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

Via website: www.aemc.gov.au

Dear John

Draft Determination on Distribution Network Pricing Arrangements Rule Change, Ref ERC0161

AusNet Services welcomes the opportunity to provide comments on the Commission's draft determination for the distribution network pricing rule change. The pricing of network services is an important factor in facilitating economic and efficient future energy investment decisions by both consumers and industry. We consider that reforms to the current network pricing arrangements is a key component in improving current and future industry performance, and this review provides an important opportunity for achieving this outcome.

Tariff reform is an important current issue, particularly with changing energy usage patterns and developing technologies which provides customers with much greater choice for their energy services. This means it is increasingly important that network pricing signals are provided to customers which will allow them to make the most rational and economic decisions, rather than having these decisions influenced by distortions in the network pricing signals. Efficient prices and network pricing signals are critical for the economic and efficient development of the sector.

It is crucial that network pricing reform looks to the future, as it is apparent that the trends for customer choice will increase further, exacerbating the potential efficiency losses that will occur if the price signals provided to customers do not reflect the costs of providing their services.

While significant change is anticipated in the industry the precise nature of the change is uncertain. Participants have considered a range of future scenario, including for example the scenario analysis of the CSIRO led Future Grid Forum.

Reforms to the network pricing principles should be equally applicable to the range of future scenarios, and over the course of the Commission's review there has been considerable discussion on how the pricing arrangements should accommodate the trends discussed above. It is also important that imperfections in the network pricing arrangements do not inhibit the most efficient scenario emerging in the future.

Our submission, attached, outlines AusNet Services views on the proposed rule changes and tariff reforms we believe will support holistic economic decision-making on energy supply

investment to support the energy supply future that will continue to evolve. We consider that the proposed changes provide a useful step in seeking to improve the current network pricing arrangements.

As an overall comment however we believe that the proposed changes fall short of the fundamental change required to tariff reform to allow the industry to be properly prepared for the future changes in the industry. However we do recognise the significant constraints that make it extremely difficult to achieve the changes that are ideally required, and accept that the proposal, together with our specific comments represents a pragmatic step to achieving worthwhile change in the short term.

We consider that the challenges for network tariffs will continually evolve as the future develops, and would encourage the AEMC to continue to monitor the need for ongoing tariff reform to ensure that the industry is appropriately prepared for these changes.

For enquiries regarding this submission, please contact Kelvin Gebert, our Regulatory Frameworks Manager, telephone 03 9695 6603.

Yours sincerely,

John Howarth

Manager Regulation and Network Strategy

AusNet Services Submission on Draft Determination Distribution Network Pricing Arrangements Rule Change ERC0161

1. Objectives of tariff reform

The Commission proposes a pricing objective, being that:

> *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*[1]

AusNet Services supports the inclusion of an over-arching objective to provide guidance in the application of the pricing principles to develop network prices. The objective should be efficiency driven, consistent with the National Electricity Objective, and provide focus, in this case the costs of providing services to the retail customer. The Energy Networks Association has proposed an alternative objective, which we believe would also provide appropriate guidance.

We note that the objective is drafted to apply to Direct Control Services, however believe that this reference should be to Standard Control Services. Distribution Direct Control Services are further classified as Standard Control Services and Alternative Control Services. Only those services that fall under the sub classification of Standard Control Services relate to the "poles & wires" energy delivery functions covered by the Annual Revenue Requirements of the DNSP and provided universally to all connected customers. Typically those services covered by the sub-classification of Alternative Control Services are the discretionary services provided by the DNSP and purchased by end use customers on as needs basis, these are mostly fee based and quoted services or charges made on an individually calculated basis.

Additionally, it should be clarified that the tariffs referred to in the objective and principles are those that are actually provided by the DNSP, i.e. Distribution Use of System charges. The inclusion of transmission charges within the concepts of the distribution pricing principles, through referencing a Network Use of System (NUOS) charges, could prove problematic. Potentially application to NUOS would require tariff classes to be set with reference to each transmission connection point, and so the process of tariff setting would become extremely complex and understanding would suffer accordingly. There are other differences in methodology for transmission pricing and the proposals for distribution pricing that are incompatible, in particular distribution network pricing is forward looking whereas the principles for transmission pricing invoke a backward looking approach. In our view a thorough assessment of practicality and net benefit would be necessary before the principles could be confidently applied at the NUOS level.

