Australian Energy Market Commission

RULE CHANGE

CONSULTATION PAPER

National Electricity Amendment (Distribution Network Pricing Arrangements) Rule 2014

Rule Proponents

Independent Pricing and Regulatory Tribunal of NSW
Standing Council on Energy and Resources

14 November 2013

For and on behalf of the Australian Energy Market Commission

Inquiries

Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

E: aemc@aemc.gov.au
T: (02) 8296 7800
F: (02) 8296 7899

Reference: ERC0161

Citation

AEMC 2013, Distribution Network Pricing Arrangements, Consultation Paper, 14 November 2013, Sydney

About the AEMC

The Council of Australian Governments (COAG), through its then Ministerial Council on Energy (MCE), established the Australian Energy Market Commission (AEMC) in July 2005. In June 2011, COAG established the Standing Council on Energy and Resources (SCER) to replace the MCE. The AEMC has two main functions. We make and amend the national electricity, gas and energy retail rules, and we conduct independent reviews of the energy markets for the SCER.

Executive Summary

This consultation paper seeks stakeholder comments on a rule change process relating to the way distribution network prices are structured. In this process the Australian Energy Market Commission (AEMC or Commission) will consider the National Energy Rules (NER or rules) framework under which distribution businesses set their network prices, including the guiding principles and the relevant process.

The rule change requests relating to distribution network pricing were received from the Independent Pricing and Regulatory Tribunal (IPART) and the Standing Council on Energy and Resources (SCER). Due to the overlap of subject matter, going forward the AEMC will consider both requests in one process. The AEMC published an initial consultation paper on the IPART rule change request on 6 June 2013. This additional consultation paper, in part, builds on that earlier paper.

The SCER rule change request draws on the conclusions and recommendations on network pricing made by the AEMC in its *Power of Choice Review*. The AEMC will now test the specific proposals raised in the rule change requests against the National Electricity Objective (NEO). This work will reflect the AEMC's strategic priority of strengthening the ability of consumers to engage in the energy supply chain, including through pricing decisions. It also forms part of the ongoing reform by the AEMC in the area of network regulation, which included significant rule changes in November 2012. Those rule changes better equip the regulator to set efficient revenues for network businesses. The SCER and IPART rule change requests now look at how that revenue should be recovered from consumers through the way distribution network prices are structured.

Under the current arrangements, once the revenue for a distribution business is set by the AER, there is a further annual process by which prices are set. The distribution business proposes prices which the AER must assess having regard to certain principles, which include:

- the stand alone and avoidable cost boundaries of providing the distribution service;
- the long run marginal cost of providing the distribution service;
- transaction costs for consumers and distribution businesses; and
- whether consumers are able to respond to price signals.

SCER proposes that these principles should be adjusted to encourage distribution network prices to be set on a more cost reflective basis, which will provide more efficient pricing signals to consumers.

Other objectives of the rule change requests received from IPART or SCER include:

- greater certainty for retailers and consumers on how and when distribution network businesses will change their network prices over time; and

- more opportunity for those affected by distribution network prices to be consulted on the development of those prices.

Any rule changes that result from the requests will not actually set the new prices. It is important that the distribution network businesses continue to determine their network prices, with appropriate consumer consultation and oversight by the Australian Energy Regulator (AER). The rules create a framework which guides those businesses to achieve prices which are efficient and therefore benefit all consumers. It is this framework that the rule change requests address.

The AEMC follows a technology neutral approach to its decisions. While it will be important to understand the impact different technologies – which could include air-conditioning, solar photovoltaic (PV) or electric vehicles – have on the costs faced by distribution network businesses, any rules will apply irrespective of the technology being used. The actual impact of rule changes on particular consumers will depend on a range of factors. In addition to distribution network charges, electricity prices faced by consumers also comprise, among other things, transmission charges, wholesale energy costs, retailer operating costs and the cost of governments' policies.

If changes to the rules are made, the AEMC will also consider how the framework should provide for transition to the new rules as smoothly as possible and in a way that manages any price impacts.

Any new rules that are made are likely to apply to the pricing processes in 2015. This would include those for the New South Wales, ACT, Queensland and South Australian distribution businesses. The new rules would not apply to pricing processes that are completed in 2014. Transitional rules would be required if new rules are to be applied to the revenue determinations to be made by the AER in 2015.

This consultation paper has been prepared to facilitate public consultation on the rule change requests. Stakeholders are encouraged to provide any submissions by 19 December 2013. In addition, the AEMC will be holding a public forum on 27 November 2013. Further details can be found on the AEMC's website.

Contents

1 Introduction

1.1 The rule change requests

On 12 September 2012, the Independent Pricing and Regulatory Tribunal (IPART) submitted a rule change request to the Australian Energy Market Commission (AEMC or Commission). That rule change request seeks to modify the annual network pricing arrangements for distribution network service providers (DNSPs) under the National Electricity Rules (NER or rules).

In response to AEMC's *Power of Choice Review*, on 18 September 2013, the Standing Council on Energy and Resources (SCER) submitted a rule change request to address the current incentives and level of guidance in the NER for DNSPs to set cost-reflective network tariffs[1], as well as the consultation process with consumers.

Background to these two rule change requests is provided in Chapters 2 and 3, respectively. There is significant overlap between the IPART and SCER rule change requests. As further discussed in Chapter 4, the Commission has consolidated the two rule change requests due to the overlap of issues.

1.2 Purpose of this consultation paper

1.2.1 Process for distribution network pricing

The first purpose of this consultation paper is to explore in greater detail stakeholders' views on issues regarding the process for distribution network pricing such as:

- consultation on the development of network tariffs; and
- providing pricing certainty on future changes to network tariffs.

The AEMC has already undertaken a round of consultation in respect of these issues on the rule change request from IPART, including the release of an initial consultation paper on 6 June 2013.[2] The rule change request from SCER has raised an alternative proposal on similar issues that will need to be considered together with IPART's proposed changes. Submissions from stakeholders on the initial consultation paper have been reflected in the discussion of these issues in this consultation paper.

