



Australian Energy Market Commission

RULE DETERMINATION

**National Electricity Amendment (Aligning
Network and Retail Tariff Structures for Small
Customers) Rule 2015**

Rule Proponent
COAG Energy Council

17 September 2015

**RULE
CHANGE**

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About the AEMC

The AEMC reports to the Council of Australian Governments (COAG) through the COAG Energy Council. We have two functions. We make and amend the national electricity, gas and energy retail rules and conduct independent reviews for the COAG Energy Council.

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Summary

The Australian Energy Market Commission has determined not to make a rule in relation to the Aligning Network and Retail Tariff Structures for Small Customers rule change request.

The objective of this rule change request was to help retailers manage the risks that they may face if a state or territory government requires them to offer small customers with an interval meter a retail standing offer with a prescribed price structure.¹ If the price structure prescribed by the relevant government does not match the structure of network charges, retailers may be exposed to risks. The rule change proponent, the COAG Energy Council, was concerned these risks could result in retailers incorporating a risk premium in their retail prices for consumers that are supplied under such a standing offer.

The supply of electricity to consumers involves a number of market participants and different input costs, including transmission and distribution network charges, electricity generation charges, and the costs of complying with government environmental policies.

A key role of retailers is to package all of these input costs to develop a range of different retail pricing offers for consumers. This enables small consumers to deal with a retailer to pay an all-encompassing retail price, instead of paying each input cost directly. Importantly, this also allows consumers a choice between retail offers and they can select the one that best aligns with their preferences. This selection occurs in the context of a competitive retail market, which drives retailers to innovate and make offers in response to consumer preferences.

In a competitive market, the overall prices of these various retail offers should reflect the retailer's costs, including any risks that the retailer manages on behalf of the consumer. However, this does not require that the structure of retail prices must match the structure of network prices. Retailers have a number of tools to help them manage the risk of differences in network and retail price structures and efficiently price that risk.

The Energy Council's rule change request proposed to amend the National Electricity Rules so that where a state or territory government requires retailers to make a standing offer with a prescribed tariff structure to small customers with an interval meter,² distribution businesses would be required to:

- make available a network tariff with a structure that matches that of the retailers' standing offer; and

¹ In accordance with section 22(1a) of the NERL.

² An interval meter records consumption over half hour intervals, or potentially over shorter periods. These metering installations can be used to provide information about the timing of a consumer's consumption. These metering installations are either manually read at the premises or remotely read using a communications network.

- allow retailers to assign small customers to this network tariff where those customers have chosen the standing offer.

Further, the rule change request proposed to require the Australian Energy Regulator to only approve a distribution business' annual pricing proposal if it met the above requirements.

The Commission considers that the role of the retailer would not change if a government decides to mandate that the retailer make available a standing offer with a prescribed tariff structure. The retailer would still need to manage the various input costs and compete to make available a range of retail offers to small customers that reflect different consumer needs and preferences. Consumers would still be able to select from a range of different offers from different retailers that best align with their preferences.

As consumers can select a retail offer in line with their personal preferences, the Commission considers that it is appropriate for consumers that are supplied under a specific offer to pay a price that reflects the costs incurred by retailers in providing that offer. This provides an efficient outcome whereby any additional costs that are incurred by a retailer in providing a specific retail offer are only borne by those consumers that receive that offer.

In practice, some consumers may choose to be supplied under a market retail offer with a time varying price structure. These offers provide consumers with the opportunity to save money by shifting some of their consumption from high priced to low priced periods. Other consumers may prefer a flat retail price structure.

In making a time varying price offer or a flat price offer, a retailer would assess the risks of any mismatch between the offer and the cost structures the retailer faces in terms of the network and wholesale electricity costs. Some retailers may charge consumers a premium to reflect such risks. Other retailers may offer to help consumers manage these risks by providing demand management services such as load control of hot water, pool pumps or air-conditioning. In each case, the outcomes are efficient, as individual consumers pay the costs associated with their choice.

The Commission notes that the rule change request was submitted in 2014, before changes to the distribution pricing rules were introduced as part of the Commission's 2014 *Distribution Network Pricing Arrangements* rule change (2014 pricing rule change). The 2014 pricing rule change included additional measures to enable retailers to better manage risks associated with the recovery of network charges, including the types of risks that would arise if retailers were required by a state or territory government to make a standing offer with a prescribed tariff structure.

The 2014 pricing rule change requires distribution businesses to consult with retailers in designing network tariff structures and to develop a tariff structure statement. The tariff structure statement, which will outline the network tariff structures each distribution business will apply for the upcoming regulatory control period, will provide retailers with visibility of a distribution business' proposed tariff structures well in advance of them taking effect. It will also limit changes in network tariff

structures during a regulatory control period. Retailers will also receive earlier notification of annual network price changes. Combined, these measures will support retailers to develop better business strategies for managing their input costs and to price retail offers for consumers.

The rule change proponent was also concerned about managing the impact on consumers of the transition to cost reflective network tariffs. The Commission considers that the 2014 pricing rule change contains appropriate mechanisms to manage this transition, including the 'consumer impacts' principle. This principle requires distribution businesses to consider and manage the impact of changes in network tariffs on consumers. Distribution businesses can manage this impact by gradually transitioning to more cost reflective network tariffs over more than one regulatory control period. This will assist retailers to manage the transition to any new retail offers that they may make to consumers.

The Commission acknowledges that requiring distribution businesses to match the structure of a mandated standing offer, as proposed in the rule change request, would provide retailers with an additional tool to manage the risks incurred as a result of differences between the structure of network tariffs and a government-mandated retail standing offer tariff. The rule change proponent considered that this requirement would reallocate risks from retailers to distribution businesses, and that this would be appropriate as distribution businesses could spread these risks over a wider customer base.

However, the Commission considers that such an allocation of risks would not be efficient. The effect would be to reallocate the costs of managing these risks from the particular consumers whose decisions cause those risks to all consumers. The result may be a reduction in prices paid by consumers that are supplied under a standing offer with a government-mandated structure, but at the expense of imposing additional costs and risks on distribution businesses that may result in higher prices for all consumers.

It would also likely reduce incentives on retailers to use other tools available to them that can reduce the costs incurred by consumers. For example, by offering a range of retail offers that match consumer preferences and offering innovative demand management services that could reduce the retailer's costs and consumers' charges.

Given the above considerations, the Commission is not satisfied that making a rule will, or is likely to, contribute to the achievement of the national electricity objective.

