

8 December 2011

Mr. Richard Khoe  
Australian Energy Market Commission  
PO Box A2449  
Sydney South NSW 1235

Dear Mr Khoe,

**Re: Network Regulation Rule Changes from the AER (ERC0134 & GRC0011)**

The Energy Retailers Association of Australia (ERAA) welcomes the opportunity to provide comments on the rule change requests from the Australian Energy Regulator (AER) which seeks to change the way revenues are set for electricity and gas businesses.

The Energy Retailers Association of Australia (the Association) is the peak body representing the core of Australia's energy retail organisations. Membership is comprised of businesses operating predominantly in the electricity and gas markets in every state and territory throughout Australia. These businesses collectively provide electricity to over 98% of customers in the NEM and are the first point of contact for end use customers of both electricity and gas.

Retailers broadly support the AER's rule change proposal. However, we believe that further rule changes are warranted in relation to the distribution pricing approvals process. The current price approval and notification processes do not support the interests of network users (retailers or end users), nor do they support the efficiency of the regulatory process, the National Electricity Objective or National Gas Objective.

**Expenditure forecasts**

Retailers are well placed to understand and gauge the impact of high network prices on customers. Some drivers of price increases in wholesale and distributed energy are unavoidable, but it is unacceptable that customers should also be required to pay for inflated forecasts of monopoly network providers. Retailers believe network revenues under the current framework have not consistently reflected efficient costs.

The amendments proposed by the AER will allow for a mixture of top down and bottom up approaches to estimating efficient costs, significantly reducing the likelihood that the AER's determinations of network revenues will be systematically inflated. As outlined by the AER, NSPs are currently incentivised to inflate forecasts because the burden rests with the AER to disprove each item that it deems to be in excess of an efficient forecast costs. Assessing projects at an aggregate level is more akin to the budget process in large organisations and is more likely to drive project prioritisation and deferral.

Retailers support the amendment proposed by the AER whereby no more than 60 percent of any capital expenditure overspend will be added to the asset base at the next regulatory reset, because this provides better incentives to avoid over-capitalisation of networks. Retailers note that when the cost of capital is set too high for a monopoly provider under the current framework there is a strong incentive to overspend capital towards the end of the regulatory period.



Retailers provide conditional support for the additional measures the AER has proposed for dealing with uncertainty in relation to distribution capex, specifically:

- Yearly reopener provisions;
- A “contingent projects” framework, and
- An amended materiality threshold applying to distribution of 1 percent of revenues.

Support for the first two additional measures above is conditional on the AEMC also addressing the deficiencies in the pricing approval and notification process, as yearly reopeners and allowances for contingent projects will exacerbate pricing risk for retailers, unless shortcomings in the pricing notification framework are addressed.

Retailers’ support for re-openers and contingent projects in distribution is also conditional on the AEMC putting in place a rigorous approach to assessing reopeners and contingent projects. Retailers note the AER’s comments that:

*“[...]the incentive based framework of the five yearly reset model can be undermined by overly frequent cost pass through applications to adjust revenue determinations. If the framework offers too much flexibility to adjust regulatory decisions, then NSPs have an incentive to devote resources to continually seeking upward adjustments to their forecasts rather than to beating their targets.”<sup>1</sup>*

The framework for pass throughs, re-openers and contingent projects must be limited to exceptional and material items that could not have been foreseen at the time the regulatory decision was made.

We support the AER’s proposal to absorb the expenditure criteria into the new decision-making test and to remove entirely the criterion whereby the AER must explicitly consider the particular circumstances of the individual network. Retailers concur that good benchmarking practice will automatically take into consideration the circumstances of individual networks, and that this amendment should facilitate an increased use of benchmarking.

### **Inefficiency in the regulatory process**

Retailers support the AER’s proposed changes to regulatory process, whereby:

- Network service providers will no longer be able to make submissions on their own regulatory proposals or on the AER’s draft decisions;
- The AER has discretion to give ‘such weight as it considers appropriate’ to confidential information contained in regulatory network proposals, given that the information has not been made publicly available.