The initial consultation paper also focussed on changes to the timing of the annual pricing process in terms of achieving earlier notification of annual network price changes. This is one of the key concerns expressed by retailers in their submissions to

1 In this paper, the term "network tariffs" is used as a generic term to refer to both structure and pricing levels of DNSPs' 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.

2 In this consultation paper, the consultation paper released by the AEMC on 6 June 2013 in respect of the IPART rule change is referred to as the "initial consultation paper".

the initial consultation paper. Any changes to the timing of the annual pricing process will now need to be considered in light of any changes that may result to the overall network pricing framework as a result of the SCER rule change request.

1.2.2 Basis on which distribution network prices are set

The rule change request from SCER raises new issues that were not raised in IPART's rule change request. The second purpose of this consultation paper is to seek stakeholders' views on these new issues. They include changes to:

- the distribution pricing principles that DNSPs are required to apply in developing cost reflective network tariffs that provide efficient pricing signals;
- the tariff class provisions that would allow DNSPs to group customers into tariff classes on an economically efficient basis; and
- side constraint provisions that limit the degree to which network prices are able to change annually.

1.2.3 AEMC's Power of Choice Review

SCER's rule change request is largely based on the AEMC's findings and recommendations from its *Power of Choice Review* advice to SCER.[3] In recognition of the significant level of consultation and consensus that was achieved in the *Power of Choice Review* work, the Commission intends to build on the relevant analysis and conclusions from that review in considering the issues in this rule change process.

To the extent that SCER's rule change request is based on the AEMC's *Power of Choice Review* recommendations, the focus of this rule change process will be on how to implement those recommendations in a way that balances the risks and benefits expected from those changes to better achieve the National Electricity Objective (NEO).

1.3 Consultation

The AEMC has identified a number of issues in this consultation paper that are relevant in considering the rule change requests from IPART and SCER. The issues that have been identified are not exhaustive but are provided to assist stakeholders in preparing their submissions. The AEMC welcomes comments from stakeholders on the issues raised in this consultation paper as well as SCER's views as set out in its rule change request.

3 AEMC, *Power of choice review - giving consumers options in the way they use electricity*, Final Report, 30 November 2012.

1.4 Timing of consolidated rule change process

As noted in Chapter 4, the rule change requests from SCER and IPART have been consolidated. The timeframe for the consolidated rule request process will be as follows:

- Consultation paper on consolidated rule request published on 14 November 2013
- Public forum in Melbourne on the consolidated rule request on 27 November 2013
- Submissions on consolidated rule request consultation paper close on 19 December 2013
- Stakeholder workshops in February/March 2014 (to be confirmed)
- Publication of draft rule determination in August 2014
- Further stakeholder workshops in September 2014 (to be confirmed)
- Publication of final rule determination in November 2014.

1.5 Structure of paper

This consultation paper is structured as follows:

- Chapter 2 provides background to the rule change request;
- Chapter 3 sets out a summary of SCER's rule change request;
- Chapter 4 outlines the Commission's reasons for consolidating the rule change requests from IPART and SCER;
- Chapter 5 sets out the assessment framework for the consolidated rule change request;
- Chapter 6 provides a discussion of some of the overarching concepts relevant to the new network pricing framework proposed by SCER. It also highlights some of the key differences between IPART's proposal and SCER's proposal on changes to the pricing framework;
- Chapter 7 discusses issues relevant to implementation of a new network pricing framework;
- Chapter 8 discusses issues relevant to improving the timing of the annual pricing process to allow earlier notification of approved network tariffs;
- Chapter 9 discusses issues relevant to proposed changes to the distribution pricing principles;

- Chapter 10 discusses issues relevant to proposed changes to how DNSPs should determine tariff classes;
- Chapter 11 discusses issues relevant to proposed changes to the operation of side constraint provisions; and
- Chapter 12 outlines the process for making submissions.

2 Background

This chapter provides background to this consultation paper and is structured as follows:

- section 2.1 describes the current network pricing framework;
- section 2.2 provides a summary of the relevant Power of Choice Review recommendations; and
- section 2.3 provides a summary of IPART's rule change request that was the subject of the initial consultation paper released on 6 June 2013.

SCER's rule change request is described in Chapter 3.

2.1 Current network pricing framework

Network tariffs are a key cost component of the retail prices offered to electricity consumers. Network tariffs are made up of transmission and distribution use of system charges. These are usually combined by DNSPs into the network tariff applied to retailers' customers. This network charge is then passed through to customers by the retailers as part of the retail electricity price.

Network tariffs applying in any particular year depend on the revenues that the DNSP is allowed to earn in that year in accordance with the regulatory determination of the Australian Energy Regulator (AER). It is also influenced by certain distribution pricing provisions in the NER. Network tariffs must be approved by the AER annually. These arrangements are described below.

2.1.1 Regulatory determinations

The AER is the economic regulator of DNSPs operating in the National Electricity Market (NEM). Chapter 6 of the NER sets out the timelines, regulatory processes and principles governing the determination of revenues that a DNSP can earn for distribution network services.

DNSPs must periodically apply to the AER to determine their revenue allowances for a defined regulatory control period, typically five years. The AER is required to determine the form of control mechanism to be applied to a DNSP's revenues in the upcoming regulatory control period.[4] The NER sets out the control mechanisms that the AER may select from in making this determination.[5]

4 NER clause 6.8.1(f).

5 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.

2.1.2 Pricing Proposals

Once the allowed revenues are determined by the AER, network tariffs are then set on an annual basis in each year of the regulatory control period. The network tariff prices allow DNSPs to recover their allowed revenues for that year, including the applicable transmission charges and any amounts to recover jurisdictional scheme obligations.

