



19 December 2013

Mr John Pierce  
Chairman  
Australian Energy Market Commission  
PO Box A2449  
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[by email to [aemc@aemc.gov.au](mailto:aemc@aemc.gov.au)]

Dear Mr Pierce

**RE: ERC0161 CONSULTATION PAPER**

Origin appreciates the opportunity to comment on the Australian Energy Market Commission's (AEMC) Consultation Paper on the National Electricity Amendment (Distribution Pricing Arrangements) Rule 2014.

Origin supports much of the two sets of rule changes proposed by the Independent Pricing and Regulatory Tribunal (IPART) and the Council of Australian Government's Standing Committee of Officials (SCER), respectively. Taken as a suite of reforms the changes address most but not all of the concerns Origin has with current processes for setting and applying distribution network prices in the National Electricity Market (NEM).

Elements of the SCER rule change and the AEMC's initial response raise some concern. Origin is concerned that the AEMC has not yet adequately addressed issues raised by SCER and IPART with respect to the timing of the annual network pricing process - specifically the request from SCER that AEMC consider changes to allow earlier notification of approved annual network tariffs. With respect to distribution pricing principles Origin is concerned that the long-run marginal cost (LRMC) approach proposed by SCER will be too costly and complex to apply. We do not believe that in light of existing constraints in the market that an LRMC approach will leave sufficient flexibility to address pressing need for tariff reform driven by changing market dynamics.

***A. Consultation on network prices and confirmation of final prices***

Origin supports the proposals of SCER and IPART with respect to consultation on network tariffs. We believe there is broad recognition across the industry that there is a need for a formalised process for networks to consult on proposed changes to the structure of their network tariffs, where currently no formal requirement exists. Furthermore, we believe there is equally broad recognition across the industry that final prices should be notified further in advance of when they apply. While SCER asked the AEMC to address the timing issue<sup>1</sup> we do not believe that what the AEMC has proposed thus far represents an adequate response in terms of the National Electricity Objective or the criteria adopted by the AEMC to assess this rule change.

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<sup>1</sup> Standing Council on Energy and Resources, Distribution Pricing Rule Change Request, 18 September 2013, p.12

Retailers generally choose to align retail prices with network prices in order to reduce the risk of under-recovery. Retailers must also understand changes to network tariffs, both structure and level, when formulating retail prices. There are a large number of regulatory publication requirements for retailers (for price/product listings and comparators) and these generally differ by state. All retail tariffs must be updated in specific formats per state and comply with regulatory timeframes.

There is no value in elaborate cost-reflective network tariffs if the retailer has just a few days to adapt its retail prices, since due to time pressures retailers may be forced into applying flat increases and any price signals at the tariff level will be lost. Equally, system constraints can sometimes mean that prices cannot be applied at all and retailers have no opportunity to provide this feedback.

Customers would benefit from better notice of changes in pricing structure when considering demand response measures, for example installing PV panels. When Distribution Network Service Providers (DNSP) propose to change the structure of tariffs customers would also have an opportunity to respond and highlight the impact of these changes. It will be a minority of small customers who have a more sophisticated understanding of the energy market who seek to understand changes in network prices, but in Origin's experience this is a growing customer segment, due to increases in network prices in recent years and growing interest in embedded generation and other demand response measures. There are also consumer advocacy bodies that are well placed to comment on proposed changes to structure on behalf of customers, such as the National Energy Consumer Advocacy Body.

There are binding restrictions on retailers as to how often they can change their prices and on how they must consult with customers on changes in retail prices. NECF will not obviate this problem. Comparable requirements for notification will remain in place under the National Energy Customer Framework<sup>2</sup> even after prices are deregulated. Also, a significant possibility remains that some jurisdictions will seek to derogate from the national framework by maintaining more stringent jurisdictional requirements.<sup>3</sup> These binding notification requirements stand in contrast to the more fluid arrangements that govern the finalisation of network prices, with DNSPs facing a (best endeavours) obligation to finalise prices 20 business days before they apply and no requirement on the AER to complete its review of prices within any timeframe. With no obligation on the AER, DNSPs are not consistently able to meet the 20 business day indicative timeframe.

If there is consistently a lag between the increase in network prices and increases in retail prices then retail prices will be set to recover additional network component, inhibiting the formation of efficient retail prices and dulling network price signals. This runs counter to the increasing focus on more efficient prices.

