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Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
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Submitted via www.aemc.gov.au

22 May 2015

Dear Mr Pierce,

Submission on the expanding competition in metering and related services draft rule determination (ERC0169)

EnerNOC is grateful for the opportunity to comment further on this proposed reform. As indicated in our submission of 29 May 2014, we support reforms to promote innovation in metering.

Access to metering data or services is necessary to deliver many third-party services. While in some cases it is practicable for third parties to deploy their own metering devices – this is what we do at present – it would be a great deal more efficient for the market meter to be used to provide multiple services. Successful reform would encourage this.

We agree that competitive pressures may be the best way to foster innovation and efficiency. However, we have serious concerns about the likely interactions between Metering Coordinators (MCs) and third-party access seekers.

This submission describes these concerns in detail, and then proposes a straightforward solution.

1 This is a textbook case for access regulation

If the reform works as intended, MCs should compete aggressively for retailers' business,[1] leading to the pricing for these services tending towards the MCs' marginal costs plus a normal profit margin. This is the outcome one would hope for from a competitive market. Let's call this **Market A**.

However, as discussed in our previous submission and in my presentation at the public forum on 30 April 2015, it is not reasonable to expect a similar outcome for third parties, as the relationship between MCs and third parties will be rather different: MCs have no need to compete for third parties' business.

[1] … and also to be directly appointed as MC by large customers, if dominant retailers are not able to discourage customers from exercising this choice.

Consider a third party who wants access to metering services associated with a particular customer's connection. They are a potential consumer of these services, and the MC is a potential supplier. The market in question is a very small one: that of additional metering services associated with that customer's connection. Let's call it **Market B**. It is quite distinct from Market A.

The MC's position in Market B is that of a natural monopoly: they have incurred high fixed costs to provide the basic metering service to the retailer in Market A (owning, installing, maintaining, and reading the meter), but, due to their control of that asset, they now have very low marginal costs to provide services from that same meter to additional parties in Market B.[2] This means that the MC has great economies of scale, which creates a very high barrier to entry in Market B: any other party seeking to provide a service to the access seeker in Market B (without being appointed MC in Market A) would have to incur the high fixed costs to install a second meter.[3]

The efficient outcome here is for the access seeker to gain access to the existing meter, rather than installing a separate meter (or a "network device"), because that is the outcome that has the lowest total costs.[4] If these reforms lead to networks installing their own network devices, or third parties installing their own metering equipment, instead of gaining access to the existing meter, then they will have failed.

This is recognised in the draft determination, which suggests that the threat of an access seeker being able to bypass the MC in this way "may be sufficient to constrain any exercise of market power by the Metering Coordinator"[5]. We agree that this means that the MC's market power is not unlimited. However, it will still be excessively high, to consumers' detriment.

The MC will be aware that it has this very high level of market power, and so can be expected to maximise its profits by charging the access seeker a price just a little below the cost of the access seeker's alternative: to install a second meter.

This is a particular problem in this situation, because it means that the customer will be paying (as a mandatory part of their retail electricity service) the cost of having the meter installed, available, read, and maintained, but then will also be paying a similar amount in "economic rent" on the meter, possibly several times over – built into the costs of their network services and the services of each third party they deal with.[6]

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2 The marginal costs have been described as "close to zero" by people in metering businesses.

3 The metering hardware used by the substitute supplier may be slightly cheaper than a market meter, because it may not need such a high level of accuracy and traceability. However, the total fixed costs are unlikely to be much lower, because the installation, maintenance, and telemetry costs tend to dominate.

4 i.e. The MC's position in Market B is consistent with the definition of a natural monopoly in William J. Baumol, *On the Proper Cost Tests for Natural Monopoly in a Multiproduct Industry*, American Economic Review LXVII, December 1977, pp. 809–822.

5 Draft determination, p. 73.

6 It has been suggested that competitive pressures may incentivise MCs to use the revenue from deals with access seekers in Market B to allow them to offer a more competitive price for their services in Market A. If this were to occur, it would reduce costs for retailers, and may mean that customers would not end up paying rent multiple times over. However, this arrangement – allowing a party to use its monopoly position

The MC has a sustainable monopoly position, as it can continue to extract rent from all access seekers for as long as it remains the MC for that connection: Market B is not contestable.

This doesn't seem like a good outcome for consumers: since metering services from Market B are an essential input for many third-party energy services, if the prices of those metering services are set inefficiently high, it will lead to third-party energy services being inefficiently expensive. Since these third-party services are optional (unlike the services in Market A), inefficiently high prices would lead to inefficiently low consumption of those services.