[1] Draft Rule Determination, page 15

More broadly the pricing objective and pricing principles should accommodate key objectives for tariff reform associated with the efficient provision and use of network services. This includes pricing related to the use and investment in sunk assets, such as asset replacement and critical safety expenditure in higher risk localities. These objectives include:

a) Fairness

   Fairness and equity may not be outcomes for a DNSP to have discretion over through pricing. However if network costs are allocated on a 'cost to serve' basis then there would be reduced distortion and the opportunity for greater transparency in costs and the provision of customer support where this may be considered necessary

b) Recognition of efficient new technology solutions

   At the network fringe, stand-alone energy solutions may be more efficient than continuing investment in the network. In these circumstances networks should be encouraged to co-optimise the service provided to customers, with those customers, so that the most economic and efficient short run and long run network management and asset investment decisions are made

c) Use price signals to discourage inefficient network bypass

   Cross-subsidisation is inherent in current pricing arrangements. In the future this may lead to energy choice decisions which are inefficient compared to network provided energy in parts of the network, and the reverse in other locations.

   Where the investment decision does not account for the cost of servicing the existing network this cost would not be mitigated by that investment decision.

d) Pricing should align to an altering service paradigm

   The network's customer can no longer be thought of as an energy 'consumer'. The change that is occurring in energy supply means that the network may be better described as part of a customer's energy solution.

   The attributes of network include supply security, stability and sharing. The value of these broader benefits needs to be captured in the service model, and in the pricing arrangements.

e) Retail tariffs should reflect DNSP pricing intentions

   The Commission's draft determination recognises the importance of retail customers understanding and being able to respond to network prices. Pricing is a strategy to facilitate efficient investment and the pricing signals should not be muted by intermediary retailer objectives.

2. Use of Long Run Marginal Cost in pricing

LRMC is the cost of supplying an additional unit of a good or service when capacity can be varied. A strong linkage between tariffs and LRMC is particularly relevant where network constraints are foreseen and pricing can signal the impending investment costs to relieve the constraint. Customers are able to respond to the pricing signal to facilitate the most economic outcomes for customers consistent with their energy needs or preferences.

However, where usage is declining on part of a network, and constraints in capacity is not an expected occurrence in the foreseeable future, it is unclear how a textbook LRMC should form the basis of prices. Clearly an LRMC value can be derived, but the predominant cost drivers into the future, in those circumstances, will be safety and reliability. Allocation of associated costs in a way which reflects the 'cost to serve' customers would improve signalling of the costs of the customer's use of the network. Throughout the Commission's consultation process we have sought greater clarification on how the pricing principles may practically address cross-subsidisation in the on-going investment in the existing network and we urge the Commission to give further consideration and further clarification on this aspect in the final determination and rule provisions.

AusNet Services interprets the rule change as giving primacy to LRMC amongst the principles. This is because tariffs are to be 'based on' LRMC, distortion to the LRMC signal is to be minimised, and customer impact is a key consideration (i.e. over-signalling may contravene this principle). However, it is not entirely clear from the Commission's discussion on the application of LRMC in the draft determination whether this is the case, or whether there is flexibility for tariffs to accommodate the legitimate signalling of other key future costs in the efficient provision and use of the network. It would be helpful if the intent was more clearly presented in the determination, for example in the following paragraph drawn from the draft determination:

> *LRMC will be the first step for DNSPs in developing their network tariffs under the new pricing principles. This is important as LRMC will form the basis of the pricing signals that should be sent to consumers and therefore should be the starting point for tariff design. DNSPs will then adjust these tariffs based on LRMC to recover their total efficient costs, to comply with the consumer impact principle and to comply with any applicable jurisdictional pricing obligations…*[2](underlining added to draw attention to this text for this discussion).

We note that accountability for the use of LRMC in setting tariffs can be expected to be considerably strengthened with introduction of the proposed Tariff Structures Statement (TSS), even if the existing principle, to take LRMC into account, was retained. The TSS is required to set out the DNSPs pricing methodology and increase transparency.