Each DNSP's annual network tariffs must be submitted to the AER as a pricing proposal and approved before they can take effect. DNSPs' pricing proposals set out the proposed tariff classes for the upcoming regulatory year and the proposed tariffs and charging parameters that correspond to each of these tariff classes. They also include information, including demand forecasts, which supports assessment of the compliance of the DNSP's proposed tariffs with the applicable control mechanism under their regulatory determination.[6]

Pricing proposals must be submitted within fifteen days of the publication of the distribution determination for the first regulatory year of a regulatory control period and at least two months before the commencement of subsequent regulatory years during the regulatory control period.[7] The AER is responsible for assessing and approving proposed network tariffs before they go into effect.

Pricing proposals must comply with a set of pricing principles set out in Clause 6.18.5 of the NER. These principles can be summarised as follows:

- the revenue of each price class must be greater than the incremental cost and less than the standalone cost of the service;[8]
- DNSPs must take into account the long run marginal cost (LRMC) for a network service in setting network prices;[9]
- DNSPs must have regard to (i) transaction costs associated with the tariff, and (ii) whether retail customers of the relevant tariff class are likely to respond to price signals in setting network prices;[10] and
- where the above principles do not result in prices which recover expected revenue, the DNSP must adjust prices in a way that minimises distortion to efficient patterns of consumption.[11]

In addition to the pricing principles, the network tariff price changes must also comply with the 'side constraints' provisions in the NER. These provisions limit the magnitude of tariff changes from year to year.

6 NER clause 6.18.2.

7 NER clause 6.18.2(a)(2).

8 NER clause 6.18.5(a).

9 NER clause 6.18.5(b)(1).

10 NER clause 6.18.5(b)(2).

11 NER clause 6.18.5(c).

The AER must approve a pricing proposal if it is satisfied that:

(i) it complies with rule 6.18 of the NER (including the pricing principles); and

(ii) all forecasts associated with the proposal are reasonable.[12]

If the AER is not satisfied with a proposal on this basis, it may require the relevant DNSP to amend and resubmit the proposal within ten business days of the AER's notice, or make the necessary amendments itself.[13] If the DNSP fails to submit an amended proposal, or the amended proposal is unsatisfactory, the AER may also make the necessary amendments.[14]

2.1.3 Consultation and pricing information

The current annual network pricing process does not require DNSPs or the AER to consult with stakeholders on the way prices are structured. Nor do DNSPs have any obligation to consult with retailers or consumers on the development of the structure of their network tariffs or the level of prices. The NER also does not require the AER to consult with stakeholders on its decision on whether or not to approve the DNSP's pricing proposals as distinct from their revenue proposals.

The NER does however impose certain pricing publication requirements on a DNSP once its annual pricing proposal is approved by the AER. The DNSP must publish:

- a statement of the DNSP's tariff classes and the tariffs applicable to each class;
- for each tariff – the charging parameters and the elements of the service to which each charging parameter relates; and
- a statement of expected price trends (to be updated for each regulatory year) giving an indication of how the DNSP expects prices to change over the regulatory control period and the reasons for the expected changes.[15]

The NER requires this information to be published on the DNSP's website 20 business days before commencement "if practicable", or "as soon as practicable" thereafter.[16] Since the regulatory year for network price changes is 1 July in all NEM jurisdictions except Victoria, the effective date for publication of this information in those jurisdictions is in June. In Victoria the regulatory year commences on 1 January and the date for publication of the network pricing information would occur in December.

The types of network tariffs that apply to similar type of customers vary from DNSP to DNSP. Table 2.1 provides a sample of network tariff structures for residential

12 NER clause 6.18.8(a).

13 NER clause 6.18.8(b).

14 NER clause 6.18.8(c).

15 NER clause 6.18.9(a).

16 NER clause 6.18.9(b).

customers in 2013-14 within the NEM. The typical residential network tariff is the tariff for each DNSP with the highest number of customers and applies to residential customers on the DNSP's network regardless of location. There are a number of other tariffs that DNSPs have that include time and demand based charges. However, these tariffs only apply to a small proportion of customers and have not been included in the table below.

Table 2.1 Structure of typical residential network tariffs in 2013-14

DNSP	Tariff name	Tariff structure
ActewAGL	Residential basic network	Two-part tariff comprised of a fixed charge in cents per day and a flat volume charge in cents per kWh.
Ausgrid	LV Res non-TOU	Three block, inclining block tariff comprising of a fixed charge in cents per day and three volume charges in cents per kWh hour. A relatively low volume charge for use below 1000kWh per billing quarter, a medium rate for use between 1000-2000 kWh per quarter and a relatively high rate for usage above 2000kWh per quarter.
Energex	Residential flat	Two-part tariff comprised of a fixed charge in cents per day and a flat volume charge in cents per kWh.
South Australian Power Networks	Low voltage residential single rate	Four block, inclining block tariff comprising of a fixed charge in cents per day and four volume charges in cents per kWh hour. A relatively low volume charge for use below 333.3kWh per month, a low-to-medium rate for use between 333.3-833.3kWh per month, a high-to-medium rate for use between 833.3-1666.6kWh per month and a relative high rate for use above 1666.6kWh per month.
Aurora Energy	General network residential	Two-part tariff comprised of a fixed charge in cents per day and a flat volume charge in cents per kWh.
CitiPower	Low voltage residential single rate	Two block, inclining block tariff comprising of a fixed charge in cents per day and two different volume charges in cents per kWh hour. A relatively low volume charge for use below 340kWh per month and a relatively high rate for use above 340kWh per month.

Source: ActewAGL approved 2013-14 pricing proposal, Ausgrid approved 2013-14 pricing proposal, Energex approved 2013-14 pricing proposal, South Australian Power Networks 2013-14 approved pricing proposal, Aurora Energy 2013-14 approved pricing proposal and CitiPower 2013 approved pricing proposal.

