in terms of how to calculate LRMC and how to demonstrate that their method of calculation takes this factor into account.

We would therefore recommend that this second factor be removed from proposed paragraph (f) and moved to paragraph (i), alongside the other consumer impact principles.

¹⁰ Specifically in relation to cost recovery, the AEMC observes that if network prices only recovered LRMC, then the revenues from these prices would be unlikely to allow DNSPs to recover their total efficient costs. The AEMC therefore proposes to include an additional requirement the amount of revenue recovered from each tariff must reflect the total efficient costs of providing network services to the consumers that are assigned to that tariff (proposed principle (g)(1)). This requirement is framed by the AEMC as an allocation rule – i.e. total efficient costs to be recovered by the business (the total revenue requirement) must be allocated to individual network tariffs so that each tariff is cost reflective (Draft Rule Determination, p 17).

3.5 Requirement for tariffs to reflect total efficient costs

The AEMC recognises that if network prices only recovered LRMC, then the revenues from these prices would be unlikely to allow DNSPs to recover their total efficient costs. The AEMC therefore proposes to include a requirement that the amount of revenue recovered from each tariff must reflect the total efficient costs of providing network services to the consumers that are assigned to that tariff (proposed paragraph (g)(1)). This requirement is framed by the AEMC as an allocation rule – i.e. total efficient costs to be recovered by the DNSP (the total revenue requirement) must be allocated to individual network tariffs so that each tariff is cost reflective.¹¹

However in the Draft Rule, proposed paragraph (g) is drafted in a way that is potentially open to different interpretations. Sub-paragraph (1) is drafted as a requirement that revenue expected to be recovered from each tariff must reflect the DNSP's "total efficient costs" of serving retail customers assigned to that tariff. However it is unclear from the drafting what is meant by "total efficient costs", since this term is not defined and is not linked to the revenue requirement specified in the distribution determination for the DNSP.

We consider that the drafting of proposed paragraph (g) should be improved, in order to better give effect to the AEMC's stated intent. Specifically, we recommend that:

- the primary requirement in sub-paragraph (2) – that in total, revenue expected to be received across all tariffs must equal the revenue requirement set out in the distribution determination for the relevant DNSP – be listed as a separate principle which is to be mandatory in terms of tariff outcomes; and
- proposed sub-paragraphs (1) and (3) be amended to provide normative requirements in relation to the allocation of the revenue requirement among tariff classes – that is, the allocation of the total revenue requirement should reflect the share of total efficient costs attributable to each tariff class and that such allocation should be done so as to minimise distortions to efficient patterns of consumption.

Specific drafting amendments to give effect to these proposals is set out in the Attachment.

3.6 Consumer impact principles

The consumer impact principles (proposed paragraphs (h) and (i)) are intended to assist DNSPs to manage price shocks by allowing them to slowly transition consumers to cost reflective prices over time.¹² The Draft Rule expressly allows this transition to take place over more than one regulatory control period.

However we consider that the way these principles are drafted may not reflect this intention, and may lead to unintended consequences. In particular, the way in which these principles are drafted means that they are likely to conflict with other principles, thus creating difficulties for DNSPs in ensuring overall compliance with the pricing principles (as required by proposed clause 6.18.1A).

The potential for conflict arises because the consumer impact principles are drafted as absolute requirements as to tariff outcomes – for example, a DNSP *must minimise* the impact on retail customers of changes in tariffs. On one view, an absolute requirement to minimise the impact on retail customers of tariff changes could be seen as precluding any change to tariffs at all. On this reading, proposed paragraph (h) will almost always be in conflict with the cost reflectivity principles.

A related issue arises due to the way in which the conflict resolution principle (proposed paragraph (c)) is framed. As currently drafted, this principle contemplates that not all principles will be capable of being complied with at once, and that there may be conflict between the customer impact principles

¹¹ Draft Rule Determination, p 17.

¹² Draft Rule Determination, p 19.

and the cost reflectivity principles. This is inconsistent with other proposed provisions which will require a TSS to comply with all pricing principles (in particular, proposed clause 6.18.1A).

We therefore recommend that the language of proposed paragraphs (h) and (i) be amended to make these mandatory process requirements, rather than absolute requirements as to tariff outcomes. That is, DNSPs should be required to take into account impacts on retail customers of changes in tariffs, rather than being required to 'minimise' the impact.

As noted above (section 3.3), we also recommend that proposed paragraph (c) be moved and amended to make clear that what is allowed for is a departure from the LRMC 'starting point' in certain cases. That is, it is not a departure from the pricing principles that is permitted, since this would be in conflict with other proposed provisions which would require a TSS to comply with the pricing principles. Rather, what is permitted under the pricing principles is deviation from the LRMC starting point in specific circumstances, including where this is considered necessary having regard to the matters set out in paragraphs (h) and (i).

3.7 Compliance with Rules and regulatory instruments

The requirement for tariffs to comply with the Rules and all applicable regulatory instruments has been inserted in recognition of the potential conflict between the cost reflectivity requirements embedded in other pricing principles, and existing regulatory obligations.¹³

However, for reasons stated above, we do not consider that merely recognising this conflict is sufficient. If the potential for conflict remains, then this will create difficulty for DNSPs in ensuring compliance with the pricing principles.

As noted above (section 3.3) we consider that there is scope to better organise and clarify the principles, so as to reduce scope for conflicts and provide DNSPs with a 'roadmap' to ensuring compliance.