Our conclusion is that LRMC is relevant and important in setting tariffs, however there are other cost signals for customers and flexibility should be assured so that these that should also be accommodated.

[2] Draft Rule Determination, page 103

3. Geographic differentiation

Acceptance that tariffs may be differentiated on a geographic basis is a key reform need. In the current and future environment this is primarily necessary to address cross-subsidisation that exists in uniform tariffing.

Geographic differentiation in pricing already exists across the NEM, predominantly at the boundaries of the networks. It is accepted that there are differences between neighbouring DNSPs tariffs, which reflect the different costs to serve customers. For example, within Victoria geographic differentiation occurs between the network prices of the 5 distribution businesses, and depends upon whether network is predominantly an urban DNSP or has significant rural topology.

Uniform tariffing is prescribed in some states. In other states, such as Victoria, this is not the case. Nevertheless, where there is no legislative constraint DNSPs have still not adopted geographic differentiation. This is presumably because social licence to do so has not been established.

The draft rule provides explicitly for geographic differentiation, and the process which may achieve social licence. This includes:

- The clarification placed in the Rules;
- Provisions to minimise the impact of tariff changes on customers; and
- customer consultation provisions.

We support the Rule Change Proposal and draft determination in providing for geographic differentiation. However, these measures also constrain the effectiveness of geographic differentiation.

The current rules are silent on geographic differentiation of prices and implicitly do not constrain this. As noted above, differentiation exists at the network boundaries, and constraining differentiation would not be consistent with this natural outcome. However the draft rule could be interpreted to limit geographic differentiation to the LRMC component only, since it specifically provides for this alone, i.e. if the primary differentiator is to be LRMC, and the explicit provision for geographic differentiation sits within the relevant considerations for determining LRMC. Geographic differentiation could therefore be bound by first necessitating an LRMC difference. Other cost drivers may also be subject to geographic differentiation and broader explicit acknowledgement in the pricing principles should be provided.

Transitioning to different tariffs over a period of time, potentially more than one regulatory period, would provide unclear signals to customers in the short term, and across the transition period the creeping growth in the signal is likely to result in a diminished responsiveness by customers.

An alternative approach, providing a more direct pricing signal to customers would be for the cost reflective prices to be presented to customers, and for an off-tariff impact mitigation scheme which would provide the ability for re-balancing to form the basis of transition. In this way customers would have a clear incentive to respond to the price signals provided.

Another mechanism included in the draft rule to minimise customer impact is to have regard to the extent to which customers can choose the tariff to which they are assigned. AusNet Services seeks clarification of the intention of this provision, since the pricing approach appears to be prescriptive, leading to a 'best outcome' based on LRMC. Choice would appear to be inconsistent with the broader intention of the rule change. Potentially choice relates to transitionary tariffs (which should be structured in accordance with the new Rules, rather than historic tariffs which predate the new Rule) however clarification by the Commission is necessary.

Our conclusion is that geographic differentiation in prices should be explicitly included in the pricing principles, with clarification that geographic considerations are not bound by LRMC differences. The DNSP would be required to consult on intended geographic differentiation and address this in the TSS. An off-tariff impact mitigation scheme could be included at the discretion of the DNSP, taking into account the materiality of impacts and the results of engagement on this issue, of potentially in consultation with its jurisdiction.

4. Tariff structures

A key issue identified by many commentators and NERA in its consultancy for the Commission is that historic energy based tariff structures are not well suited to networks and are a significant cause of inequity in tariffs. This has become apparent as some customers have been able to take advantage of new technologies which have impacted network utilisation. These include high energy consumption air conditioning, and rooftop solar generation. In the past, typical electricity usage across the customer class was more uniform.

Tariffs structures, for small customers, are typically energy (kWh) based. However electricity networks in the hot Australian climate generally become limited by the capacity of the network elements, which is commonly reduced at the time that demand (kW) is highest. Charging for network usage on a kW would provide improved cost-reflectivity.

In Victoria, where smart meters are rolled out it is straight forward to introduce demand into tariffs. In fact across the NEM, large commercial and industrial customers with electricity consumption exceeding the threshold requiring a type 4 meter already have demand charging.