The Commission is conscious of the need for certainty for distribution businesses in this area and has therefore published its final rule determination three weeks earlier than the statutory time requirement.

Contents

1	The COAG Energy Council's rule change request	1
1.1	The rule change request	1
1.2	Solution proposed in the rule change request.....	1
1.3	Rationale for the rule change request.....	2
1.4	Current arrangements	3
1.5	The Commission's rule making process.....	5
2	Final rule determination.....	6
2.1	Rule making test.....	7
2.2	Assessment approach.....	7
2.3	Summary of reasons	8
2.4	Strategic priority.....	9
3	Commission's conclusion and assessment.....	10
3.1	Stakeholder views on the consultation paper	10
3.2	Stakeholder views on the draft rule determination	12
3.3	Commission's analysis	14
3.4	Commission's conclusion.....	19
	Abbreviations.....	21
A	Legal requirements under the NEL	22
A.1	Final rule determination.....	22
A.2	Commission's considerations	22

1 The COAG Energy Council's rule change request

1.1 The rule change request

On 25 June 2014, the Council of Australian Governments' (COAG) Energy Council (the Energy Council) submitted a rule change request to the Australian Energy Market Commission (AEMC or Commission).

The rule change request sought to modify the National Electricity Rules (NER) to require a distribution business to make available a network tariff with a structure that aligns with that of a standing offer made by retailers to small customers with an interval meter³, where the structure of the retailer's standing offer is prescribed by a state or territory government⁴ (rule change request).

The rule change request did not include a proposed rule.

1.2 Solution proposed in the rule change request

The rule change request sought to amend Chapter 6 of the NER to place new obligations on distribution businesses with respect to network pricing. The proposed new obligations would have been triggered by a state or territory government enacting a local instrument under section 22(1a) of the National Energy Retail Law (NERL).⁵

Specifically, under the proposal, where a state or territory government declares that retailers must make a standing offer with a prescribed retail tariff structure to small customers with an interval meter in its jurisdiction,⁶ distribution businesses would be required to:

- offer a network tariff with a structure that matches the structure of that standing offer;⁷ and
- allow a retailer to assign a small customer to this network tariff where that customer has chosen that standing offer.⁸

³ An interval meter records consumption over half hour intervals, or potentially over shorter periods. These metering installations can be used to provide information about the timing of a consumer's consumption. These metering installations are either manually read at the premises or remotely read using a communications network.

⁴ This prescription is facilitated by Section 22(1a) of the NERL. See section 1.4.3 of this final rule determination.

⁵ Section 22(1a) of the NERL is described in section 1.4.3 of this final rule determination.

⁶ In accordance with section 22(1a) of the NERL.

⁷ COAG Energy Council's rule change request, 25 June 2014, p.2.

⁸ Ibid.

Further, the rule change request proposed to require the Australian Energy Regulator (AER) to only approve a distribution business' annual pricing proposal if it met the above requirements.⁹

Under the rule change request, distribution businesses would maintain discretion over the level of network tariffs.¹⁰ This would mirror the arrangements in the NERL, where retailers are able to set the price of the standing offer, but the structure of the standing offer is mandated by a state or territory government.¹¹

1.3 Rationale for the rule change request

In its rule change request, the Energy Council noted that more widespread availability of interval meters and advanced meters¹² will enable distribution businesses and retailers to offer cost reflective tariff structures, to the benefit of all consumers in the long term.¹³ However, as these tariff structures will effectively unwind some of the cross subsidies prevailing in existing flat tariff structures, this transition needs to be managed to enable consumers to adjust to, and accept, new pricing arrangements.

To manage the potential impact on consumers from the transition to cost reflective network tariffs, the Energy Council noted that some state or territory governments may seek to mandate that retailers operating in their respective jurisdictions make a standing offer with a prescribed tariff structure to small customers with an interval meter.¹⁴ It contended that this will facilitate choice by enabling 'consumers who wish to remain on a flat retail tariff to do so.'¹⁵

However, the Energy Council considered that without a corresponding obligation on distribution businesses to offer a similar network tariff, and to assign small customers to that tariff if requested by the retailer, retailers may price a risk premium into the standing offer to minimise the risk of under-recovering network charges.¹⁶ This would result in higher charges under the mandated standing offer.

The Energy Council considered that its proposed rule change would give retailers a reasonable opportunity to recover the network charges for those small customers. As a consequence, retailers would reduce the risk premium they would otherwise apply, resulting in lower charges under the mandated standing offer.¹⁷

⁹ Ibid., p.3.

¹⁰ Ibid., p.4.

¹¹ Subject to any retail price regulation that may apply in that jurisdiction.

¹² Advanced meters are remotely read interval metering installations that can also provide a range of advanced metering services beyond simply measuring electricity consumption or generation. The services available depend on the functionality of the advanced metering installation.

¹³ COAG Energy Council's rule change request, 25 June 2014, p.6.

¹⁴ Ibid., p.7.

¹⁵ Ibid., p.2.

¹⁶ Ibid.

¹⁷ Ibid.

The Energy Council suggested that its proposed rule change would result in a more efficient allocation of risk to distribution businesses. It considered that distribution businesses are better placed to spread risk over a comparatively larger customer base than retailers. Additionally, under the existing regulatory framework, some distribution businesses may be able to adjust the amount of revenue they recover on a yearly basis, so as to account for any previous over- or under-recovery of revenue.¹⁸

1.4 Current arrangements

This section provides a brief overview of the current network and retail pricing arrangements. More detailed information is provided in the AEMC consultation paper, which is available from the AEMC website.¹⁹

1.4.1 Network pricing arrangements

Network charges are a key cost component of the retail prices offered to consumers, comprising around 50 per cent of residential electricity prices. The other key cost inputs are retail and wholesale costs, which on average make up about 40 per cent of residential prices, and the costs of government environmental policies, which on average account for about 8 per cent of costs.²⁰ Residential consumers do not pay these charges directly, and instead pay an all-encompassing retail price to their retailer.

Network charges are made up of the costs of transporting and distributing electricity from generators to consumers via transmission and distribution networks. These costs are generally combined by distribution businesses into a single network charge which is paid by retailers.

The network tariffs²¹ that apply for a specific distribution business in any particular year depend on the revenues that the distribution business is allowed to earn in that year and the control mechanism that applies to the distribution business. Each distribution business' control mechanism and revenue allowance is determined by the AER generally once every five years in the regulatory determination process.²²

¹⁸ The COAG Energy Council noted that this depends on the type of control mechanism applied to the distribution business by the AER. COAG Energy Council's rule change request, 25 June 2014, p.7.

