19 December 2013

Mr John Pierce
Chairman
Australian Energy Market Commission
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Dear Mr Pierce

NATIONAL ELECTRICITY AMENDMENT (DISTRIBUTION NETWORK PRICING ARRANGEMENTS) RULE 2014 – CONSULTATION PAPER

Thank you for the opportunity to comment on the *National Electricity Amendment (Distribution Network Pricing Arrangements) Rule 2014 – Consultation Paper* (**Consultation Paper**).

CitiPower and Powercor Australia (**the Businesses**) welcome the Australian Energy Market Commission (**AEMC**) and Standing Council of Energy and Resources (**SCER**) addressing network tariff reform. The Businesses encourage the AEMC to consider tariff reform carefully in ensuring that any Rule Change does not create uncertainty and unwanted outcomes.

The Rule Change Proposal in its current form reduces network flexibility and constrains Distribution Network Service Providers (**DNSPs**) from responding to a rapidly changing environment with innovative tariffs.

The premise that all DNSPs' supply costs are driven by peak demand is incorrect. Pricing services at long run marginal cost (**LRMC**) which measures growth related capital expenditure will not ensure cost reflective pricing. The electricity market is currently experiencing a low demand environment and it is likely that demand will continue to remain at current levels or decline even further. As a consequence, peak demand growth drives only a small percentage of capital expenditure. In respect of the Businesses, for the last five years only 15 percent of capital expenditure is made up of growth related expenditure.

There are a number of supply cost drivers including:

- an increase in the allowance for the cost of capital largely reflecting the impact of the global financial crisis;
- a range of enhanced Federal and State environmental, safety and statutory obligations;

- an increase in materials and construction costs, and land and labour rates reflecting cost pressures across the Australian economy;
- operating cost increases caused primarily by bushfire mitigation costs and electrical safety regulation compliance; and
- network augmentation which has driven capital expenditure following significant peak demand growth.

If prices are strictly based on LRMC, there would be a significant residual amount which would need to be smeared across the customer base in order to ensure cost recovery. The Businesses urge the AEMC to recognise that a strict application of LRMC will result in significant under recovery.

Any Rule Change should be progressed as part of a complementary suite of measures supporting network tariff reform. Some of the features of such a reform program may include focusing on achieving demand-based pricing structures, rather than fixed and volume based pricing structures. Such an approach can be complemented with demand management options and new incentive schemes, for example offering rebates for further reductions.

The submission sets out the following issues:
- cost reflective retail energy prices for consumers;
- proposed approach to measuring the cost of supply;
- engaging with consumers on price levels and pricing structure;
- SCER's inaccurate statement on recent rises in electricity prices;
- the removal of side constraints; and
- the role of the pricing structure statement (**PSS**).

Cost reflective retail prices

The Proposed Rule Changes seeks to reform pricing just for the distribution sector.

The focus on achieving cost reflective distribution pricing through regulatory reform only solves part of the problem. There are a number of barriers to achieving cost reflective prices and the take up of cost reflective tariffs, including the following:
- the distribution network tariff is only one component of the electricity retail price. The distribution component of the average electricity bill in Victoria is only about 23 percent or 32 percent if the smart meter rollout is included;
- under the Advanced Metering Infrastructure (**AMI**) Order, retailers determine whether or not to offer consumers a flexible time-of-use tariff or a flat tariff. Retailers will choose a tariff level and tariff structure which maximises profit and does not necessarily reflect cost-reflective distribution pricing;
- without unbundled tariffs, customers cannot see how much they are paying for network services which will effectively blunt their responses to distribution pricing; and
- there is inertia with many customers who are reluctant to move to a new tariff. The Businesses have very few customers who have moved to a time of use tariff.

Proposed approach to measuring the cost of supply

The Businesses considers the debate on the appropriate methodology to determine LRMC is a secondary issue. The primary issue is whether or not basing prices on LRMC is appropriate.

It is unclear exactly what LRMC means or the potential ramifications of pricing at LRMC. Also for consideration are the practical difficulties in applying LRMC to an individual customer. There are a number of methods in calculating the LRMC. Marsden Jacob Associates articulated these alternatives, in its review of possible approaches for the Queensland Competition Authority.

Previously the methodology adopted by the Businesses to estimate LRMC was based on internally developed estimates of the marginal cost of reinforcement, being the cost per mega-volt-ampere (**MVA**) of deep capacity augmentation. It is similar in concept to an estimate of LRMC based on the *'Turvey'* approach which considers long run incremental change in the cost of supply caused by one unit (one MVA) change in maximum demand.