#### *DNSPs better placed to manage price risk*

Origin notes that changing timing shifts some risk from retailers to DNSPs, since DNSPs will need to commit to structures and tariff levels somewhat in advance of when they do under current arrangements. The change in timing is marginal and we maintain that DNSPs are best placed to manage this additional risk. When a retailer seeks to estimate network prices they rely on the "x factor" from the Access Arrangement, the pricing trends statement from the prior year and anything the DNSP may have chosen to make public about changes in price structure and level. Problems with relying on these inputs are outlined in Table 1, below.

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<sup>2</sup> Retailers must publish increases in prices in newspapers no less than 10 business days before they apply, s.205(3), National Energy Retail Law

<sup>3</sup> On 17 December the Victorian Opposition Shadow Minister for Energy, Ms Lily D'Ambrosio, announced that it was Labor policy to require a month's notice of changes in prices for standing contracts. This would be a derogation from the national framework that requires 10 business days. "Labor to hold energy retailers to account on price increases", Press Release, Shadow Minister for Energy and Consumer Protection, 17 December 2013

<i>Available inputs</i>	<i>Problems</i>
'x factor' in the Access Arrangement	<ul style="list-style-type: none"> <li>• Can be up to 4 years out of date</li> <li>• Takes no account of factors such as pass throughs, incentive schemes, etc</li> <li>• Does not take into account the outcome of reviews at the Australian Competition Tribunal</li> <li>• Doesn't provide guidance on structure changes or re-weighting</li> </ul>
Pricing trends document from the previous year	<ul style="list-style-type: none"> <li>• Level of detail varies widely by DNSP</li> <li>• Is not a binding statement so cannot be relied upon</li> <li>• Is a year out of date.</li> </ul>
Information the DNSP makes available on upcoming changes	<ul style="list-style-type: none"> <li>• At DNSP's discretion</li> <li>• Not provided uniformly by all DNSPs</li> </ul>

As outlined in Table 1 the retailer has a very weak basis upon which to devise forecasts of changes in network prices: much of the information is between one and four years out of date, cannot be relied upon, or is not provided in a uniform manner across networks. The AEMC lists the factors that alter a pricing outcome from the price path in the Access Arrangement, including transmission pricing, unders and overs adjustments and cost-pass throughs and the accuracy of demand and customer forecast numbers, noting:

*Given these factors, it could be difficult for a DNSP to forecast with sufficient certainty the price path of average network prices, and even more difficult to forecast the expected tariff pricing levels and their strategy for changing individual charging elements to the average change in network tariffs.<sup>4</sup>*

These are precisely the difficulties faced by the retailer when relying on forecasts of network prices as the basis for setting retail prices, but the problems are far more acute, since the retailers' sources of information are far more limited. Each DNSP has access to the most accurate and up-to-date information available on its network at the time it makes its forecast. The types of information DNSPs may have reference to are wide ranging and include changes in overall volumes, changes in consumption among particular segments, the likely outcome of incentive schemes and the likely outcome of any pending Tribunal reviews.

In our view no party is better placed to take on the risk of deriving a forecast one month further in advance than the DNSP. The benefit of providing better notice of prices is not only that retailers will be better placed to pass on network price signals, but also that the party best placed to manage the risk of changes in forecasts will manage this risk, which is likely to bring down cost overall in a relative sense.

#### *Requirements must be binding*

It is important that the requirements to consult on prices, finalise structures and to notify final prices two months in advance of when they apply be formal and binding and coordinated by the AER. Some DNSPs currently engage with retailers about their intentions but this is not uniformly the case. Price trends documents currently outline the intentions of networks with respect to prices but this is not a binding document and the level of detail provided varies. Creating formal

<sup>4</sup> AEMC, National Electricity Amendment (Distribution Network Pricing Arrangements) Rule 2014 Consultation Paper, p.45

requirements to consult and to finalise prices a set time before they apply will ensure that the pricing increase process is efficient.

*Consultation and notification must be separate*

Consultation on tariffs serves a separate purpose from final notification and one is not a substitute for the other.