2.2 Power of Choice Review recommendations

In November 2012, the AEMC completed the *Power of Choice Review* and submitted its final report to SCER.[17] This review recommended a package of reforms designed to

17 AEMC, *Power of choice review - giving consumers options in the way they use electricity*, Final Report, 30 November 2012.

increase the responsiveness of the demand side to evolving market and technological developments and changing future consumer interests. The AEMC concluded that efficient and flexible pricing options are important tools to help consumers to adapt their consumption patterns and hence manage expenditure.

The AEMC, amongst other things, recommended to SCER a package of rule changes to address identified deficiencies in the current distribution network pricing arrangements.

The specific recommendations included:

- changes to the distribution pricing principles to facilitate DNSPs to set efficient and flexible network tariffs;[18]
- a new requirement for DNSPs to develop and consult with retailers and consumer groups on a statement of proposed network pricing structures as part of their regulatory proposals;[19]
- more robust consultation and verification applied to the annual network tariff setting process, including consulting on requested changes to the approved statement of network pricing structures;[20]
- possible changes to the network pricing side constraints that prohibit price changes from one year to the next; and[21]
- a requirement for the AER to publish a guideline for network tariff arrangements.[22]

2.3 Rule change request from IPART

On 12 September 2012, IPART submitted a rule change request relating to the annual distribution network pricing arrangements. IPART's rule change request identified a number of issues, including that the current annual network pricing process:

- does not provide for adequate notification of network prices creating difficulties for retailers in passing on annual network price changes to consumers;
- lacks consultation with retailers and consumers in the development of network prices; and
- does not provide certainty for retailers and consumers with regard to forward network prices.

18 id., pp. 183-186.

19 id., p.190.

20 id., p. 191.

21 id., p. 189.

22 id., p. 181.

To address these issues, IPART has proposed that:

- the annual network pricing process timeframe for transmission and distribution network service providers be moved forward to allow the annual approval and notification of distribution network prices to occur at least two months prior to taking effect (this also entails transmission network prices being notified two months earlier, ie. by 15 March). IPART also raised the issue of changes to initial year network pricing processes, but deferred the solution to the AEMC;

- the AER to be required to develop guidelines that outline how DNSPs should consult with retailers and consumers in developing and changing their statement of expected price trends. As part of developing the guidelines, the AER would establish what information DNSPs should include in their statement of expected price trends and the timing of the statement; and

- to provide certainty about changes to future prices, the AER should be required to consider whether the DNSPs' annual pricing proposals are consistent with their statement of expected price trends before the AER approves their network price changes each year.

On 6 June 2013, the Commission issued a notice under the National Electricity Law (NEL) to commence the *Annual Network Pricing Arrangements* rule change request from IPART. A consultation paper was also published on 6 June 2013 seeking comments from stakeholders.[23] Further details on the IPART rule change request are set out in that initial consultation paper which is available on the AEMC's website.

On 29 August 2013, the AEMC extended the rule change process timeframe to allow for additional stakeholder consultation. At that time, the AEMC had not received the rule change request from SCER.

23 AEMC, *Annual Network Pricing Arrangements*, Consultation Paper, 6 June 2013.

3 Details of SCER's Rule Change Request

This chapter summarises the rule change request received from SCER.

The rule change request identifies a number of issues in the current distribution network pricing framework. These include:

- the need for consultation on a DNSP's proposed network tariff structures and earlier provision of more detailed network pricing information;
- requiring DNSPs to set cost reflective network tariffs in accordance with Long Run Marginal Cost (LRMC) to reflect efficient network costs;
- requiring DNSPs to take into account consumer impacts in designing efficient network tariffs;
- allowing recovery of residual network costs in a manner that is efficient and does not distort or undermine flexible pricing;
- amending the tariff class provisions to promote clarity and certainty in how DNSPs should group customers into different tariff classes; and
- extending the operation of side constraints on annual network price changes.

Each of these issues is briefly described below.

3.1 Consultation on network tariffs and timing changes

3.1.1 Issues identified

SCER notes that DNSPs currently have wide discretion over the structure and application of their network tariffs. It suggests that stakeholders such as end-use consumers and retailers are particularly affected by the choices that DNSPs make in relation to their tariff structures. Furthermore, SCER suggests that retailers and consumers may need to plan some time ahead to adapt to the cost impacts of changes in network tariff structures.

SCER states that the information currently made available to DNSPs' customers on future expected pricing changes is limited. It also states that the annual network pricing process does not require DNSPs to align their price changes with past projections.

SCER further states that while DNSPs are currently required to consult with their customers in relation to their regulatory proposals to the AER, they are not required to consult with their customers or retailers in setting their tariff structures.

3.1.2 Proposed solution

In order to improve consultation on the development on network tariffs by DNSPs, SCER has proposed the introduction of a new framework for how the distribution network pricing process will operate. As part of this framework, SCER has proposed a significant change to the timing of the pricing process. Instead of this occurring entirely after the AER approves revenues, SCER proposes that consultation and approval of network tariff structures would occur during the DNSP's regulatory determination process. There would still be an approval process for pricing levels after revenues are determined.

The key feature of this new framework would be the introduction of a document that would set out a DNSP's proposed network tariff structures. SCER's proposal refers to this document as a Pricing Structures Statement (PSS). SCER notes that the intent of the PSS is to:

- assist consumers and other stakeholders to respond effectively to changing network tariff structures and pricing levels over the coming determination period by providing information on tariff classes, tariff structures and charging parameters;
- support the development of flexible network tariffs that can be passed through to consumers in retail tariffs;
- provide transparency and allow scrutiny (in particular by AER) that pricing principles have been followed; and
- inform the subsequent annual network tariff publication processes.

The PSS would need to be consistent with the distribution pricing principles and approved by the AER as part of the regulatory determination process. Network tariffs proposed by the DNSP in their annual network pricing proposals to the AER would need to comply with the approved network tariff structures in the PSS. DNSPs would be able to amend the PSS during the regulatory period subject to consumer consultation and AER approval.

While the PSS would include a statement on expected pricing levels on proposed network tariff structures, SCER's proposal indicates that the network pricing levels would not be binding on the DNSP in their annual pricing proposals.