This would would be a poor outcome for allocative efficiency, and would be inconsistent with the competition criterion of the Commission's assessment framework.[7]

2 The Commission's reasons not to worry about market power are unconvincing

In the draft determination, the Commission suggests that MCs' ability to exercise market power will be restrained by four factors:[8]

(i) The threat of entry by new competitors, due to low barriers to entry.

(ii) The risk that metering assets will become stranded.

(iii) The monopsony power of access seekers.

(iv) The ability of consumers to switch retailers.

Most of these provide no comfort to third-party suppliers of energy services: (i) and (ii) apply only to Market A, not to Market B; (iii) only applies to distribution networks.

So it all hinges on consumers switching retailers. The Commission goes into more detail on this idea:

> *"This may mean that if an energy service company is not satisfied with the terms and conditions offered by the incumbent Metering Coordinator, it may opt to offer its services through other Metering Coordinators and retailers operating in the market. If a consumer values the services of that energy service company it may choose to switch to one of these alternative providers."*[9]

in a non-contestable market to cross-subsidise its activities in a contestable market – would still be problematic, because the cross-subsidy would lead to the costs of third-party energy services, for which metering services are an essential input, being higher than the efficient level.

7 Draft determination, p. 25: "Whether the draft rule promotes incentives for parties to supply consumers with metering services and other energy products and services that consumers want at a price that reflects the efficient costs of doing so."

8 Paraphrased from draft determination, pp. 68-69.

9 Draft determination, pp. 262-263.

Unfortunately, this is a rather limited remedy, for two reasons:

- Customers overwhelmingly choose their retailers on the basis of the retail energy deal they offer, rather than on the basis of how they interact with third parties. This makes perfect sense, because, generally, paying a fraction of a cent less per kilowatt-hour of energy is worth more to the customer than any third-party energy service.
- Even if third parties can convince customers that they should change retailers in order to overcome a barrier put in place by the MC, customers' retail contracts would present a major impediment to the growth of the energy services businesses: having invested the time and money to acquire each customer, they would then have to either (a) wait possibly several years for the customer's retail contract to end before they could start delivering (and hence charging for) their service, or (b) pay the customer's early termination fee, which for large customers can be substantial. These hurdles are likely to discourage third parties from entering the market – the business case may not stack up – so that customers would not even be aware of the possibility of such third party services.

The draft determination also suggests that, as an alternative to network businesses negotiating with MCs for access to metering services, they could contract with DSP aggregators, who would then be responsible for negotiating framework agreements with multiple MCs.[10] This is a strange idea, because DSP aggregators have no more bargaining power than networks to negotiate such agreements on reasonable terms. In fact, as we will explore in the next section, third parties are likely to be in a much worse position because of the influence of the retailer.

3 Retailers' interests are likely to dominate

The draft determination explains very clearly that an MC controlled by a retailer:

> *"may have an incentive to deny or frustrate access for use of its functionality and data because:*
>
> - *managing a consumer's energy consumption, and in particular reducing it, may conflict with the retailer's core service of supplying energy to its customers. The Metering Coordinator may perceive that denying access would increase, or prevent a decrease in, the retailer's profits; or*
> - *the retailer also wishes to offer such services to its customers."*[11]

[10] Draft determination, p. 247.

[11] Draft determination, p. 266.

It also details various methods by which an MC could achieve this.[12] In fact, even an independent MC could be motivated to frustrate access by third parties: a retailer may be willing to pay more for a service (in Market A) which includes the frustration of access by third parties than for one which allows open access on reasonable terms.

As mitigating factors, the draft determination only suggests:[13]

(i) That the access seeker could install a second set of metering equipment. As discussed in section 1 of this submission, this would be a costly and inefficient outcome.

(ii) That the access seeker could persuade the customer to change retailer. As discussed in section 2 of this submission, this is a very limited remedy.

We conclude that, under the proposed arrangements, retailers will be able to frustrate access by third parties to metering services associated with their customers. The draft determination appears to accept this:

> *"Ultimately, consumers will face a choice between selecting a retailer that bundles the relevant energy management service and selecting a retailer that allows them to use an independent energy service company."*[14]

This raises an important question. This rule change proposal is a result of the Power of Choice review. What is the Power of Choice all about? Is it about giving consumers more choice? Or is it about giving retailers more control?

We assumed it was all about consumer choice. However, if retailers are to be given the opportunity to exclude parties they consider to be competitors (such as purveyors of energy intelligence software), or whose services may cause customers to seek out better deals (such as price comparison tools), or whose services they judge to be counter to their wider strategic interests (such as demand response aggregators), then this reform is unlikely to give customers more choice: they would simply be faced with a choice between bundles of services put together by retailers. Such bundles would be unlikely to include the services described above that would empower consumers, enhance competition, and improve efficiency.