We believe that the structure for tariffs should be set at the time of the Access Arrangement and then changed up to once annually during the regulatory period. The Pricing Structure Statement (PSS) should include structure and indicative price levels, but the price levels should not be binding. Once finalised, the price structure should be binding. The Pricing Proposal should be submitted three months prior to when it applies and the AER should be required to approve this two months prior to when the prices apply. The two processes as Origin believes they should operate are outlined in Table 2, below.

Table 2. Proposed process for consultation and notification			
<i>Objective</i>	<i>Document</i>	<i>Process</i>	<i>Comments</i>
Consultation	Pricing Structure Statement	<p><i>Initial process</i></p> <ul style="list-style-type: none"> <li>• DNSP includes pricing structure as part of Access Arrangement.</li> <li>• AER publishes pricing structure statement as part of Access Arrangement approval process.</li> <li>• AER collects submissions on PSS and provides these to the DNSP</li> <li>• DNSP has an opportunity to revise its PSS in light of feedback, then must lodge final with the AER, AER must publish it</li> </ul> <p><i>Subsequent changes to PSS</i></p> <ul style="list-style-type: none"> <li>• DNSP can change structure up to once a year by submitting to the AER, separately from the pricing approval process</li> <li>• AER publishes pricing structure document, seeks feedback from stakeholders, provides this to DNSP</li> <li>• DNSP has opportunity to revise proposal in light of feedback, then must lodge final with the AER, AER must publish it</li> </ul>	<ul style="list-style-type: none"> <li>• AER is not required to assess the PSS, merely to provide formal channel for feedback</li> <li>• DNSP is not obliged to change structures in response to feedback</li> <li>• Once the DNSP re-submits its pricing proposal the structure is binding on the DNSP</li> <li>• DNSP can change structure up to once annually but must re-submit each time and must do so prior to the commencement of the pricing approval process</li> <li>• PSS should be at the tariff level and should include indicative price levels for the next year, but price levels are subject to change and not binding</li> </ul>
Notification	Pricing Proposal	<ul style="list-style-type: none"> <li>• DNSP submits Pricing Proposal document to AER 3 months prior to when the prices to apply</li> <li>• AER required to assess based on pricing principles by 2 months before they apply.</li> </ul>	<ul style="list-style-type: none"> <li>• The approved pricing proposal covers changes in prices and structure and is binding - no further changes to prices permitted</li> </ul>

As outlined in Table 2 price structures should be confirmed in advance of the pricing approval process. This is important because it allows retailers and customers to understand well in advance how pricing structures and price levels will change and allows for formulation of pricing products that reflect these changes. Reflecting changes in structure can have significant implications for billing systems.

Origin notes that suggestion from the AEMC that formalising the pricing structure could be a substitute for formal notification of price and level. The AEMC writes:

*Having a Pricing Structure Statement (PSS) in the network pricing framework could therefore provide for a more straightforward and simple approval process of network tariffs each year. A simpler pricing process will create scope for earlier notification of network tariffs if less time is required for DNSPs to prepare their pricing proposals and for the AER to assess them.<sup>5</sup>*

Earlier notification needs to be formalised: retailers need final notification of changes in price and structure provided according to a binding timeframe with at least two months notice. A dramatic rebalancing within the existing structure has significant impacts for retailers and end customers. To cite an example from the gas industry, Envestra once increased their supply charge in Queensland by 52 percent. Yet Envestra's change would not trigger a requirement for a change of structure in the strict sense. Retailers cannot anticipate rebalancing on this scale and current timelines do not provide adequate notice of changes like these for retailers to respond in a meaningful way.

Relying on the PSS as a substitute for adequate notice of final prices does not meet the criteria adopted by the AEMC to assess this rule change, in our view:

- **Efficient pricing** - Retailers need time to assess final network prices in terms of structure and level, devise cost-reflective retail tariffs, enter these into retail systems and notify customers of these in line with requirements. Rebalancing and other factors change prices but are unrelated to pricing structure. Without adequate notice of changes in price level retailers have to rely more frequently on simpler but less efficient price changes to obviate risk;
- **Stakeholder engagement** - the quality of stakeholder engagement among DNSPs varies greatly and there is currently only a best endeavours obligation on DNSPs to publish final prices before they apply. The 'best endeavours' obligation was justified on the basis that there is no timing constraint on the AER as to when it must approve network prices. Binding timeframes must be placed on the AER to approve and on DNSPs to notify, otherwise stakeholder engagement will remain variable and of low quality;
- **Predictability** - changes to price levels have been highly unpredictable in the past due to pass throughs, revenue reviews and other factors that are entirely unrelated to the structure of prices. Increases have exceeded projected levels by many multiples. Retailers anticipate greater rebalancing between pricing components over coming years and these will not be captured in the pricing structure documents. Only a binding requirement to notify final prices a set time before they apply can address this.
- **Allocation of risks** - the allocation of risk is sub-optimal in that DNSPs have the most information on likely changes to price forecasts but retailers currently do most of the forecasting - devising retail prices on retail forecasts of network prices right up until just before the prices apply.