¹⁹ See:
<http://www.aemc.gov.au/getattachment/948fd780-0ba4-480e-85d4-62403ba95135/Consultation-paper.aspx>.

²⁰ AEMC, 2014 Residential Electricity Price Trends Report, December 2014.

²¹ In this determination, the term "network tariffs" is used as a generic term to refer to both structure and pricing levels of distribution businesses' charges. Where specific reference is made to the structure of tariffs, the term "tariff structures" is used and the term "pricing level" is used to refer to the level of prices.

²² NER clause 6.2.5(b). The AER has the option, subject to considering relevant criteria, to apply control mechanisms from a range that includes a revenue cap, a price cap, a weighted average price cap or an average revenue yield approach.

The NER sets out a network pricing objective and a number of pricing principles that distribution businesses must comply with in the design of their network tariffs, as well as the process they must go through to develop network tariffs.²³ The NER also set out the considerations the AER must have regard to when approving network tariffs.

As a result of the 2014 *Distribution Network Pricing Arrangements* rule change, significant changes were made to the distribution pricing principles and the network pricing process under the NER.²⁴ The new distribution pricing rules will be fully implemented in all states and territories from 2017.

1.4.2 Retail pricing arrangements

A key role of the retailer in the energy supply chain is to manage the risks inherent in various supply side inputs, including network and wholesale charges, and to package these into a range of retail offers for consumers.

Retailers receive pricing signals from distribution businesses in relation to the costs of using the network. Based on these price signals and other input costs, retailers are able to develop different retail offers for consumers as they see fit and in accordance with their view of different consumers' preferences.

Retailers supply electricity to small customers²⁵ under either a standing offer²⁶ or a market offer. In states and territories that have adopted the National Energy Customer Framework (NECF),²⁷ the terms and conditions of standard retail contracts for electricity and gas are prescribed by the NERL and the National Energy Retail Rules (NERR). In contrast, market retail contracts are electricity and gas contracts in which only minimum terms and conditions are prescribed by the NERL and the NERR.

Residential consumers are currently able to choose from a wide variety of different offers from a range of retailers. These offers can have different price levels as well as different price structures. The AEMC's 2015 retail competition review found that consumers can choose from a range of retail offers from up to 21 different retailers and could save significant amounts by using government price comparator websites to help them find an offer that best suits them.²⁸

23 These provisions are outlined in Part I of Chapter 6 of the NER.

24 AEMC, *Distribution Network Pricing Arrangements* Final Rule Determination, November 2014.

25 NERL sections 5 and 6, and NERR clause 7, define a small customer as any residential customer or any business customer consuming less than 100 megawatt hours (MWh) a year. However, the upper consumption threshold for small business customers has been varied in some jurisdictions. In South Australia, the upper consumption threshold is 160 MWh (SA NERL regulations clause 5); while in Tasmania, it is 150 MWh (Tas NERL regulations clause 7).

26 A standing offer is an offer to provide customer retail services to small customers at the standing offer price and under the retailer's standard retail contract.

27 The NECF has been adopted in all states and territories in the National Electricity Market (NEM), with the exception of Victoria. In Victoria, jurisdictional requirements regulate the arrangements for retail contracts.

28 AEMC, 2015 Retail Competition Review, June 2015.

1.4.3 Amendments to the National Energy Retail Law

In November 2013, the Standing Council of Resources and Energy²⁹ amended the NERL to enable a state or territory government to require retailers to offer a standing offer with a prescribed tariff structure to classes of small customers with an interval meter in its jurisdiction.

As this provision operates under the NERL, it only applies in states and territories that have adopted the NECF.³⁰ At present, no state or territory government has enacted a local instrument under the NERL to require retailers to offer a standing offer with a prescribed tariff structure in their jurisdiction.

1.5 The Commission's rule making process

On 2 April 2015, the Commission published a notice advising of its commencement of the rule making process and first round consultation in respect of the rule change request.³¹ A consultation paper identifying specific issues and questions for consultation was also published. Submissions closed on 7 May 2015. The Commission received 15 submissions from stakeholders.

On 16 July 2015, the Commission published a notice and a draft rule determination in relation to the rule change request. The draft rule determination was to make no draft rule. Submissions on the draft rule determination closed on 27 August 2015. The Commission received nine submissions from stakeholders.

All submissions are available on the AEMC website.³²

²⁹ Predecessor to the COAG Energy Council.

³⁰ See footnote 28 as to which states and territories have adopted the NECF.

³¹ This notice was published under section 95 of the National Electricity Law (NEL).

³² www.aemc.gov.au

2 Final rule determination

The Commission's final rule determination is to not make a rule.

The supply of electricity to consumers involves a number of different inputs. The Commission considers that it is the role of retailers to manage risks related to the costs of these various inputs, including network charges, and to package these inputs into a range of retail offers for consumers. This allows consumers to select the retail offer that best aligns with their preferences.

Risk management practices vary across different retailers. As noted in submissions, the efficiency with which a retailer manages risk distinguishes it from its competitors, and is likely to be reflected in a more competitive retail offer to consumers.³³ In the context of a competitive retail market, retailers are driven to manage risks efficiently to develop a range of products that enable consumers to choose a package that matches their preferences.³⁴

In circumstances where a government decides to mandate that a retailer make available a retail standing offer with a prescribed tariff structure, the Commission considers that this does not change the role of the retailer. The retailer would still need to manage its various input costs and compete to make available a range of retail offers to small customers that reflect different consumer needs and preferences. Consumers can exercise choice across different retailers and offers that best align with their preferences.

The proposed rule change would have only applied to small customers with an interval meter supplied under a government-mandated standing offer. Consumers are likely to have a choice between a standing offer and a range of market offers. If a consumer is supplied under a government-mandated standing offer, and that offer imposes additional costs on the retailer, including managing additional risks on behalf of the consumer,³⁵ it is appropriate for the relevant consumer to pay a price that reflects those costs.

The Commission notes that the rule change request was submitted to the AEMC during the 2014 *Distribution Network Pricing Arrangements* rule change (2014 pricing rule change) process, and prior to the publication of the Commission's draft and final

³³ EnergyAustralia submission, 7 May 2015, p.1; ERAA submission, 7 May 2015, p.1; and Origin submission, 7 May 2015, p.1.

³⁴ CUAC submission, 27 August 2015, p.2.

