

Australian Energy Markets Commission
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NSW 1235



10 October 2014

RE: National Electricity Amendment (Distribution Network Pricing Arrangements) Rule 2014 – Draft Rule Determination

AEMC Reference: ERC0161

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Dear Commissioners,

Thank you for the opportunity to make a submission to this important rule change process and for the opportunity afforded our Jo De Silva in presenting to the public forum in Sydney on September 22nd 2014. As the peak body for the community services sector in South Australia, SACOSS has a long-standing interest in the delivery of essential services. Our research shows that the cost of basic necessities like energy and water impacts greatly and disproportionately on vulnerable and disadvantaged people. Our advocacy is informed by our members; organisations and individuals who witness these impacts in our community.

As stated in our submission to the initial stage of this rule change process, SACOSS sees that changes to electricity tariff structures are inevitable - particularly in the South Australian context of peaky demand from air-conditioners and high penetration of embedded generation (around 1 in 4 households has a solar power system)¹.

It is clear to us that existing pricing structures are becoming further removed from the underlying costs of networks and energy generation and that tariff reform could yield long-run benefits exist for consumers at large. However, we remain very concerned about the inevitable “winners and losers” from the significant changes proposed. Based on feedback directly from householders and frontline workers, our constituents have demonstrated very little capacity to endure sudden changes in their living costs. In our view, the distributional impacts warrant deep understanding and careful implementation.

The Draft Determination refers to “More consumer consultation and transparency” (page v) via a two stage network pricing process; the Tariff Structures Statement (TSS) at the start of the 5-year regulatory period followed by the more familiar annual review of price levels against the agreed structures. SACOSS agrees with the Commission’s proposal for a two stage process. We support the development of a Tariff Structure Statement by the Distribution Network Service Providers (DNSPs) which would outline tariff classes, tariff structures and the methodologies associated with the pricing principles. We agree that the

¹ <http://py-map.apvi.org.au/historical> accessed October 7th 2014 showed >25% of dwellings with a solar power system in South Australia

TSS should apply over the five year regulatory control period. For the second stage, we support the role of the AER in compliance checking the approved TSS.

SACOSS is of the view that this enhanced consultation should build on the AER's existing Consumer Engagement Guidelines for Network Service Providers² rather than be established as a separate process. However, we would like to see an independent evaluation of the guideline's operation prior to incorporating any amendments necessary to accommodate the new pricing process.

SACOSS welcomes the transparency of the proposed pricing process but is concerned that the value of the TSS is undermined by the opportunities for it to be changed by the DNSP within the five-year regulatory period (see chapter 5.7, p64). Households are "energy investors" too and need stable price signals if they are to invest efficiently in the ways they use (and produce) electricity. The TSS seems like a reasonable instrument to signal these changes and explain the basis for them – but consumers must be able to rely on the TSS for it to be effective.

SACOSS is not convinced that the case has been made for DNSPs to alter the TSS outside of the 5-yearly regulatory reset cycle. In addition to the uncertainty introduced by making the TSS process subject to Limited Merits Review (p64), the AEMC has provided two examples of what it sees as reasonable scenarios for amending the TSS. The first example is demand forecasting errors. SACOSS believes that demand forecasting errors should not be allowed as a basis for amending the TSS. The use of a revenue cap common across the regulatory determinations in process has significantly reduced the risk to revenue of demand forecasting. Given the annual opportunity to change price levels in response to demand changes, the opportunity to also amend price structures in the TSS would seem to put all of the risk back on to consumers. SACOSS does not accept this without it being explicitly reflected in a lower allowance for the cost of capital.

The second example the AEMC has provided is changes to jurisdictional requirements. SACOSS is of the view that this can be accommodated through a process initiated by the jurisdiction, through the AER rather than necessarily being initiated by the DNSP. In terms of price levels, jurisdictional requirements can and should be accommodated through existing 'pass through' mechanisms.