There does not appear to be one superior methodology for determining LRMC. If the AEMC approves LRMC as the bases for determining prices, the Businesses consider there should be a requirement on the AER to publish a guideline setting out a number of options for measuring LRMC. This will reduce the risk of the AER rejecting the Businesses' proposed pricing proposal whilst providing DNSPs flexibility to tailor their approach. The Businesses consider this approach provides the right balance between flexibility and certainty.

The AEMC does recognise that network charges which are set to recover LRMC could lead to under recovery of total network costs. However, as noted the AEMC does not appear to appreciate how significant the residual costs are. The AEMC proposed a number of methods such as Ramsey or postage stamp pricing to smear the residual cost over the network.

The Businesses consider Ramsey pricing would appear to achieve the SCER's objectives. That is, flexible pricing would be facilitated by allowing the introduction of LRMC pricing (by time and location) and then recovering residual costs through fixed charges. Potential impacts on particular classes of consumers could be minimised by decreasing fixed charges for consumers who have received a relatively high usage or demand charge due to likely network expenditure in their location on the network.

Equity/efficiency trade off

The LRMC will vary based on a number of factors including price differentials between customers, times of use, types of use and location. The Businesses encourage the AEMC to consider the potential efficiency/equity trade-offs with cost reflective locational pricing.

For example, the marginal cost of serving a rural customer in western Victoria will vary from that of serving a residential customer in Melbourne. Equally, the marginal costs of serving an industrial customer during business hours on Monday to Friday will vary from that of serving the same customer at 4.00am on a Sunday morning.

There will be winners and losers with cost reflective pricing and serious political ramifications that need to be seriously thought through.

Engaging with consumers

The Businesses strongly support formal consultation with stakeholders when developing network prices during the regulatory proposal stage. Consumers want to be engaged and in order for cost reflective pricing to work they must be well informed.

The Businesses are working hard to effectively engage with consumers. The website, *Taking Electricity*, has been launched by the Businesses. It will be a key channel for keeping customers informed of opportunities to participate in the Businesses' engagement activities, as we develop our 2016-2020 regulatory proposals and proposed pricing structure statement.

In order to avoid duplication, the Businesses consider that the regulatory reset pricing proposal consultation should be incorporated with the consultation on the regulatory proposal.

SCER's inaccurate statement on recent rises in electricity prices

The SCER stated that recent rises in electricity prices have been primarily driven by increases in network charges.[1] This statement is not accurate for Victoria.
Victoria's electricity distribution sector has performed well since major reforms were undertaken in the mid-1990s:

- network charges (including additional costs of the smart meter rollout from 2009) decreased in real terms between 1995 and 2010. Network charges decreased by 20 percent on a $ per MWh basis, or by 12 percent on a per customer basis;
- network charges comprise a relatively low share of electricity prices to consumers; and
- the Businesses have continued to deliver safe, reliable and efficient performance to our customers.

The removal of side constraints

The Businesses consider side constraints inhibit cost-reflective pricing and there is little economic justification for its existence.

[1] SCER Rule change request, *Reform of the distribution network pricing arrangements under the National Electricity Rules to provide better guidance for setting, and consulting on, cost-reflective distribution network pricing structures and charges*, 18 September 2013, pg. 13.

Role of PSS

The Businesses considers there is no role for a PSS. It simply duplicates the existing regulatory reset pricing proposal and annual pricing proposal. The Businesses note that DNSPs are already required under the National Electricity Rules (**NER**) to consult on pricing.

The Businesses do not support additional requirements to consult with retailers on any of its pricing proposals. In Victoria, under the Use of System Agreement, the Businesses are required to inform retailers of changes in the pricing structure. Any changes in the rules should promote the National Electricity Objective which seeks to achieve the long term benefits of consumers, not retailers who are a profit maximising business.

The Businesses considers the PSS should not be binding. There are a range of factors which affect prices that DNSPs cannot predict:

- specification of the consumer price index;
- changes to transmission pricing;
- any unders and overs adjustment to the annual revenue requirement of DNSPs under revenue caps;
- cost pass-throughs and contingency projects mechanism adjustments to the annual revenue requirement approved by the AER;
- the accuracy of forecast demand; and
- the accuracy of forecast customer numbers.

Given these factors, it would be impossible to accurately forecast the expected pricing levels for the next five years prior to the beginning of the next regulatory control.

The Proposed Rule Change requires the DNSPs to include in the pricing structure statement a statement of expected price trends giving an indication of how the DNSPs expect prices to change over the regulatory control period. The Businesses are only able to provide information on the distribution network price trends. They do not have visibility over transmission and retail price trends. The Businesses encourage the AEMC to consider restricting this requirement to distribution network price trends.

Please do not hesitate to contact Ms Renate Tirpcou, Manger Regulation, on (03) 9683 4082 or rtirpcou@powercor.com.au if you would like to discuss the positions presented in this submission.

Yours sincerely

Brent Cleeve
MANAGER REGULATION