In addition, SCER has proposed that the AER should be required to develop consultation guidelines on how DNSPs are to consult in developing and changing the PSS.

SCER has also proposed consideration of changes to the timing of the annual network pricing process under the new framework to allow earlier notification of approved annual network tariffs. However, it has deferred the solution on the timing to the AEMC.

3.2 LRMC as the basis of setting cost reflective network tariffs

3.2.1 Issues identified

SCER has proposed a number of changes to the existing distribution pricing principles in the NER that guide DNSPs in how they should set network tariffs to better reflect the efficient costs of providing network services to customers on their networks.

SCER notes that energy and network costs are currently averaged by a combination of fixed and variable charges across the vast majority of residential and small business consumers. SCER states that this approach results in each customer paying a proportion of total costs that depends on their absolute consumption level rather than taking into account the timing and locational aspects of their consumption, which are important drivers of network costs.

SCER states that having network tariffs that reflect the structure of network costs is important because it provides efficient signals for consumers to capture the value of their demand side participation, such as reducing consumption at peak times. This in turn will reduce network and other system costs over time.

SCER considers that DNSPs should be required to set network tariffs on the basis of the long run marginal cost (LRMC) of providing network services.[24]

LRMC is important for cost reflective network tariffs because it signals the future costs of investing in the network. As consumption increases, the capacity of the network requires augmentation to accommodate the additional demand. Therefore, in order for consumption decisions to take into account these increased costs, current network tariffs need to reflect the expected additional costs arising from additional consumption. SCER notes that if network tariffs provide a price signal that reflects the consequences of increasing consumption on future network costs, then it provides consumers with the opportunity to contribute to lowering future network costs and thereby potentially facilitate a reduction in their own network charges.

SCER considers that the significant discretion that DNSPs currently have in setting network tariffs, and the insufficient guidance that the NER provide about the interpretation and application of LRMC as a pricing principle, have resulted in DNSPs not setting network tariffs in a way that reflects LRMC.

SCER agrees with the P*ower of Choice Review* conclusions that the existing lack of prescription in the distribution pricing principles of using the LRMC are based on a misconceived assumption that price capped DNSPs are incentivised to price at efficient

24 Marginal costs represent the change in costs that arise from a change in demand in the 'short run' or 'long run'. In the short run, investments in capacity and overhead is fixed and so marginal cost captures operational inputs such as additional labour, materials and energy. However over the long run all inputs can feasibly be altered such that marginal cost captures the cost of building additional capacity.

costs. SCER acknowledges that this may not be the case given that the profits of price capped DNSPs are linked to volumes and not efficiency.[25]

SCER also considers that the use of LRMC to set network tariffs can be enhanced if there is a link between LRMC and peak utilisation of the network. This would be achieved where LRMC based network tariffs take into account the additional costs of meeting demand at times of greatest utilisation of the network (coincident peak demand).

In addition, SCER recognises that LRMC is likely to vary depending on the level of spare capacity in different parts of the network and that the distribution pricing principles should encourage DNSPs to set network tariffs that reflect this variability.

As a result of these issues, SCER suggests that DNSPs have tended to use more stable pricing approaches such as flat or inclining block tariffs. It further notes such pricing approaches also reflect a compromise of a range of factors, including:

- jurisdictional limitations on geographic price variation for specific customer classes;
- transaction costs of developing or designing flexible tariffs;
- perceptions on whether consumers are capable of responding to any tariffs developed.

3.2.2 Proposed solutions

Having regard to the AEMC's findings and recommendations from the *Power of Choice Review*, SCER has proposed amending the distribution pricing principles to include:

- a requirement for network tariffs developed by DNSPs to be based on the LRMC of providing network services, rather than just being required to take LRMC "into account";
- a requirement for network prices to be determined having regard to their impact on consumers and the additional costs associated with peak demand;

25 Under a revenue cap, DNSPs do not have an incentive to set efficient network tariffs that reflect the underlying costs of supply, given that they receive the same, fixed amount of revenue over the regulatory control period irrespective of the network prices they set. Under a price cap, the actual revenue earned by the DNSP will depend on actual quantities sold under each tariff component. This means that the revenue earned by the DNSP within the regulatory control period is affected by changes in demand such that where demand is greater than (or less than) initially forecast, DNSPs will earn greater than (or less than) the revenues determined under the building block cost build-up. A price cap therefore exposes DNSPs to a greater degree of volume and profitability risk where demand differs from forecast. In theory, a price cap form of control provides incentives for DNSPs to adopt more efficient pricing structures, as a means of addressing the profitability risk they face.

- a requirement for network prices to be determined having regard to the extent to which the LRMC of providing network services may vary by customer location (this could, for example, be the result of current and forecast constraints within the distribution network);

- a requirement to for network prices to be determined having regard to any transaction costs associated with implementing the tariff; and

- a requirement to for network prices to comply with relevant jurisdictional instruments (this is in recognition of the fact that DNSPs may be limited in the extent to which they can base prices on LRMC, locational, or temporal factors by jurisdictional constraints).

SCER's proposed changes also recognise that there would be value in AER providing guidance and clarity to DNSPs on how the LRMC could be interpreted and applied in deriving network prices.

3.3 Consumer impacts

3.3.1 Issues identified

SCER states that the introduction of flexible pricing options resulting from a move to cost reflective pricing could expose some consumers to a range of new and different network tariff structures. It notes that the existing distribution pricing principles set out that DNSPs are to have regard to whether a consumer is able or likely to respond to network price signals.

SCER suggests that this principle could be interpreted to mean that network tariffs should be set in a way that matched the price responsiveness of consumers, rather than how such tariff structures and price levels may impact particular types of consumers, such as those with limited capacity to respond to proposed pricing options.

As a result, SCER suggests that there is a risk that costs may be shifted onto consumers with flat network tariffs as these consumers are less likely to respond and adjust their behaviour.