To summarise our views on this point, SACOSS can only accept very limited scope for the need to amend the TSS but does not believe the DNSPs should be able to initiate the change in any case. The process must be a lot tighter than that proposed in the draft rule to really be a material improvement on the status quo. In our view, the amendment mechanism for a change in price structure should only be via the AER's powers to amend a TSS.

SACOSS acknowledges the Commissions' efforts to explicitly address the impacts on vulnerable customers³. The Draft Determination states

"The Commission acknowledges that some consumers will face higher charges under cost - reflective network prices, and some of those consumers may be vulnerable consumers.

² www.aer.gov.au/node/18894

³ Draft Determination chapter 4.3

We caution against making generalisations about which types of consumers may face higher or lower network prices under these changes.

The key factor that will determine how much consumers pay will be their individual load profiles.”

SACOSS agrees with this statement except we note that inadequate information on load profiles exists on which to relate profiles to vulnerability. If stakeholders are to meaningfully engage in the network pricing process then we need to assess the impacts across a range of load profiles to see who wins and who loses. In our view, meaningful consultation requires timely notification, adequate information and education.

Further on the subject of vulnerable consumers, the Draft Determination states (p40):

“The design of network pricing structures is too blunt a tool to use in response to concerns about the potential impact of electricity prices on vulnerable consumers.

Appropriately targeted concession and hardship schemes are a more effective approach.

... To address concerns that cost reflective network prices could potentially result in higher prices for some vulnerable consumers, we recommend that governments review the structure of their energy concession and hardship schemes so that they deliver on their purpose in an efficient and targeted way. This review should occur at the same time as network businesses develop their new network prices over the next 12-18 months.”

For information, The Essential Services Commission of South Australia (ESCOSA) has covered very similar ground in its Water Pricing Inquiry⁴ and I have asked our utilities adviser Andrew Nance (Principal of St Kitts Associates) for a comparison between the two inquiries. His summary (attached) underlines the ever-present gap in public policy between energy and water markets and social policy objectives.

SACOSS was disappointed that the Commission did not make a more significant contribution to the development of these “efficient and targeted” concession schemes other than to present an overview of existing schemes in Appendix C. Government funded concession schemes are very much part of the NEM and we strongly urge the AEMC to consider the integration of energy market and social policy initiatives as within scope. I encourage you to revisit this issue in the final determination.

As outlined in the St Kitts Associates summary, the logic of the arguments presented seems to imply, but doesn't elaborate, that in order to not compromise the economic efficiency of price signals concessions should only be delivered as a fixed amount as part of the residual cost component (i.e. all except the marginal cost price signal). If this is the case then it seems entirely appropriate that the Final Determination elaborates on this further and provides much more guidance on how this should be achieved.

⁴ The inquiry is also at a draft report stage and further information is available from the project page at www.escosa.sa.gov.au/projects/189/inquiry-into-drinking-water-and-sewerage-retail-services-pricing-reform.aspx

In terms of preserving price signals SACOSS is concerned about the decision to not mandate the pass-through of network costs by energy retailers. As stated (page iii):

“The draft rule does not require retailers to structure their retail prices in a way that matches the structure of network prices. Retailers operate in a competitive market and should be free to design their prices as they see fit in response to consumer preferences and the other costs they face. However, because network charges are retailers’ largest cost, they will have a significant incentive to pass on network price signals to consumers when deciding how to structure their retail prices.”

SACOSS is not convinced that the logic behind these positions is consistent. It is unclear why concessions should in no way compromise price signals but retail prices can and we would appreciate elaboration in the rule change’s final determination.

To summarise our views:

- We accept the need for change but are concerned about the nature and pace of change
- We welcome transparency but seek stability
- We support the two-stage network pricing process including developing the TSS as part of the revenue determination each 5 years
- We only accept very limited scope for the need to amend the TSS outside of the 5-year regulatory cycle but do not believe the DNSPs should be able to initiate the change in any case
- We seek elaboration of the attributes of government funded concessions that will not compromise economic efficiency

We thank you in advance for your consideration of our comments. If you have any questions relating to the above, please contact SACOSS Senior Policy Officer, Jo De Silva on 8305 4211 or via jo@sacoss.org.au.