³⁵ For example, a consumer may choose a government-mandated flat rate retail price instead of a time-of-use or capacity price because the consumer values simplicity and reduced price volatility over the ability to save money by changing his/her consumption patterns. However, if a consumer is supplied under a flat rate retail offer, the retailer will face the risk that the consumer will use a greater proportion of power at peak times than average consumers and therefore incur higher network charges than average consumers, which will increase the retailers' costs of supplying that consumer.

rule.³⁶ The Commission considers that the arrangements consulted on and finalised in late 2014 for that rule change provide retailers with additional tools by which they can manage risks created through a misalignment of network and retail tariff structures, including where a specific retail tariff structure has been mandated by a state or territory government.

Accordingly, the Commission considers that the proposed rule change is not necessary, would allocate risks in an inefficient way, and could result in additional administrative costs that are passed on to consumers. Therefore, the Commission considers that the proposed rule change would not be likely to promote the long term interests of consumers.

2.1 Rule making test

The Commission may only make a rule if it is satisfied that the rule will, or is likely to, contribute to the achievement of the national electricity objective (NEO).³⁷

The NEO is:³⁸

“The objective of this Law is to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to:

- (a) price, quality, safety, reliability and security of supply of electricity;
and
- (b) the reliability, safety and security of the national electricity system.”

For this rule change request, the Commission considers that the relevant aspects of the NEO are the promotion of efficient investment in, and operation and use of, electricity services for the long term interests of consumers of electricity, with respect to price.

2.2 Assessment approach

To support its assessment of the rule change proposal, the Commission focussed on the following issues:

- **Efficient allocation of risk.** To achieve efficiency, the cost of managing risks should generally be allocated to the parties that cause those risks. This incentivises parties to minimise the cost of managing risk. For example, retailers manage a number of risks for consumers and package input costs and the associated risks into offers based on consumer preferences. Consumers can

³⁶ The rule change request was received on 25 June 2014. The *Distribution Network Pricing Arrangements* draft rule determination and draft rule were published on 28 August 2014, with the final rule determination and final rule published on 27 November 2014.

³⁷ See section 88(1) of the NEL.

³⁸ See section 7 of the NEL.

manage risk by selecting a retail offer that matches their risk preferences and choosing whether to adjust their usage in order to minimise costs. The efficient allocation of risk leads to prices for consumers that are no more than necessary over the longer term.

- **Efficient network and retail prices.** Efficient network tariff structures signal to retailers a distribution business' efficient costs of providing network services to the retailers' consumers. In order to recover these costs from consumers, retailers have an incentive to manage costs and risks effectively in order to develop competitive retail offers that consumers prefer. Efficient retail prices that are developed based on efficient network prices and other input costs provide consumers with the opportunity to make an informed decision in relation to their energy usage and investment in technologies to manage their use and energy costs.
- **Predictable outcomes for consumers, retailers and distribution businesses.** Predictable outcomes support confidence in, and credibility of, markets and supporting regulatory arrangements. For distribution businesses and retailers, confidence in the regulatory arrangements may encourage them to actively participate and invest in the market, which promotes efficiency. Similarly, if the prices that consumers face are relatively simple, transparent and predictable, this provides consumers a reasonable opportunity to decide whether to respond to those signals, and helps them to manage their costs.
- **Administrative and compliance costs.** Changes to the NER should not create any unnecessary compliance and administrative burden for stakeholders. A rule that is complex to administer, difficult for stakeholders to understand, or imposes unnecessary risks, is less likely to achieve its intended purpose or will do so at a higher cost.

The rule change proposal has been assessed against the relevant counterfactual of not making the proposed change to the NER, including a situation where a state or territory government decides to require retailers to make a standing offer with a prescribed tariff structure in its jurisdiction.

2.3 Summary of reasons

The Commission is not satisfied that making a rule will, or is likely to, contribute to the achievement of the NEO for the following reasons:

- **Efficient allocation of risk.** The rule change proposed reallocating certain risks from retailers to distribution businesses. Retailers are equipped to manage risk on behalf of consumers in relation to the different cost inputs of electricity charges, and it is more efficient for retailers to manage these risks rather than imposing additional risks and costs on distribution businesses. This is discussed further in section 3.3.2.

- **Efficient network and retail prices.** The proposed rule change may result in network tariffs that are not cost reflective and do not send efficient pricing signals to retailers. This may affect a retailer's ability to develop efficient retail offers that reflect the costs incurred by the consumers' use of the electricity network. Over time, this could lead to higher network costs and higher charges for all consumers.
- **Predictable outcomes for consumers, retailers and distribution businesses.** The proposed rule change may result in price volatility in network tariffs and, thereby, retail offers. This is not likely to result in more predictable outcomes for any party and may undermine consumer confidence in the regulatory framework. The rule change proponent was concerned about managing the impact on consumers of the transition to cost reflective network prices, but the 2014 pricing rule change contains appropriate mechanisms to manage that transition.
- **Administrative and compliance costs.** The proposed rule change would likely result in administrative and compliance costs for distribution businesses and administrative costs for retailers. These costs may be passed onto consumers.

The Commission's conclusion and assessment for making this final rule determination are set out in Chapter 3.

Appendix A sets out further detail regarding the legal requirements for the making of this final rule determination.

2.4 Strategic priority

This rule change request relates to the AEMC's strategic priorities regarding empowering consumers to participate confidently in energy markets where they desire to do so, and market arrangements that encourage efficient investment. Efficient pricing signals allow consumers to make consumption and investment decisions about their electricity usage by giving them the information they need to compare the value they place on using energy against the costs of providing them services. If consumers choose to take actions that reduce costs, then they may be rewarded with lower charges.

3 Commission's conclusion and assessment

This chapter sets out the Commission's rationale and conclusions with respect to its final rule determination.

3.1 Stakeholder views on the consultation paper

Generally, most submitting stakeholders were not supportive of the proposed rule change.