This would allow the major retailers to extend their dominance of electricity retailing into the adjacent energy services markets, rather than allowing for new entrants, innovation, and vigorous competition.

[12] Draft determination, pp. 266-267

[13] Draft determination, p. 267.

[14] *Loc. cit.*

4 Proposed light-handed regulation of third-party access to metering services

If third parties were able to access metering services from a competitive market – i.e. if the desires of the retailers and the natural monopoly character of the MC's position in Market B were somehow neutralised – then we would expect market prices for the services to be closely related to the marginal costs of providing the services. There would be a normal profit margin, but no extraction of "economic rent".

The aim of a regulatory regime is to achieve something close to this outcome, while minimising overheads and distortions.

The competitive metering market in the United Kingdom has tackled this by mandating that all access to meters be channeled via a central agency – the Data Communications Company – which provides access on a neutral basis. The fixed costs of access to the meters are recovered through fixed per-meter monthly charges charged to retailers and distributors, and the variable costs for particular services are recovered through "explicit charges" which are set "on a non-discriminatory and cost reflective basis so as to recover the incremental cost … associated with the [service] (and disregarding any costs and expenses that would be incurred whether or not that [service] occurred)".[15]

This is an effective solution which has considerable merit. However, it is highly interventionist. For the NEM, we instead propose a much more light-handed approach, in two parts:

(i) The rules should include "access and pricing principles" for services provided by MCs to third parties. The text in the current version[16] of National Electricity Rules clause 7.2.3(g) provides a good starting point, as it also deals with a situation in an interaction with a monopoly supplier. To adapt the clause for this purpose:

- Subclause (1) should require the offer to be fair and reasonable, taking into account the incremental cost associated with providing the service (and disregarding any costs that would be incurred whether or not that service were provided), and allowing a level of profit commensurate with the risks involved in providing the service.[17]
- Subclause (2) should include third parties who do not happen to be market participants.

[15] Smart Energy Code, clause K7.6(c). The Data Communications Company has confirmed (pers. comm., May 2015) that, in accordance with this requirement, the per-meter charges for third parties to access services are currently set to zero.

[16] Version 71.

[17] Other pricing principles in the National Electricity Rules – e.g. clauses 6.7.1, 6.7A.1, 6.18.5, 6A.9.1 – require prices to be set between marginal and stand-alone costs. This makes sense, because they are concerned with equity between different customers, and with allowing the service provider to recover their fixed costs. This case is different because (a) there is only one customer ultimately paying for all of the services – the aim is to avoid that customer paying the stand-alone costs several times over; and (b) the MC has the opportunity to recover their fixed costs for providing the mandatory service in Market A.

(ii) The rules should provide access to a dispute resolution process in the event that MC and the access seeker cannot agree on terms that both agree comply with the principles. The current wording of clause 7.2.3(h) provides a model for this, by allowing disputes to be resolved under clause 8.2. It would also be necessary to amend clause 8.2.1(a1) to cover Metering Coordinators and access seekers.

This is a very light-handed approach to regulation because:

- It only applies to interactions between MCs and third parties. The main business of MCs – which should account for the vast bulk of their revenue, costs, and profits – remains completely unregulated because it should be subject to effective competition.
- There is no up-front regulatory involvement: the dispute regulation process is only triggered if commercial negotiations fail. MCs can straightforwardly avoid disputes by pricing their services to third parties in accordance with the principles.

The Commission has expressed concern that even light-handed regulation "will involve significant costs and could deter investment in advanced meters".[18]

The first factor above means that investment should not be deterred, as this minimal level of regulation does not affect the important parts of an MC's business: MCs' business plans should be centred on competing for business in the contestable Market A, not on using their monopoly position in the non-contestable Market B to extract economic rent from networks and third parties.

The second factor means that costs should not be significant: the costs of the Chapter 8 dispute resolution process are borne by the parties involved in a dispute; an MCs that sets prices for their non-contestable services at efficient levels should not attract successful disputes. If unfounded disputes were to be raised, the dispute resolution panel could be expected to use its power under clause 8.2.8(b) to allocate all costs against the vexatious complainant.

We note that these pricing principles and access to this dispute resolution process should also resolve the "hold-out" problem identified by distribution networks.[19]

In summary, our concern is not that we don't believe that there will be effective competition to provide metering services in Market A. Rather, it's that there is no reason to expect this competition to provide efficient outcomes in Market B. Fortunately, the highly targeted, light-handed regulation we have proposed should fix this with minimal cost and risk.

[18] Draft determination, p. 69.

[19] See, for example, the Energy Networks Association's presentations at the AEMC public forum on 30 April 2015.

I would be happy to provide further detail on these comments, if that would be helpful.

Yours sincerely,

Dr Paul Troughton
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