Yours sincerely,



Ross Womersley
Executive Director

Attachment: St Kitts Associates report “Network Pricing and Public Policy” dated 10 September 2014

SOUTH AUSTRALIAN COUNCIL OF SOCIAL SERVICE

NETWORK PRICING AND PUBLIC POLICY

A background paper to inform policy development by SACOSS

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10th September 2014

INTRODUCTION AND SUMMARY

SACOSS is seeking to compare and contrast the draft reports from two utility pricing inquiries affecting households in South Australia.

- ESCOSA’s Inquiry into Reform Options for SA Water’s Drinking Water and Sewerage Prices – Draft Inquiry Report¹
- AEMC Network Pricing Rule Change²

From the perspective of SACOSS and its constituents, these inquiries relate to the gap in public policy between social policy objectives and the pursuit of economic efficiency through energy and water markets and cost-reflective pricing. This gap is a persistent one and it is disappointing that these inquiries have chosen not make a more significant contribution to its bridging.

Following the arguments presented to their logical conclusions arrives at a view that the permissible scope for concessions is the ‘residual costs’ (i.e all except the ‘marginal cost’ price signals). In my view, it would be appropriate for both the AEMC and ESCOSA to be asked to more comprehensively consider the issues of how to implement their proposals alongside a government funded concession regime.

DISCUSSION

The market settings and scope are different in each case but both inquiries are seeking to implement more efficient, cost-reflective pricing for utility networks. Both Draft Reports and the main consultant reports attached to each of them have been reviewed and are summarised below:

- Overall, both reports (with accompanying consultant reports) go to extraordinary lengths (several hundred pages combined) to emphasise the importance of pricing for *efficiency* and that *fairness* must be addressed using alternate methods that do not compromise *efficiency*. However, after hundreds of pages of making this point, there is very little on offer as to how, practically, these *fairness* measures can have a meaningful impact on bills (or, strictly speaking, *Capacity to Pay*) without impacting on the price signals being sent to promote efficiency.
- Both inquiries discuss the concept of economic efficiency and the theoretical basis of marginal cost pricing to considerable length. Both acknowledge that debate exists as to how marginal cost should be measured.
- Both arrive at similar preferences (consistent with economic theory since the second half of the 1800’s): ensuring customers are exposed to marginal cost pricing.

¹ www.escosa.sa.gov.au/projects/189/inquiry-into-drinking-water-and-sewerage-retail-services-pricing-reform.aspx

² AEMC Reference ERC0161 www.aemc.gov.au/Rule-Changes/Distribution-Network-Pricing-Arrangements

- Both inquiries acknowledge that pricing at marginal cost does not usually recover enough revenue (especially when the network has enough capacity as is the case in both energy and water in South Australia) and so considerable effort is put into the various options available for recovering these residual costs. Constructively, The Brattle Group have provided the AEMC with three principles for the recovery of these costs: *efficiency, fairness and gradualism* but, unfortunately, have not considered the role of concessions³
- Both inquiries are explicit about their basis in economic efficiency and that the broader context of pricing reform, including impacts on social policy objectives, are matters for the broader role of government.

This last point is consistent with longstanding policy positions of governments in both cases. For energy, the Second Reading Speech of the *National Electricity Bill 2007* by then South Australian Energy Minister the Hon PF Conlon (27th September 2007) clarified the intent:

“... It is important to note that the National Electricity Objective does not extend to broader social and environmental objectives Environmental and social objectives are better dealt with in other legislative instruments and policies which sit outside the National Electricity Law.”

Further, the Australian Energy Market Agreement states⁴:

“14.14 The Parties agree that social welfare and equity objectives will be met through clearly specified and transparently funded State or Territory community service obligations that do not materially impede competition.”
[emphasis added]

For water, the South Australian Government’s 2010 *Water for Good* plan⁵ provides the current policy basis for the *Water Industry Act 2012*. The document made it clear that the intention was to move towards economically efficient, cost reflective water pricing and equity considerations were to be addressed through “*targeted income support (concessions) measures*”. This is also consistent with the National Water Initiative Pricing Principles⁶ and the Productivity Commission’s Inquiries into Urban Water (2011) and Electricity Network Regulatory Frameworks (2013)⁷.