A number of stakeholders noted that the Energy Council's rule change request was submitted to the AEMC during the development of the 2014 *Distribution Network Pricing Arrangements* rule change (2014 pricing rule change), and prior to publication of the draft and final rule in relation to that rule change request.³⁹ These stakeholders submitted that the Energy Council may not have been fully aware that the 2014 pricing rule change would 'address the issue of potential price shocks to consumers from the unwinding of cross subsidies in network tariffs.'⁴⁰ In any case, these stakeholders considered that the issues raised by the Energy Council in the proposed rule change were effectively addressed in 2014 pricing rule change.⁴¹

In submissions, retailers supported allowing the competitive retail market to operate without government intervention.⁴² This supports the retailers' key role in packaging the input costs related to the supply of electricity to develop a range of different retail pricing offers for consumers. Retailers considered that intervention by a state or territory government in the competitive retail market, through use of section 22(1a) of the NERL, would reduce competition and ultimately lead to less choice for consumers.⁴³

Origin and the Energy Retailers Association of Australia (ERAA) qualified their views by noting conditional support for the proposed rule change if a state or territory government decided to use section 22(1a) of the NERL.⁴⁴ Origin considered that enabling retailers to assign small customers to a matching network tariff could be one option to manage any misalignment between the retail and network tariff.⁴⁵

³⁹ The rule change request was received on 25 June 2014. The *Distribution Network Pricing Arrangements* draft rule determination and draft rule were published on 28 August 2014, with the final rule determination and final rule published on 27 November 2014.

⁴⁰ NSW DNSPs submission, 7 May 2015, p.2.

⁴¹ AusNet Services submission, 7 May 2015, p.1; AER submission, 7 May 2015, p.1; CitiPower and Powercor submission, 7 May 2015, p.1; Energex submission, 7 May 2015, p.2; ENA submission, 7 May 2015, p.3; Jemena submission, 7 May 2015, p.3; NSW DNSPs submission, 7 May 2015, p.2; and United Energy submission, 7 May 2015, p.1.

⁴² EnergyAustralia submission, 7 May 2015, p.1; ERAA submission, 7 May 2015, p.1; and Origin submission, 7 May 2015, p.1.

⁴³ ERAA submission, 7 May 2015, p.1; and Origin submission, 7 May 2015, p.1.

⁴⁴ ERAA submission, 7 May 2015, p.1; and Origin submission, 7 May 2015, p.1.

⁴⁵ Origin submission, 7 May 2015, p.1.

Lumo Energy and Red Energy supported the proposed rule change.⁴⁶ These stakeholders considered that the proposed rule change would assign risk to distribution businesses who are better placed to manage it due to the size of their customer base and their access to over- and under-recovery mechanisms.⁴⁷ They considered that the proposed rule change would result in more predictable outcomes for retailers, who would not have to estimate an appropriate risk premium and that it would facilitate choice for consumers while minimising the potential for price shock.⁴⁸

On the other hand, distribution businesses were not supportive of the proposed rule change.⁴⁹ The distribution businesses considered that the existing consumer impacts principle within the NER is a superior approach to the transition of consumers to cost reflective pricing.⁵⁰ Distribution businesses considered that the proposed rule change would be contrary to the network pricing objective, would increase the volatility of electricity charges and be an additional regulatory burden on distribution businesses.⁵¹

Distribution businesses noted that under similar arrangements currently operating in Victoria, few small customers with advanced meters have chosen to opt-in to cost reflective tariffs, even though many could be better off.⁵² Jemena noted that in Victoria, only 0.3 per cent of residential consumers chose a flexible price in the year after the introduction of the Advanced Metering Infrastructure (AMI) Tariff Order, despite an extensive campaign to communicate the benefits of this tariff to consumers.⁵³ The distribution businesses considered that the experience in Victoria demonstrates that where consumers are effectively given a choice to opt-in to cost reflective network prices, there is a slower transition to cost reflective pricing and, thereby, a slower realisation of the benefits of cost reflective pricing.⁵⁴

The Energy Supply Association of Australia (ESAA) was not supportive of government interference in the competitive retail market, nor the proposed rule change. It proposed that if a government considers declaring that section 22(1a) of the NERL applies in its jurisdiction, it should put a time limit on the requirement to make available a network and retail tariff with a prescribed structure.⁵⁵ It also considered that the mandated

46 Lumo Energy submission, 7 May 2015, p.2; and Red Energy submission, 7 May 2015, p.2.

47 Lumo Energy submission, 7 May 2015, p.2-3; and Red Energy submission, 7 May 2015, p.2-3.

48 Lumo Energy submission, 7 May 2015, p.3, 4; and Red Energy submission, 7 May 2015, p.3, 4.

49 AusNet Services submission, 7 May 2015; CitiPower and Powercor submission, 7 May 2015; Energex submission, 7 May 2015; ENA submission, 7 May 2015; Ergon submission, 7 May 2015; Jemena submission, 7 May 2015; NSW DNSPs submission, 7 May 2015; and United Energy submission, 7 May 2015.

50 Including approaches considered as part of the AEMC's Power of Choice review and the National Smart Meter Consumer Protections Review. ENA submission, 7 May 2015, p.4.

51 ENA submission, 7 May 2015, p.3.

52 ENA submission, 7 May 2015, p.4.

53 Jemena submission, 7 May 2015, p.5.

54 ENA submission, 7 May 2015, p.4; and Jemena submission, 7 May 2015, p.5.

55 ESAA submission, 8 May 2015, p.2.

tariff would need to be adjusted over this time to 'account for the worsening utilisation profile of the remaining customers that do not opt for cost reflective tariffs.'⁵⁶

The AER considered that the NER arrangements developed as part of the 2014 pricing rule change provide for a 'nationally consistent framework to guide moves towards greater cost reflectivity in network prices.'⁵⁷ In particular, it identified that distribution businesses are required to directly consider the impact of their tariffs on consumers under the NER and manage the transition to cost reflective prices.⁵⁸ Further, the AER noted that distribution businesses are required to consider the ability of consumers to respond to the tariff structures distribution businesses intend to introduce.⁵⁹ It suggested that these arrangements provide for a 'robust and preferable framework' for managing the impacts that consumers may experience in the transition toward cost reflective pricing.⁶⁰

The Commission's draft rule determination contains a table summarising other issues raised by stakeholders in submissions to the consultation paper and the Commission's response.

3.2 Stakeholder views on the draft rule determination

Generally, stakeholders were supportive of the AEMC's draft rule determination to not make a rule. Most stakeholders' submissions reaffirmed positions previously put forward in submissions to the consultation paper as outlined above.