These amendments will improve the quality of consultation, leading to superior regulatory outcomes. Network service providers operating in monopoly markets should need to keep very little information in a revenue proposal confidential, unless it relates to the terms of commercial third party contracts. Also, retailers oppose network service providers being permitted to withhold information until the day submissions are due and then providing this to the AER as a submission to their own proposals, since this clearly runs counter to the intent of the regulatory process.

Retailers seek further amendments we believe are required to address regulatory inefficiency in relation to consultation on draft network tariffs and notification of final approved network tariffs. We believe the current retail price arrangements are not in the interests of consumers.

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<sup>1</sup> AER Rule Change Proposal, September 2011, Part B, p.49

The AER has recognised that when distributors choose to keep information confidential the AER should then be permitted by the rules to give this information less weight, since the information has not been subject to public scrutiny. Retailers' view is that the same principles of transparency and scrutiny should apply to distribution pricing approvals. Network charges account for between 40 and 50 percent of a retailer's revenue, yet there are:

- No binding commitments on distributors to release the finalised version of their prices, only a best endeavours obligation in electricity that is rarely honoured;<sup>2</sup> and
- No opportunity for retailers to provide formal input on these prices.

The NER and NGR recognise the importance of making the details of a revenue determination public and readily available to users of deemed networks. Yet the revenue determinations are only a limited guide to final price outcomes. The impact of factors such as carryovers and rebalancing are frequently significant, both overall and at the individual tariff level, but information about the extent of these impacts is generally unavailable until right before the tariffs apply. Understanding the impact of a revenue determination on final prices is as important to ensuring equal, efficient and fair access to the networks as understanding the other features of the revenue determination such as decisions on the cost of capital and operational expenditure.

When retailers have no notice of the changes in the structure and quantum of network tariffs this detracts from the efficiency of the network pricing process, because:

- Retailers then have no chance to interpret network price signals, which means sophisticated tariffs devised by distributors lose much (if not all) of their impact;
- The structure of regulated retail tariffs in some jurisdictions is dictated by the structure of network tariffs. Retailers cannot devise compliant retail tariffs if they do not know about changes in the structure of network tariffs ahead of these changes coming into effect. The result is that jurisdictional regulators have had to re-open their decisions in response to unpredictable final network price outcomes.
- As retailers have no opportunity to provide comment to the AER on the pricing proposals of distributors, the AER is not always in a position to know whether the tariffs proposed are feasible for retailers to adapt. The risk is that tariffs are approved that are unworkable, leading to inefficient cross-subsidies with unequal impacts on customers.

The inefficient pricing approval process is not in the interests of customers. If retailers are forced to base their final retail prices on draft distribution prices it is likely that they will look to incorporate this pricing risk, which means prices may need to be higher than would otherwise be the case.

This can also impact regulated retail price determinations. On occasions, jurisdictional regulators do not receive final network prices in time to change regulated retail prices in alignment with network prices. The delayed change to retail prices results in a higher increase in prices for customers because 12 months of revenue must be recovered over the 11 month period.

These negative impacts on customers could be avoided if the rules allowed a proper timeframe for the approval and publication of final prices.

In light of the shortcomings in the current regulatory process with respect to publication of approved prices, retailers propose further amendments to the rules, such that for both electricity and gas distribution:

- The AER has time to consult on the pricing proposals of distributors, at a minimum two weeks to seek, receive and consider input from major network users;
- The timelines for approval of final network prices allow sufficient time for a firm obligation to be placed on distributors to release their final and approved prices six weeks before they apply, in time for retailers to:
  - use these as inputs to their retail price models when developing retail prices, and

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<sup>2</sup> NER, 6.18.9(b)

- notify regulators and customers of their final retail prices as required by jurisdictional pricing regulation (noting that retailers face obligations to notify their retail prices up to a month ahead of when they apply, depending on the jurisdiction).

Timelines could be adjusted so the distributor would be required to provide their pricing proposal to the AER two months before the tariffs apply, allowing two weeks for receiving and considering short submissions from major network users, and six weeks for retailers to review the finalised prices, feed these into retail prices and make notifications of retail prices.

Should you wish to discuss the details of this submission further, please contact me on (02) 9241 6556 and I can facilitate further discussions with my member companies.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Cameron O'Reilly', written in a cursive style.

Cameron O'Reilly  
Chief Executive Officer

**Energy Retailers Association of Australia**