3.3.2 Proposed solution

SCER has proposed replacing the existing distribution pricing principle on having regard to whether a consumer is able or likely to respond to network price signals with a requirement for DNSPs to have regard to how their proposed tariff structures and prices may impact on different classes of consumers.

SCER suggests that an important way for DNSPs to meet this principle will be to engage in appropriate consultation on the PSS as discussed in section 3.1 above.

3.4 Recovery of residual network costs

3.4.1 Issues identified

SCER notes that when network tariffs are set to recover LRMC, it could lead to under recovery of total network costs. This is because LRMC only provides pricing signals for efficient forward-looking costs.

SCER considers that while forward-looking efficient prices provide the appropriate price signal, the costs of historical investment decisions by DNSPs also need to be recovered from consumers. SCER suggests that these costs should be recovered in network tariffs in an economically efficient and non-distortionary manner.

3.4.2 Proposed solution

SCER has identified two approaches that could be considered to recover residual network costs in a non-distortionary manner where LRMC is applied. It has identified:

- a "Ramsey pricing" pricing approach which suggests that recovery of such costs is most efficiently allocated to consumers with the lowest price responsiveness, or at times when demand responsiveness is lowest; and
- a "postage stamp" pricing approach where the unit charge does not vary with consumption or location but is applied as widely as possible so as not to affect existing utilisation of the network.

SCER has not sought to propose a particular pricing approach in its rule change request. Rather, it has requested the AEMC to consider what mechanism for recovering residual costs would be most appropriate (postage stamp, Ramsey pricing or an alternative approach). SCER has also noted that should the AEMC consider that a single approach is not appropriate for all jurisdictions or distribution network areas, it could also consider whether the AER should be given the discretion to determine the best approach at the time of making a regulatory determination.

3.5 Determining tariff classes

3.5.1 Issues identified

The NER requires DNSPs to define customers into different tariff classes. DNSPs must then set network tariffs for each tariff class in accordance with the distribution pricing principles and other applicable provisions in the NER. Tariff classes recognise there are differences between consumers and allow tariffs to be better tailored to the circumstances of a particular group.

SCER notes that the tariff class provisions in the NER currently allow DNSPs to group their customers into tariff classes on an economically efficient basis and avoid unnecessary transaction costs. However, SCER suggests that these provisions are

currently not a mandatory requirement for DNSPs (tariff classes must only be constituted "with regard to" these matters), and so DNSPs have the discretion to group customers on some other basis if they wish.

SCER considers that these provisions do not provide clarity and certainty as to how customers should be grouped together.

3.5.2 Proposed solution

SCER has proposed to make the existing tariff class provisions mandatory for DNSPs.

Under SCER's proposal, DNSPs "must" constitute a tariff class of customers on an economically efficient basis and avoid unnecessary transaction costs rather than only "have regard to" the need to do so. This will have the effect of reducing the discretion DNSPs currently have in developing tariff classes.

3.6 Side constraints

3.6.1 Issues identified

Side constraint provisions in the NER limit the magnitude of changes to network tariff pricing levels for particular tariff classes from year to year in order to reduce price shocks for consumers. The side constraints apply at the tariff class level and apply to the increase in weighted average tariff revenue beyond any revenue changes approved by the AER.

SCER has raised two specific issues with current side constraint provisions.

First, it considers that the NER may lack clarity on whether consumers with interval meters are exempt from side constraint provisions. It is of the view that tariff price changes for these consumers should be subject to side constraints.

Secondly, SCER considers that under its proposed new network pricing framework, the PSS will be an important guiding document for changes in network tariff structures through the regulatory control period. As a result, SCER suggests that consumers will expect that the network tariff structures prevailing at the end of a regulatory control period will form the basis of those at the beginning of the next, and that further substantial change will be proposed and evaluated through a subsequent PSS. SCER is of the view that this expectation is not reflected in the current side constraint rules which only apply within and not between regulatory control periods.

3.6.2 Proposed solution

SCER proposes amending the current side constraint provisions to:

- remove clause 6.18.6 (e) of the NER to clarify that regardless of whether consumers have interval meters or traditional accumulation meters, the side constraint provisions apply to their tariff; and
- apply the side constraint provisions between, as well as within, regulatory control periods.

3.7 Comparison of proposals from SCER and IPART

While there are significant similarities between the proposals of SCER and IPART, there are also some important differences. The table below compares key elements of the two proposals.

As Table 3.1 illustrates, the key area of overlap between the two proposals is in relation to consultation on network tariff structure and prices. IPART's proposal does not address the other aspects of SCER's rule change request.

In relation to consultation on network tariffs, both proposals would require DNSPs to consult with consumers and retailers in the development of a document that outlines the DNSPs' proposed network tariffs. Under both proposals, these documents would shape the DNSPs' annual network pricing proposals and would be somewhat binding on the DNSP. However, the content of SCER's proposed PSS would be set out in the NER, while the content of the statement of expected price trends document under IPART's proposal would be determined by AER guidelines. Further, while the PSS would be approved by the AER, the statement of expected prices would not be subject to any regulatory oversight.

Consultation on the development of network tariffs is considered in more detail in Chapter 6.

Table 3.1 Comparison of SCER and IPART rule proposals

Aspect of rule proposal	SCER	IPART
Consultation on network tariffs	Require DNSPs to develop a PSS that sets out their proposed network tariff structures for the regulatory control period. The PSS would need to be consistent with the distribution pricing principles and approved by the AER as part of the regulatory determination process. Tariff structures in the approved PSS to be applied by DNSPs in their annual pricing proposals. DNSPs can seek variations to the PSS within a regulatory control period from the AER if appropriate consultation is undertaken. AER guideline would outline how DNSPs should consult in developing and amending the PSS. Annual pricing process timing to be brought forward as appropriate to allow earlier notification of approved network tariffs.	Require DNSPs to consult with retailers and consumers in the development of the current statement of expected price trends document. This document would apply until amended by the DNSP. Content requirements of this statement would be set out in an AER guideline. This guideline would also establish the consultation that would need to be undertaken in developing and changing the statement. The AER would be required to assess the DNSP's annual pricing proposal against the pricing principles and consistency of proposed network tariffs against the DNSP's statement of expected price trends. Annual pricing process timing to move forward so that network tariffs are finalised two months prior to taking effect. Transmission Network Service Providers (TNSPs) to finalise transmission prices two months earlier than currently and DNSPs to commence their pricing process one month than currently. AER to have one month to approve network tariffs when DNSP submits its annual network pricing proposal.