In submissions to the draft rule determination, retailers maintained their opposition to government interference in the competitive retail market. The ERAA noted that it does not support making a rule change that would assist governments in interfering in the retail market as such interference would reduce competition and result in less choice for consumers.⁶¹ Similarly, Origin did not support government interference in the retail market, however noted its conditional support of the rule change request should government intervention occur.⁶²

EnergyAustralia agreed with the Commission that the 2014 pricing rule change provided retailers with additional risk management tools that will make it easier for retailers to minimise risk. It considered that this will provide for efficient retail pricing for small customers.⁶³

56 Ibid.

57 AER submission, 7 May 2015, p.1.

58 Ibid., p.2.

59 Ibid.

60 Ibid., p.1.

61 ERAA submission, 25 August 2015, p.1.

62 Origin submission, 27 August 2015, p.1.

63 EnergyAustralia submission, 31 August 2015, p.2.

The ESAA submitted that making the rule change would have been contrary to the intent of the 2014 pricing rule change, and to government policies to deregulate retail markets. The ESAA considered that if governments were concerned about the impact that cost reflective pricing would have on consumers, they should target assistance through energy concession programs.⁶⁴

Distribution businesses were all supportive of the Commission's draft rule determination to not make a draft rule. The ENA considered that the proposed rule change would allow some consumers to avoid paying for the costs they impose on the network. It submitted that these costs would be recovered from other consumers through higher charges. The ENA considered that retailers have access to a number of tools to help them manage the transition to more cost reflective network pricing.⁶⁵

Similarly, Jemena noted that consumer choice at the network level is not necessary for consumer choice in the retail market, and considered that a competitive retail market should provide the products and services that consumers want irrespective of the network tariff.⁶⁶

The NSW DNSPs agreed with the Commission that transferring responsibility for the design of network tariffs from DNSPs to governments is not necessary and would inhibit the efficient transition of consumers to cost reflective network pricing.⁶⁷

The AER also supported the draft rule determination, submitting that it would be inappropriate for the inefficiencies that result from a government mandated standing offer that is designed to protect certain customers from the impacts of more cost reflective network pricing to be spread across all electricity consumers. It acknowledged that if retailers are required to offer a mandated standing offer, they will need to manage the risk of the structure of the network tariff diverging from retail tariff but considered that there are mechanisms by which retailers can do this.⁶⁸

The Consumers Utilities Advocacy Centre (CUAC) noted its support for the Commission's draft rule determination. CUAC submitted that it is properly a role of retailers to manage supply chain risks on behalf of consumers and that the allocation of risk proposed in the rule change request would not be efficient. It agreed with the AEMC that the costs of managing the risks for consumers on a mandated standing offer should not be spread across a broad consumer base.⁶⁹

CUAC also considered that should a government stipulate that retailers must make a mandated standing offer, that it was not aware of any 'legislative barriers to that government placing similar requirements on distribution businesses.'⁷⁰ Further, it

64 ESAA submission, 27 August 2015, p.1.

65 ENA submission, 27 November 2015, p.1.

66 Jemena submission, 27 August 2015, p.2

67 NSW DNSPs submission, 27 August 2015, p.2.

68 AER submission, 24 August 2015, p.2.

69 CUAC submission, 27 August 2015, p.1.

70 Ibid., p.2.

noted that governments could use 'non-legislative methods to influence distribution businesses, as the Victorian Government did with the introduction of common form distribution tariff structures for flexible pricing.'⁷¹

3.3 Commission's analysis

This section sets out the Commission's analysis with respect to the issues raised in the rule change request.

3.3.1 Retailers develop a range of retail pricing offers for consumers

The supply of electricity to consumers involves a number of market participants and different input costs, including transmission and distribution network charges, electricity generation charges, and the costs of complying with government environmental policies. Small consumers do not pay these input costs directly. Instead, they are only required to deal with their retailer and pay a single retail price.

A key role of retailers is to package all of these input costs to develop a range of retail pricing offers for consumers. This allows consumers to select the retail offer that best aligns with their preferences. This occurs in the context of a competitive retail market, which drives retailers to innovate and make offers in response to consumer preferences. Effective and direct interactions between consumers and retailers are important to meeting the long term interests of consumers, as it provides direct signals to retailers, free of any regulatory intervention, regarding the products and services that consumers value most or would like to see developed.

Network tariffs are one of the input costs that retailers must manage when developing a retail offer. Network tariffs are developed by distribution businesses and charged to retailers, who then decide how to recover these costs from consumers through their retail pricing offers.

As a result of the 2014 pricing rule change, distribution businesses are required to set efficient network tariffs that reflect the efficient costs of providing network services to consumers.⁷² These tariffs signal to retailers the costs of using the distribution network. Retailers are able to determine the most appropriate way to pass on these signals to consumers, by developing retail pricing offers that align with consumer preferences. Over time, usage and investment decisions based on efficient network and retail prices help support potential reductions in the costs faced by distribution businesses and the charges paid by consumers.

The Commission considers that distribution businesses are best placed to develop efficient network tariffs, as they have the best information in relation to their drivers of future network costs. This information is passed from distribution businesses to retailers through the signals incorporated in network tariffs. Retailers have expertise in

⁷¹ Ibid., p.2.

⁷² NER clause 6.18.5(a).

understanding and repackaging these signals into different retail pricing offers which reflect consumers' preferences. Competitive tension between retailers further enhances the likelihood of retailers developing efficient retail pricing offers for different consumers.

The proposed rule change may have impacted on a distribution business' ability to design network tariffs that are suitable to the characteristics of their network and customers. In submissions received, stakeholders suggested that under the proposed rule change, governments 'would be responsible for designing tariff structures, rather than networks in consultation with stakeholders'⁷³ and proposed that 'governments are no more able than any other individual actor to predict efficient price structures.'⁷⁴ Further, the NSW DNSPs considered that transferring responsibility for network pricing away from distribution businesses would 'inhibit a network from efficiently transitioning to cost reflective network pricing and is therefore neither appropriate nor consistent with the NEO.'⁷⁵

The Commission considers that transferring the responsibility for the design of network tariffs from distribution businesses to state or territory governments is unnecessary. To do so would encroach on, and potentially inhibit, the key roles played by networks in designing cost reflective network tariffs and by retailers in the competitive retail market in managing their various cost inputs and developing different retail pricing offers that reflect consumer preferences. Even where a retailer is required by a government to make a particular retail standing offer, it has access to different tools and mechanisms by which it can manage this risk. This is discussed in further detail in sections 3.3.2 and 3.3.3.

In this context, the ENA noted in its submission that it was working with the ERAA to address potential barriers to incorporating cost reflective network tariffs into retail tariffs to allow consumers access to retail offers that include network pricing signals.⁷⁶ This includes using nationally consistent terms and methodologies to develop network tariffs and consistent communication with consumers.⁷⁷

3.3.2 Tools to help retailers manage risk

In a competitive market, the prices of various retail offers should reflect the retailer's costs, including any risks that the retailer manages on behalf of the consumer. However, this does not require that the structure of retail prices must match the

⁷³ ENA submission, 7 May 2015, p. 5.