So, in both cases, the unambiguous policy context is for equity objectives to be met through the continuation of publicly funded concessions but for these to be delivered in a way that does not impact on competition. Both inquiries provide examples of how pricing to aid *fairness* often distorts the pursuit of *efficiency* as if to over-emphasise an established point but then balk at providing concrete

³ Brown T & Faruqi A “*Structure of Electricity Distribution Network Tariffs: Recovery of Residual Costs*” August 2014. Available from the AEMC project page.

⁴ Australian Energy Market Agreement (AEMA) as amended – December 2013 available from www.scer.gov.au. The text was at 14.11 (b) in the Oct 2011 version

⁵ Part 6 of *Water for Good* at www.environment.sa.gov.au/about-us/our-plans

⁶ The National Water Initiative (NWI), agreed in 2004 by the Council of Australian Governments, is the national blueprint for water reform www.environment.gov.au/resource/national-water-initiative-pricing-principles

⁷ www.pc.gov.au/projects/inquiry/electricity/report and www.pc.gov.au/projects/inquiry/urban-water/report

recommendations. Unfortunately, neither provides much analysis on how a concession regime can be integrated with their preferred pricing structure (in order to pursue *fairness* without compromising the pursuit of *efficiency*). Both inquiries just recommend a review of concessions.

To be fair, the ESCOSA inquiry report offers to assist the Government with such a review [p156] and even makes a brief but clear preference for the attributes of concessions [p10 and p157]:

[p10] *“While the design of any subsidy or concession scheme is a matter for government, it is recommended that payments be made as a fixed amount, rather than incorporated into water usage charges, to avoid distorting the price signal benefits of cost-reflective usage pricing.”*

[p157] *“If water pricing is to remain as a tool for delivering social equity objectives, to ensure that usage charges remain cost-reflective, any exemptions and concessions should not be dependent on the amount of water consumed (i.e. they should apply to the fixed charge only). It is important that usage charges be set at cost-reflective levels to promote economic efficiency. Applying subsidies to usage charges would distort consumption decisions and reduce economic efficiency...”*

This gap in public policy between social policy objectives and the pursuit of economic efficiency through energy and water markets is a persistent one. It is disappointing that these inquiries do not make a more significant contribution to bridging this gap. In my view, it would be appropriate for both the AEMC and ESCOSA to be asked to more comprehensively consider the issues of how to implement their proposals alongside a government funded concession regime. The late Professor of Political Science and Public Policy at University of California Berkeley, Aaron Wildavsky wrote (over 25 years ago in 1987)⁸:

“I would like to return to a (by now) ancient verity of policy analysis: economic analysis by itself is insufficient; complete analysts place their studies and their search for organizational support within a broader political and organizational context.”

In order to follow the arguments from these reports to their logical conclusions for concessions I have attempted to distill the arguments down into a simple sequence of logical steps as follows:

1. Energy and Water prices should be of a level and structure that incentivises economic efficiency
2. Public policy objectives related to *fairness* or the *environment* should be pursued only in ways that do not compromise efficiency. The contemporary policy mechanism for this is via concessions (rebates directly to consumers) and community service obligations (CSO's; rebates directly to suppliers)
3. Economic efficiency is most likely when the marginal cost of consumption (i.e. the price of the next unit of energy or water) reflects the marginal cost of production.

⁸ Wildavsky, A *“Speaking Truth to Power / The Art and Craft of Policy Analysis”*, 2nd Ed 1987, Boston

4. This provides for efficient decision making but does not provide enough revenue to cover the costs of existing assets and services.
5. These *residual costs* can be recovered in a number of ways but the aim is to have minimal impact on consumption decisions (i.e. maximise economic efficiency through marginal cost pricing alone).
6. For concessions to similarly have minimal impact on the marginal cost price signals, it follows that they must be structured similarly to how tariffs recover residual costs (and therefore can only impact on *fairness*, not *efficiency*)

The conclusion therefore seems to be that the “*residual*” is the scope (or boundary) for concessions and that they should only be applied as a fixed amount.