Aspect of rule proposal	SCER	IPART
LRMC as the basis of setting cost reflective network tariffs	Amend the distribution pricing principles to require that network prices are based on LRMC and determined having regard to their impact on consumers and the additional costs associated with peak demand; the extent to which LRMC may vary depending on customer location; and transaction costs associated with implementing the tariff.	Not addressed.
Taking into account consumer impacts	Require DNSPs to have regard to how their proposed tariff structures and pricing levels may impact on different classes of consumers.	DNSPs to consider consumers views when consulting on their statement of expected price trends in accordance with consultation requirements to be set out by the AER in a guideline.
Recovery of residual network costs	Allow for a mechanism for recovering residual costs in an economically efficient and non-distortionary manner.	Not addressed.
Determining tariff classes	Require DNSPs to constitute a tariff class of customers on an economically efficient basis and avoid unnecessary transaction costs.	Not addressed.
Side constraints	Clarify that the side constraint provisions apply to consumers regardless of whether they have interval meters or traditional accumulation meters and apply the side constraint provisions between, as well as within, regulatory control periods.	Not addressed.

4 Consolidation of the Rule Change Requests

IPART's rule change request on the *Annual Network Pricing Arrangements* deals with a similar subject matter to SCER's rule change request in respect of consultation on the development of network tariffs and improving the existing annual network pricing process.

Having regard to the fact that the two rule change requests have raised issues that overlap, the AEMC has decided that these two rule change requests should be consolidated into one rule change process.

Through consolidation, the AEMC will be able to consider the issues raised by both rule change requests together and make an informed decision about the problems identified in the distribution network pricing arrangements framework in both the rule change requests. Additionally, consolidation will make it easier for stakeholders to engage in the rule change processes. By consolidating, stakeholders will not be required to engage separately on two rule processes which consider very similar issues.

The consolidated rule request will follow the extended timetable that was established for IPART's *Annual Network Pricing Arrangements* rule change request on 29 August 2013. The indicative timetable, including various stages of stakeholder consultation, is provided in section 1.4.

5 Assessment Framework

The Commission's assessment of the consolidated rule request must consider whether the proposed rules promote the NEO as set out under section 7 of the NEL.

The NEO states that:

> "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."

The NEO refers to the three fundamental limbs of efficiency: allocative (efficient use of), productive (efficient operation) and dynamic efficiency (efficient investment). The AEMC will be required to form a balanced view of the rule change requests with respect to all three aspects of efficiency.[26]

Having regard to these concepts of efficiency, the AEMC intends to assess whether the rule changes proposed by IPART and SCER promote efficiency using the following criteria:

- efficient pricing;
- stakeholder engagement;
- predictability;
- allocation of risks; and
- regulatory burden.

The AEMC has added efficient pricing as an additional criterion to its assessment framework originally proposed for the IPART rule change request. It reflects the requirement for the AEMC to consider the additional rule change proposed by SCER as part of a consolidated rule request that relates to reforming the distribution pricing principles in Chapter 6 of the NER.

---

26 Allocative efficiency is achieved when resources used to produce a given set of goods and services are allocated to their highest value uses. This requires that goods and services are provided, and that consumption decisions are made, on the basis of prices that reflect as closely as possible the opportunity (or marginal) cost of supplying those goods and services. Productive efficiency is achieved when only the minimum resource inputs are used to produce a given set of goods and services. Achieving productive efficiency is important because it avoids wasting resources which could have been used for producing something else. Dynamic efficiency is concerned with ensuring allocative and productive efficiencies are sustained over time. This requires markets and supporting regulatory arrangements to provide incentives for firms to innovate and invest at efficient levels over time

The AEMC has also sought, in the scope of this criterion, to address concerns raised in submissions to the IPART consultation paper that the previous assessment framework did not adequately address a requirement for DNSPs to have sufficient flexibility to structure their charges in ways that recover efficient costs.[27]

Each of these criteria in relation to the rule changes proposed are briefly discussed below.

5.1 Efficient pricing

The SCER rule change request seeks to promote efficient price setting in the NEM. The AEMC intends to assess whether the rule changes proposed will promote efficiency by having regard to two important objectives of a pricing framework in relation to network services.

First, prices should signal to consumers the future (or avoidable) costs of providing network services, as it is these costs that consumers can influence by making informed choices about their consumption. A price signal based on future costs provides opportunities for consumers to respond by adjusting their consumption in ways that can reduce their own cost of using the network as well as contribute to reducing future network costs more broadly.

Second, efficient prices should also allow DNSPs to recover the sunk costs of providing network services. If DNSPs are not assured of recovering efficient costs that they have already incurred, then this may diminish their incentives to undertake future investment in the network in a timely and efficient manner. Such an outcome would be inconsistent with achieving dynamic efficiency under the NEO.

An important challenge for the distribution pricing principles framework is to provide sufficient flexibility and guidance to encourage DNSPs to set network prices that achieve the two objectives of signalling future costs and recovering sunk costs of network investment. The AEMC intends to consider whether the proposals put forward by SCER in relation to reforming the distribution pricing principles achieve these objectives in a way that contributes to the NEO.

5.2 Stakeholder engagement

In order for prices to be effective in their role in allocating resources and reducing costs, consumers must be able to respond to them. Without the ability of consumers to understand and respond to price signals there is no increase in efficiency because outcomes will not change.