⁷⁴ ESAA submission, 8 May 2015, p.1.

⁷⁵ NSW DNSPs submission, 7 May 2015, p.2.

⁷⁶ ENA submission, 27 August 2015, p.2.

⁷⁷ Seed Advisory, Network Tariff Reform - May 2015 Workshop Summary Report, Report for the Energy Retailers Association of Australia and Energy Networks Association, 7 August 2015, available:
http://www.ena.asn.au/sites/default/files/eraa15_ntr_workshop_outcomes_report_final_7_august_2015.pdf.

structure of network prices. Retailers have a number of tools to help them manage the risk of differences in network and retail price structures and efficiently price that risk.

In submissions received, several retailers submitted that retailers have a number of strategies to manage risk. The ERAA and Origin noted that a 'point of competitive difference between retailers is their effectiveness in managing risks.'⁷⁸ EnergyAustralia outlined that while retailers often 'attempt to minimise risk by matching the structure of the retail tariff with the structure of the distribution network tariff this is not always the case and may reflect commercial strategies.'⁷⁹ Further, EnergyAustralia argued that 'any inefficient pricing will be readily challenged by retailers' in a competitive retail market.⁸⁰

While Origin and the ERAA were supportive of the proposed rule change in submissions to the consultation paper, on the proviso that they did not support a state or territory government using section 22(1a) of the NERL, these stakeholders suggested that the proposed rule change was just one option that may assist retailers to manage risk.⁸¹ Likewise, ESAA expressed a preference for governments to 'not impose limits on tariff reform.'⁸²

In its submission to the draft rule determination, Origin agreed with the Commission that it is the business of retailers to effectively manage risk in the market. Origin considered that in a deregulated, competitive market, it is able to quantify risk and price this into the range of products offered to consumers. However, where a government intervenes in the market by mandating a standing offer with a prescribed tariff structure, Origin considered that retailers would be constrained in the tools available to them to manage risk. Limiting the options retailers can use to manage risk increases the cost of managing risk. For this reason, Origin did not accept the Commission's draft rule determination and conditionally supported the proposed rule change in its submission on the draft rule determination.⁸³

Submissions received from Lumo Energy and Red Energy outlined the difficulties a retailer may have in determining the size of a risk premium, if it decides to include one.⁸⁴ These stakeholders suggested that a 'prudent retailer would most likely apply a high risk premium to standing offers with a prescribed retail tariff structure.'⁸⁵ They considered that this would likely lead to inefficiently high standing offers, which would be inconsistent with the NEO.⁸⁶

78 ERAA submission, 7 May 2015, p.2; Origin submission, 7 May 2015, p.1.

79 EnergyAustralia submission, 7 May 2015, p.1.

80 EnergyAustralia submission, 7 May 2015, p.1.

81 ERAA submission, 7 May 2015, p.1; Origin submission, 7 May 2015, p.1.

82 ESAA submission, 8 May 2015, p.2.

83 Origin submission, 27 August 2015, p.1.

84 Lumo Energy submission, 7 May 2015, p.3; Red Energy submission, 7 May 2015, p.3.

85 Ibid.

86 Ibid.

The Commission considers that retailers are equipped with, and have access to, a variety of tools to manage risk on behalf of consumers in relation to the different cost inputs of electricity charges. While the potential inclusion of a risk premium is one of these tools, the Commission is aware that retailers are considering a number of different ways in which they can better manage their risks, while also helping consumers to maximise the value that they can derive from more efficient prices. For example, a number of retailers are providing demand management services, such as solar panels and batteries or load control of hot water, pool pumps or air-conditioning. These ways of managing risk also help consumers manage the costs that they incur with respect to their use of electricity services and could contribute to lower costs and charges in the longer term.

While the potential inclusion of a risk premium into a retail tariff is a commercial matter for the retailer to determine in line with its competitive strategy, the Commission considers that its inclusion is not an inefficient outcome. This is because it is appropriate that consumers contribute to the costs incurred by retailers in providing retail offers and services that reflect their consumption preferences. Competition in the retail market is expected to result in any such risk premiums being set at an efficient level, as consumers can otherwise switch to other offers or retailers with lower prices.

Additional risk management tools

The Commission notes that the distribution pricing rules, developed under the 2014 pricing rule change, give retailers additional tools to help them manage risks. These new rules give retailers earlier notification and more information with respect to changes to network prices. Earlier notification and more information affords retailers with greater opportunity to consider how they will package network costs into retail offers. This allows retailers to better manage risks associated with a difference between retail and network pricing structures and efficiently price that risk.

The new rules include a requirement that a distribution business develop a tariff structure statement that outlines the tariff classes, tariff structures and approach to setting the pricing levels of network tariffs of that business. Distribution businesses are also required to publish a schedule of indicative pricing levels, which outlines expected price levels across the regulatory period. The new rules also require distribution businesses to demonstrate to the AER how they have consulted with retailers on the design of network tariffs and have sought to address any relevant concerns raised. These new tools will assist retailers to plan how they will develop retail offers to meet the needs and preferences of consumers.

Further, the new rules include a 'consumer impacts' principle, which requires distribution businesses to consider the impact on consumers of changes in network prices and allows networks to gradually transition to cost reflective price structures. A more gradual transition to cost reflective network price structures will assist retailers to manage the transition to any new retail price structures that they may offer consumers. This principle will address some of the concerns raised by the Energy Council in the

rule change request about the impact on consumers of the transition to cost reflective network prices.

3.3.3 Ability of retailers to manage risks under government mandated standing offers

If a state or territory government decides to mandate that a retailer make available a standing offer with a prescribed tariff structure, the Commission considers that this does not change the key role of the retailer. Retailers would still manage various input costs and compete to make available a range of retail offers to small customers that reflect different consumer preferences. Consumers will still be able to exercise choice across different retailers and a range of different standing and market offers that best align with their preferences.

The proposed rule change would have only applied to small customers with an interval meter supplied under a government-mandated standing offer. These consumers are likely to have a choice between a range of offers.

If a consumer is supplied under a government-mandated standing offer, and that offer imposes additional costs on the retailer, including managing additional risks on behalf of the consumer, it is appropriate that the price of the government-mandated standing offer reflects those costs. Under this approach, any additional costs that are incurred by a retailer in providing a specific retail offer are only borne by those consumers that are supplied under that offer.