It is noted that the introduction and promulgation of pricing with reference to electricity demand does not require a rule change. Experience, as discussed above, is that the key determinant to improved cost reflective pricing is the introduction of metering infrastructure which will permit capture of customer demand at the period of peak network utilisation.

Looking further forward, it is expected that the economics of energy storage will create a new wave of customer ability to 'respond' to network pricing signals. Whilst the aim is for pricing to be technology neutral this concept is less relevant where the technology enables customers to maintain network services but avoid contributing to the cost of service. Some customers may increasingly use the network predominantly as supply security, a physical insurance, in case of failure of their home installation. This approach would push up network prices for other customers. To provide for this service a premium, such as an agreed capacity tariff component, may be warranted.

The Rules currently preclude DNSPs from treating customers with micro-generation differently from supply on residential customers. As discussed, unless a standby premium or some other innovative pricing may be charged to these customers they will be able to avoid paying costs associated with the value of standby. This rule requires reconsideration but is not addressed in the consultation to date. More broadly there is a need for pricing to consider how recovery of sunk network costs is equitably distributed amongst customers as some customers use the network less, and the burden falls on fewer customers. At one end of the range of customer energy solution choices is the option of leaving the grid. At this extreme the inclusion of a network exit charge may lead to the most equitable charging outcome for the broad customer base.

5. Role of networks

The role of networks is changing. In the past the network has predominantly provided a one way energy supply service. What is emerging is an energy connectivity service, more in the nature of a road network or communications network, where the services are two way. There are many future scenarios however, and it is not even clear that the current capacity of networks will always be required, or that continuing to invest in fringe parts of networks will be efficient or prudent.

In light of this future uncertainty, networks need the clarity of purpose to be able to co-optimise the future of localised network investment with the energy supply options that may be available to the customer.

Revised pricing arrangements should provide encouragement to networks to charge on the basis of the cost to serve customers, to facilitate the most economic overall investment in energy services.

6. Retailer pass through

In many discussions it has been noted that it is not necessary that retailers be required to pass through the DNSP charges directly to customers. The Commission also supports this view, for example the Commission states:

> *The draft rule does not require retailers to structure their retail prices in a way that matches the structure of network prices. Retailers operate in a competitive market and should be free to design their prices as they see fit in response to consumer preferences and the other costs they face*[3]*.*

However, the draft rule requires DNSPs to consult with end use customers on proposed tariffs, and requires consideration of tariff impact on customers to account for their ability to receive and respond to the price signals.

AusNet Services strongly supports an end customer focus for prices, but believes greater incentives are necessary to encourage retailers to pass through the DNSPs price signals without attenuation. It is important that customers see the actual network 'cost to serve' pricing established by the DNSP. These prices will be set to advance network investment efficiency,

[3] Draft Rule Determination, Executive Summary, page iii

and address other concerns such as cross-subsidisation that could lead to inefficient network by-pass. It is not sufficient that retailers absorb the risks in a way which dampens these network signals. This is not in the interests of the consumer or the DNSP.

Ultimately there may be merit in networks billing customers directly. DNSPs are increasingly having a direct relationship with customers. The pricing arrangements rule change requires close consultation with consumers. Yet the DNSP response to that consultation may be muted, which may also have the effect of impacting customer confidence.

An additional benefit of separated billing may be improved competition in the retail energy market, which is the component of the electricity bill that is intended to be competitive. Separation would improve transparency, and avoid the need for retailers systems to be able to manage a diverse range of network tariffs.

7. Final conclusions

Our conclusions are that:

- In the projected energy environment of flat demand there are network cost signals other than LRMC which should be accommodated by the pricing principles;
- A clearer ability to base tariffs on 'total efficient costs of providing services to the assigned retail customers' is preferable; and
- With changing use of the network, greater flexibility in tariff setting is necessary
    - Tariffs will remain consumption based, whereas the networks are developing a broader connectivity role for mixed generator / consumer customers, and provide for a differently defined services that may be suited to customers;
    - Broader transparency of cross-subsidisation inherent in tariffs is necessary so that DNSPs can co-optimise network and localised energy solutions; and
    - There is a growing urgency for retail tariffs to directly reflect the DNSPs pricing intentions