To meet the above criteria the rule change must stipulate set timeframes submission of prices three months before they apply and the finalisation of prices by two months before they apply.

*Obstacles to changing timing can be overcome*

Origin does not believe there are any insurmountable obstacles to creating a requirement for consultation or to earlier notification of final prices.

Obstacles identified by stakeholders are:

- The requirement for a CPI figure from the March quarter to be included in the pricing formula for networks with increases in July;
- The requirement to finalise transmission prices earlier
- What happens in the first year of the access arrangement period.

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<sup>5</sup> AEMC, National Electricity Amendment (Distribution Network Pricing Arrangements) Rule 2014 Consultation Paper, p.49

We believe all these obstacles can be addressed, as outlined in Table 2, below.

<i>Obstacle</i>	<i>Solution</i>
Current rules require DNSP to update prices in July to include a March quarter CPI component in their calculation of the pricing formula, but this will not be ready in time if DNSPs must finalise prices a month earlier	<ul style="list-style-type: none"> <li>• Change rules so that the requirement is that CPI be calculated on the four quarters previous to the March quarter</li> <li>• CPI is not a volatile input and forecasts do not vary significantly with one quarter's extra data</li> </ul>
Transmission network service providers do not finalise prices until 15 May, meaning TNSPs will need to rely more on forecasts	<ul style="list-style-type: none"> <li>• TNSPs can finalise prices earlier and rely on forecasts</li> <li>• The inputs to these forecasts are not volatile and an additional month of forecasts will not have a large impact</li> <li>• Any discrepancy created can be captured in the subsequent year.</li> <li>• This catch up is unlikely to generate significant additional volatility in network or retail prices, given the small proportional contribution the transmission prices represent in the end price</li> </ul>
In the first year of the access arrangement DNSPs revenues are not settled until close to commencement of the first year	<ul style="list-style-type: none"> <li>• Create a requirement for DNSPs to provide indicative price statement that outlines the average increase (decrease) two months before the prices apply</li> <li>• This average increase must include <b>all</b> elements that the DNSP reasonably believes will influence the quantum of the change in prices but is not binding.</li> <li>• The Access Arrangement planning process should give DNSPs good visibility over most (but not all) factors that are likely to influence the average change in prices.</li> <li>• Even having a view on all factors likely to impact prices that are in addition to the x factor is a <b>significant improvement</b> on current arrangements and of great value to retailers when they are planning prices.</li> </ul>

*Incentives for the DNSP to meet the new obligations*

Once new requirements to consult and to notify have been created there should be strong incentives in place to ensure these are met. In the event a DNSP's prices do not match the PSS or its Pricing Proposal the increase (or decrease) should be limited to the lesser of the x factor in the Access Arrangement and CPI. This is important given that retailers face binding obligations not to increase their prices more than once in a set period, hence certainty is important both in terms of meeting these obligations as well as in terms of customer certainty.

Nothing about the formal requirement to consult precludes DNSPs seeking informal feedback from retailers prior to submitting their proposal and using this inform their draft PSS.

**B. Distribution pricing principles**

Origin supports a tightening of the distribution pricing principles to ensure that DNSPs' revenues align with their approved revenues. However, Origin does not support long-run marginal cost (LRMC) being a binding principle for the formulation of distribution tariffs for residential and

small business customers. We believe the AEMC can meet the objectives of SCER for more cost-reflective pricing through simpler mechanisms that are more readily applied and more proportionate to the gains available from demand response from the small customer segment. It would be of concern if a binding LRMC principle was to preclude DNSPs acting in practical ways to address immediate problems of inefficient revenue recovery.