3.3.4 Administrative and compliance costs

The proposed rule change would have likely lead to higher administrative and compliance costs for distribution businesses and retailers. Such costs would have likely been passed on to all consumers through higher network and retail charges over time.⁸⁷

Under the NER, distribution businesses are prevented from introducing new tariff structures during a regulatory control period, unless they follow the prescribed regulatory process to seek amendment of their tariff structure statement.

To amend a tariff structure statement, distribution businesses must consult with retailers and consumers on their proposed amendments, develop an amended tariff structure statement, and then submit the proposed amended tariff structure statement to the AER at least nine months before the commencement of the relevant regulatory control year.⁸⁸ Distribution businesses are also required to consider how a change to a tariff in their approved tariff structure statement would affect all other tariffs included in the approved tariff structure statement. A distribution business would need to go

⁸⁷ ENA submission, 7 May 2015, p.8; and EnergyAustralia submission, 7 May 2015, p.2.

⁸⁸ For example, if a DNSP wanted to change a tariff structure in year three of the regulatory control period, it would have to submit its proposed amendment at least nine months before the commencement of that year.

through this process each time a jurisdiction requires it to offer a particular network tariff or changes the structure of that network tariff. This would likely result in higher administrative costs for distribution businesses.⁸⁹

In addition, a new system or procedure would likely have been needed to facilitate accurate and timely communication of data between distribution businesses and retailers. As distribution businesses do not currently have access to information in relation to the retail tariff that a small customer has elected to be supplied under, a new system or procedure may have been necessary to enable a distribution business to assign a customer to the correct network tariff. This would have likely imposed additional costs on both distribution businesses and retailers.⁹⁰

The proposed rule change would have also impacted on a distribution business' ability to manage revenue risk and had the potential to result in more volatility across network tariffs. It would have reduced distribution businesses' control over the assignment of customers to network tariffs and made it more difficult for them to accurately forecast the number of customers on each tariff and set prices that recovered their regulated revenues each year. Without this control, distribution businesses considered that they would be 'exposed to higher than otherwise levels of volume and revenue risk.'⁹¹

The rule change request noted that distribution businesses on a revenue cap may manage any increased risks by relying on the 'unders' and 'overs' mechanism. However, this may result in larger fluctuations in the pricing levels of network tariffs as the distribution business adjusts pricing levels each year to account for any over- or under-recovery of revenue in previous years.

3.4 Commission's conclusion

The purpose of the Energy Council's rule change request was to help manage the risks that may be faced by retailers if a state or territory government requires a retailer to offer small customers with an interval meter a retail standing offer with a price structure that is prescribed by the state or territory government. Retailers would be exposed to risks if the price structure prescribed by the relevant government did not match the structure of network charges. The Energy Council was concerned these risks could result in retailers incorporating a risk premium in their retail prices for consumers that are supplied under such a standing offer.

As outlined in this chapter, the Commission considers that it is the role of the retailer to manage the costs associated with the various inputs involved in the supply of electricity, including network charges, and to package these into a range of retail offers for different consumers. The Commission considers that the existing tools available to

⁸⁹ AER submission, 7 May 2015, p.3.

⁹⁰ ENA submission, 7 May 2015, p.8.

⁹¹ EnergyAustralia submission, 7 May 2015, p.2.

retailers are sufficient to enable them to efficiently fulfil this role and manage the associated risks.

Requiring distribution businesses to match the structure of a mandated standing offer as proposed in the rule change request, would provide retailers with an additional tool to manage the risks incurred as a result of differences between the structure of network tariffs and a government-mandated retail standing offer tariff. The rule change proponent considered that this requirement would move risks from retailers to distribution businesses, and that this is appropriate as distribution businesses can spread these risks over a wider customer base.

However, the Commission considers that such an allocation of risks would not be efficient. The effect would be to reallocate the costs of managing these risks from the particular consumers whose decisions cause those risks to all consumers. The result may be a reduction in prices paid by consumers that are supplied under a standing offer with a government-mandated structure, but at the expense of imposing additional costs and risks on distribution businesses that may result in higher prices for all consumers.

The proposed rule change would have likely reduced incentives on retailers to use the other tools available to them that can reduce the costs incurred by consumers. For example, by offering a range of retail price structures that match consumer preferences and offering innovative demand management services that could reduce consumers' charges.

In addition, the 2014 pricing rule change provides more tools for retailers to manage their risks and requires distribution businesses to consider the impacts that changes in network tariffs may have on consumers when setting their tariffs.

Accordingly, the Commission considers that the proposed rule change would not be likely to promote the long term interests of consumers.

Abbreviations

AEMC	See Commission
AER	Australian Energy Regulator
AMI	Advanced Metering Infrastructure
COAG	Council of Australian Governments'
Commission	Australian Energy Market Commission
CUAC	Consumers Utilities Advocacy Centre
ENA	Energy Networks Association
ERAA	Energy Retailers Association of Australia
ESAA	Energy Supply Association of Australia
MCE	Ministerial Council on Energy
NECF	National Energy Customer Framework
NEL	National Electricity Law
NEM	National Electricity Market
NEO	National Electricity Objective
NER	National Electricity Rules
NERL	National Energy Retail Law
NERR	National Energy Retail Rules

A Legal requirements under the NEL

This appendix sets out the relevant legal requirements under the NEL for the AEMC to make this final rule determination.

A.1 Final rule determination

In accordance with section 102 of the NEL, the Commission has made this final rule determination in relation to the rule proposed by the COAG Energy Council and has determined not to make a rule.

The Commission's reasons for making this final rule determination are set out in section 2.3.

A.2 Commission's considerations

In assessing the rule change request the Commission considered:

- the Commission's powers under the NEL to make the rule;
- the rule change request;
- the fact that there is no relevant Ministerial Council on Energy (MCE) Statement of Policy Principles;⁹²
- submissions received during first round and second round consultation; and
- the Commission's analysis as to whether the proposed rule will, or is likely to, contribute to achievement of the NEO.

⁹² Under section 33 of the NEL, the AEMC must have regard to any relevant MCE statement of policy principles in making a rule. The MCE is referenced in the AEMC's governing legislation and is a legally enduring body comprising the Federal, State and Territory Ministers responsible for Energy. On 1 July 2011, the MCE was amalgamated with the Ministerial Council on Mineral and Petroleum Resources. The amalgamated Council is now called the COAG Energy Council.