In relation to proposed paragraph (j), we recommend this be elevated to sit alongside the two other principles which we understand to be mandatory in terms of tariff outcomes – i.e. that across all tariffs there must be an expectation of recovering the revenue requirement, and that for each tariff class expected revenue must lie on or between avoidable and stand alone cost. These mandatory outcome principles would then be followed by the mandatory process principles, including the requirement to start with LRMC and the requirements to have regard to customer impacts.

Specific drafting amendments to give effect to these proposals is set out in the Attachment.

¹³ Draft Rule Determination, p 19.

Attachment – Proposed amendments to the Draft Rule

Clause 6.18.5 Pricing principles

Network pricing objective

- (a) The *network pricing objective* is that the tariffs that a *Distribution Network Service Provider* charges in respect of its provision of *direct control services* to a *retail customer* should reflect the *Distribution Network Service Provider's* efficient costs of providing those services to the *retail customer*.

Application of the pricing principles

- (b) ~~Subject to paragraph (e), a~~ A *Distribution Network Service Provider's* tariffs must comply with the pricing principles set out in paragraphs ~~(e) to (g)~~ (g).
- (c) ~~[moved] A Distribution Network Service Provider's tariffs may vary from tariffs which would result from complying with the pricing principles set out in paragraphs (e) to (g) only to the extent necessary to give effect to the pricing principles set out in paragraphs (h) to (j).~~
- (d) A *Distribution Network Service Provider* must comply with paragraph (b) in a manner that will contribute to the achievement of the *network pricing objective*.

Pricing principles

- ~~(da) [moved] The revenue expected to be recovered from all tariffs must permit the *Distribution Network Service Provider* to recover the expected revenue for the relevant services in accordance with the applicable distribution determination for the *Distribution Network Service Provider*.~~
- ~~(db) [moved] A tariff must comply with the *Rules* and all *applicable regulatory instruments*.~~
- (e) For each *tariff class*, the revenue expected to be recovered must lie on or between:
- (1) an upper bound representing the stand alone cost of serving the *retail customers* who belong to that class; and
 - (2) a lower bound representing the avoidable cost of not serving those *retail customers*.
- (f) Each tariff must be based on the *long run marginal cost* of providing the service to which it relates, with the method of calculating such cost and the manner in which that method is applied to be determined having regard to:
- (1) the costs and benefits associated with calculating, implementing and applying that method as proposed;
 - (2) ~~[moved] the extent to which *retail customers* that are assigned to that tariff are able to receive and respond to price signals;~~
 - (3) the additional costs likely to be associated with meeting demand from *retail customers* that are assigned to that tariff at times of greatest utilisation of the relevant part of the *distribution network*; and
 - (4) the location of *retail customers* that are assigned to that tariff and the extent to which costs vary between different locations in the *distribution network*.

(fa) ~~[moved] A Distribution Network Service Provider's tariffs may vary from long run marginal cost where:~~

~~(1) this is necessary to comply with the principles set out in paragraphs (da) to (e); or~~

~~(2) the Distribution Network Service Provider considers this necessary having regard to the consumer impact principles for direct control services,~~

~~and in such cases only to the extent necessary.~~

(g) ~~The revenue expected to be recovered from each tariff must: Where a variation from tariffs equal to long run marginal cost is necessary to comply with paragraph (da), any adjustment should be designed:~~

~~(1) so that revenue from each tariff class reflects the Distribution Network Service Provider's total efficient costs of serving the retail customers that are assigned to that tariff class;~~

~~(2) [moved] when summed with the revenue expected to be received from all other tariffs, permit the Distribution Network Service Provider to recover the expected revenue for the relevant services in accordance with the applicable distribution determination for the Distribution Network Service Provider; and~~

~~(3) comply with sub-paragraphs (1) and (2) in a way that minimises distortions to the price signals for efficient usage that would result from tariffs that comply with the pricing principle set out in paragraph (f) efficient patterns of consumption.~~

Consumer impact principles

(h) A Distribution Network Service Provider ~~must minimise~~ should take into account the impact on retail customers of changes in tariffs from the previous regulatory year having regard to:

(1) the desirability for tariffs to comply with the pricing principles referred to in paragraphs (f) and (g), albeit after a reasonable period of transition (which may extend over more than one regulatory control period);

(2) the extent to which retail customers can choose the tariff to which they are assigned; and

(3) the extent to which retail customers are able to mitigate the impact of changes in tariffs through their usage decisions.

(i) The structure of each tariff ~~must~~ should be reasonably capable of being understood by retail customers that are assigned to that tariff, having regard to:

(1) the type and nature of those retail customers;

~~(1a) [moved] the extent to which retail customers that are assigned to that tariff are able to receive and respond to price signals; and~~

(2) the information provided to, and the consultation undertaken with, those retail customers.

(j) ~~[moved] A tariff must comply with the Rules and all applicable regulatory instruments.~~

Chapter 10 New definitions

In Chapter 10, insert the following definitions in alphabetical order.

consumer impact principles for direct control services

The principles set out in paragraphs 6.18.5(h) and 6.18.5(i).

long run marginal cost

For the purposes of clause 6.18.5, the cost of an incremental change in demand for *direct control services* provided by a *Distribution Network Service Provider* over a period of time in which all factors of production required to provide those *direct control services* can be varied.

network pricing objective

The network pricing objective set out in paragraph 6.18.5(a).

pricing principles for direct control services

The requirements set out in clause paragraphs 6.18.5(da) to 6.18.5(g).

pricing schedule

For a *Distribution Network Service Provider*, means the pricing schedule as referred to in paragraph 6.18.1A(f).

tariff structure statement

For a *Distribution Network Service Provider*, means the *tariff structure statement* referred to in clause 6.18.1A that has been approved by the *AER* for that *Distribution Network Service Provider*.