In the Power of Choice the AEMC recognised:

*the LRMC of the network is driven primarily by the need to augment the network to meet coincident peak demand. Efficient network prices are therefore those that encourage consumers to reduce their contribution to coincident peak demand.*<sup>6</sup>

Thus the primary objective of SCER's reform to distribution pricing principles is to encourage DNSPs to devise prices that encourage customers to reduce their contribution to peak demand. An additional objective appears to be to ensure that DNSPs prices do not allow DNSPs to recover revenue that is additional to revenues approved by the AER.

Under ideal conditions distribution prices based on LRMC would be a highly effective way to charge customers for their incremental contribution to network revenue. These conditions include that each customer has a smart meter installed, that prices are based on latency in the customer's local network section (some form of locational marginal pricing) and that customers are charged based on the extent of their additional peak demand rather than their consumption. With highly granular LRMC prices only customers contributing to increments in peak demand would pay this component. Conversely, customers in a network area with significant latency would not pay any incremental component, and customers in network sections with minimal latency but whose increased peak demand did not coincide in time with peak demand in their network section would also make only a minimal contribution towards incremental investment. All customers would continue to pay the sunk cost of the network.

Prices under this arrangement would be highly granular and dynamic, varying by network section and time. While this system may look preferable at a theoretical level, it would be very complex and costly to implement for small customers and is some years away given existing technological and data limitations. For demand-based charging to be effective small customers would need at least two years of data to get a reasonable understanding of their average demand and to have a meaningful opportunity to respond. Demand-based charges would also be difficult to understand and would only guarantee a reduction in network expenditure relative to the base case if the demand charging was employed in coordination with prices that changed based on time of day and location in the network. If not coordinated with granular information on time and location of consumption, demand charges levied on small customers would risk penalising or rewarding customers for changes in behaviour that had no net effect on incremental network investment, leading to inefficient consumption decisions.

For a network tariff system this is costly and complex; to generate a net benefit to customers and serve the National Electricity Objectives the demand response in the small customer segment would need to be substantial. Origin doubts that small customers are willing or able to deliver savings sufficient to justify this level of complexity, since the portion of energy use that is discretionary for the average household and small business is in general small relative to total consumption. We note that there has been no cost benefit analysis provided to support the move to LRMC as a binding principle, and we doubt that it would show a positive benefits case for the small customer segment. There are mechanisms that are less costly and complex and more feasible that would still achieve the objectives of encouraging customers to use less demand at peak times and these systems could be justified based on a more realistic level of demand response. These systems are not true long-run marginal pricing but instead include proxies for the cost to network of augmentation.

The problem of cross subsidy that occurs when customers are charged based on the net-system load profile rather than their actual consumption is not new to the market. However, distortions

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<sup>6</sup> Australian Energy Markets Commission, "Power of choice review - giving consumers options in the way they use electricity, Final Report", 30 November 2012, p.185

are growing in significance as solar photovoltaic systems, air conditioners and various energy efficiency policies have led a greater divergence between peak demand and consumption for a subset of customers. Customers with peaky load are not making a proportionate contribution to network investment and this problem is becoming more acute for the remaining portion of customers with flatter loads. Origin believes that the way to address this in a timely and less costly fashion is:

- to require DNSPs to offer a time-of-use tariff on all network segments where smart meters are installed, to reflect the times when peak demand is most likely to occur and send signals to customers about consuming efficiently, and
- to require DNSPs to establish a path towards shifting revenue from the variable to the fixed component, to address the underfunding of the network by peaky customers with falling consumption.

Increasing the fixed component will have a disproportionate effect on customers who consume less. There are a variety of options to address this such as a tiered approach. Currently, revenue recovery is heavily weighted to the volume component so there is scope to move some customers more than others. While around half of the costs of a DNSP stem from return on investment (which is a sunk, fixed cost) less than twenty percent is typically recovered from the fixed component.

Retailers will then have an incentive to market time-of-use rates and the decision to move customers onto these be subject to negotiation between the retailer and the customer, unless the customer's circumstances otherwise require this. Origin supports the rollout of smart meters occurring as part of commercial roll out with a well-defined benefit case. A portion of customers will choose to remain on flat rates until most of the market has moved and DNSPs will need flexibility to increase the volumetric rate, to reflect the change in net system load profile as customers with flatter load peel off.