IMPLICATIONS FOR ENERGY AND WATER CONCESSIONS IN SOUTH AUSTRALIA

The broad implications for electricity and water in South Australia are:

- The Energy Concession (applied to Electricity bills) is a fixed amount of \$215 pa (paid quarterly). This would be considered efficient.
- Water concession is applied as 30% of the bill subject to a minimum and maximum amount. This would be considered inefficient.
- Sewerage concession is a fixed amount of \$110 pa. This would be considered efficient.

For interest, I have prepared a short worked example based on a residential demand tariff. recently introduced by South Australian Power Networks (SAPN)⁹. The tariff can be considered broadly consistent with the Draft Rule and indicative of the future direction of residential tariffs and is presented in Figure 1 below. In summary:

- No fixed charge (compared to 42.92 c per day = \$156 pa on the existing residential tariff)
- \$18/kW per month in summer (NOV-MAR) (min 1.5 kW = \$27 x 5 = \$135 pa)
- \$9/kW per month in winter (APR-OCT) (min 1.5 kW = \$13.50 x 7 = \$94.50 pa)
- TOTAL: \$229.50 pa min fixed charge (plus retail fixed costs of around \$100-\$130 pa = \$330-\$360)

⁹ Available from July 1st, 2014. Refer to www.sapowernetworks.com.au/centric/industry/our_network/network_tariffs.jsp

- Usage rate is 10c/kWh compared to (compared to 16c for 4000kWh pa and 22c for more than that)

In this case, the monthly demand charges represent the ‘marginal cost’ price signal and therefore the part that the AEMC would consider off limits when considering concessions - above the minimum charge for 1.5 kW of capacity at least. In theory then (and depending on what retail tariff accompanies this network tariff) concessions could remain as a fixed amount but be increased to well over \$300 pa without a risk of compromising efficiency.

SA Power Networks NETWORK TARIFFS											
APPLIES TO USAGE FROM 1 JULY 2014											
Customer Category	Units	Min Qty.	DUOS	excl GST	Veg Mgmt excl GST	METER excl GST	Total SA- PN excl GST	TUOS excl GST	PV JSO excl GST	Total excl GST	Total incl GST
NEW TARIFFS											
Low Voltage Residential - Monthly Demand											
Supply Rate	\$/day			0.000000			0.000000			0.000000	0.000000
Summer Monthly Demand Rate	\$/kW/mth	min 1.5 KW		11.140000	0.480000		11.620000	2.670000	2.070000	16.360000	17.986000
Winter Monthly Demand Rate	\$/kW/mth	min 1.5 KW		5.570000	0.240000		5.810000	1.335000	1.035000	8.180000	8.998000
Additional Monthly Demand Rate	\$/kW/mth			0.000000	0.000000		0.000000	0.000000	0.000000	0.000000	0.000000
Usage Rate	\$/kWh			0.061900	0.002700		0.064600	0.014600	0.011500	0.090700	0.099770

- (o) A Low Voltage Residential monthly demand customer is a Distribution Network User that is a residential customer taking supply at less than 1 kV. Consumption is charged at a flat rate. A charge also applies for the maximum demand each month with different prices applying in the summer months (November to March) and the winter months (April to October), as detailed in the Tariff Schedule. The time period when the monthly peak demand is measured is between 1600 and 2100 local SA time. The User utilises a type 1-5 NEM compliant meter read monthly. An excluded service charge applies where SA Power Networks is required to read the type 1-4 meter (eg for tier one customers and for tier two customers < 160MWh pa). An excluded charge also applies for the monthly reading of Type 5 meters. This tariff is invoiced monthly. Note that this is an optional tariff. A customer may elect to switch to another tariff after 12 months on this tariff.

Figure 1: SA Power Networks Residential Demand Tariff – an optional tariff available from July 2014