We recognise that these measures are not as precise as a theoretically ideal LRMC-based model, but they are more feasible and, in the case of the increased fixed rate, can be applied in the short term with no technological changes required. They also do not require a complex array of tariffs and are easier for customers to understand. Increasing the fixed charge is unlikely to distort customers' consumption decisions in the way that demand charges could for no net benefit, since as the AEMC has observed an increased fixed rate is largely efficient from a Ramsey pricing point of view, assuming that all customers wish to remain connected to the network. Customers will benefit from lower volumetric rates than would otherwise be the case. To the extent customers face increased hardship as a result of these changes this can be addressed via separate and transparent government concessions.

Stipulating a binding constraint that LRMC must be the basis for setting prices could perversely impede DNSPs from adopting measures like an increased fixed charge to address pressing concerns that stem from changes in consumption patterns. Furthermore, in the absence of significant changes in technology with respect to metering and locational marginal pricing, the adherence to a binding LRMC principle will be at the level of principle only in many cases, which is largely how the LRMC features in the current rules in any event.

In addition to the two changes outlined above, we believe that the pricing principles could be tightened to reduce perverse incentives to set prices that recover revenue above efficient levels. Specifically:

- Clause 6.18.15(a) of the NER requires that networks show that expected revenue lies between the "stand alone" and "avoidable cost". These are economic concepts that would never be breached in the course of normal business. This concept places no practical limits on a distribution network's revenue as proposed in its price proposal.
- Side constraints: the side constraint is applied to a tariff class (a group of tariff lines) and is less binding on individual tariff lines when each class represents a larger pool of revenue. A tariff that is an outlier in a large class can be increased significantly above the average for that class. Thus, having fewer and larger tariff classes minimises the impact of the two percent constraint. The rules give distribution networks too much discretion to allocate tariffs and customers to tariff classes and thereby to maximise the size of each class. The rules should require that a customer be assigned to a tariff class

based on all three of the criteria in the NER (cl.6.18.6), rather than any of those criteria, as is now the case. This will make the side constraint more effective.

- Appendix J of the NSW distribution network revenue decision allows for networks to take into account transfers that happen during the pricing year and to be compensated where these will lead to a reduction in revenue. The AER does not apply sufficient scrutiny *ex post* to statements networks make about the number of customers transferring and the volume implications of these, with the result that networks may over-recover revenue. The rules should require the AER to give close attention to circumstances where there may be double counting of tariff transfers or nominations of tariff transfers that never occurred, or where volumes are understated.
- Discrepancies also arise at the level of individual tariffs, where rebalancing occurs. The AER has interpreted the NER in such a way that rebalancing constraints cannot apply in the first year of a revenue determination, which means changes in network tariffs are most unpredictable in that year. Equally, while the National Gas Rules (NGR) do not address side constraints, the AER has determined it will adopt the same approach in gas as in electricity

Origin believes that addressing the above shortcomings would help promote pricing outcomes better aligned with approved revenues. Further, addressing these shortcomings would give the AER more scope to adopt weighted-average price caps rather than revenue caps. Origin understands the AER has concerns that weighted average price caps may have allowed some DNSPs to earn revenues higher than approved levels in the past and hence the AER has preference for revenue caps in future determinations. Origin believes weighted-average price caps are a more efficient option in a market with falling revenues, since revenue caps maintain revenues at projected levels even where volumes fall further than forecast, providing no incentive for networks to cut back on spending to reflect shortfalls in demand.

In summary, Origin supports revisions to the pricing principles to create:

- a formal process for providing feedback on proposed changes to network price structures (which proposal should also include indicative price levels for the following year);
- an obligation for price structures to be finalised ahead of the annual pricing process;
- a binding obligation for networks to submit prices to the AER three months before they apply;
- a binding obligation on the AER to approve prices (or make an alternative finding based on the lesser of the x factor and CPI) by two months before they apply;
- a requirement on DNSPs to offer a time-of-use tariff wherever smart meters are installed;
- a requirement on DNSPs to demonstrate a path towards increasing the fixed component of prices.

Conversely, Origin does not support LRMC being a binding principle for devising network tariffs at this time.

If you have any questions regarding this submission please contact Steven Macmillan in the first instance on (03) 8665 7155.

Yours sincerely,

[SIGNED]

Keith Robertson  
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