Stakeholder engagement, by providing scope for consumers' views to influence outcomes, is an important means by which network tariffs and prices can be developed that are meaningfully understood by consumers. It will also provide an opportunity

27 Networks NSW, Submission to the Consultation Paper, 4 July 2013, p. 3.

for consumers to better understand how to respond to the pricing signals that are being provided.

While competitive firms operate by generating efficient price signals and eliciting effective stakeholder engagement, this is not the case for the provision of network services. DNSPs are not subject to the disciplines of a competitive market to determine the needs and preferences of consumers. Effective stakeholder engagement needs to be elicited more directly through regulatory measures. At the core of the IPART and SCER rule change requests are new consultation requirements which seek to provide for such stakeholder engagement.

The AEMC considers effective stakeholder engagement in the network price setting process will promote efficiency. It intends to consider whether the proposals put forward by SCER and IPART regarding consultation are an effective means of providing for stakeholder engagement in the pricing process.

5.3 Predictability

A regulatory framework that promotes predictability (minimise uncertainty) supports both allocative and dynamic efficiency in a number of ways.

First, from the perspective of businesses operating in a regulatory environment, predictability supports confidence in and credibility of markets and supporting regulatory arrangements. If businesses have confidence in the regulatory arrangements, this in turn encourages them to continue to participate and invest in the market, which promotes dynamic efficiency. In this context, changes to the rules should be transparent and easily understood, with obligations and the manner in which to meet those obligations, are clearly specified. This leads to more predictable outcomes for businesses. Where changes lead to unanticipated outcomes, are misunderstood or are overly complex, this can undermine dynamic efficiency, as it may diminish incentives for businesses to make long term investments which reduce costs, or improve service quality, over time.

Second, from the perspective of consumers, the same principles apply. Prices can only elicit efficient outcomes if consumers understand them and have a reasonable opportunity to respond to and manage their costs in light of those prices. Prices should as a consequence be simple, transparent and predictable. This will require effective consumer engagement. Further, large step changes in prices, particularly where they are unanticipated, are likely to undermine consumer confidence in markets and supporting regulatory arrangements.

The AEMC will therefore assess the degree to which the proposed rule changes by IPART and SCER are likely to support predictable outcomes for retailers, DNSPs, TNSPs and consumers.

5.4 Allocation of risks

The rule changes proposed by IPART and SCER will change the nature and allocation of risks faced by DNSPs, TNSPs, retailers and consumers. For example, as discussed in the initial consultation paper on IPART's rule change request, bringing forward the timing for when network prices should be published could increase risks for TNSPs and DNSPs because network prices will be based on less certain information and therefore may increase the prospect of them not recovering their allowed revenues.

On the other hand, the existing arrangements create risks for retailers and their customers, because if they do not have sufficient time to incorporate published network prices into their retail prices, they will need to use estimated prices, which could lead to inefficient pricing outcomes. The effect of the IPART proposal to bring forward the timing is therefore to shift this risk from retailers/consumers to TNSPs and DNSPs.

The fact that risks may be created or shifted by certain changes to the NER does not preclude changes from being made. Risks need to be managed, which means they result in costs for those parties who are subject to them. An important question is, therefore, who is best placed to bear any new risks introduced by the proposed rules?

As a general principle, to achieve efficiency, risks should be allocated to those who are best able to manage them. This ensures the costs of managing the risk are minimised, which supports productive efficiency. Dynamic efficiency is also supported because if the environment in which businesses operate becomes riskier, this is likely to reduce incentives for them to invest and innovate.

The AEMC intends to assess the nature and allocation of risks that may be created for all relevant stakeholders by the proposed rule changes by IPART and SCER.

5.5 Regulatory burden

The AEMC is of the view that productive efficiency applies equally to regulatory and administrative arrangements as much as it does to market processes. Changes to the NER should always be the minimum required to achieve their intended objectives and such change should not create an unnecessary compliance burden for stakeholders.

The IPART and SCER rule requests create new obligations for DNSPs with regard to price setting and a supporting compliance framework, which strengthens the role of the AER in approving network charges and charging structures.

The AEMC intends to consider whether the administrative and compliance burden created by the rule changes proposed is likely to be proportionate to the benefits they are seeking to achieve. If the proposed rules are complex to administer, difficult to understand by stakeholders, or impose unnecessary risks, then they are less likely to achieve their intended end, or will do so at higher cost.

Question 1	What other considerations should be included in the assessment framework?

6 Balancing Consultation and Pricing Certainty Objectives in the Network Pricing Framework

6.1 Introduction

The initial consultation, paper published on 6 June 2013, discussed issues arising from IPART's proposal to require DNSPs to consult with retailers and consumers on the development of their network tariff structures and network tariff pricing levels through consultation on the statement of expected price trends document.

The initial consultation paper also discussed issues that were pertinent in considering IPART's objective of achieving a degree of certainty with respect to future network tariff pricing levels.

SCER's proposal also attempts to achieve the consultation and pricing certainty objectives that IPART's proposal is seeking to achieve. At a basic level, both proposals seek the same thing, being:

- greater consultation on the development of network tariffs; and
- a greater level of pricing certainty with respect to changes to network tariff structures and network tariff pricing levels.

Both rule change requests aim to achieve this consultation and pricing certainty through the concept of a document, developed in advance of the annual network pricing process. This document would provide a framework for how network tariffs will be structured for a particular DNSP.

This chapter discusses some of the overarching concepts that need to be considered in understanding the role a document on network tariffs would play in the network pricing framework where it is approved in advance of the annual pricing process. It then discusses the factors that will influence the effectiveness of a network tariff document in terms of its content and whether or not the document becomes binding on the DNSP once approved. This chapter highlights some necessary trade-offs between these two factors.

For the purpose of this document, a network tariff structure refers to the price structures through which a DNSP recovers its allowed revenues, applicable transmission charges and any amounts to recover jurisdictional scheme obligations.[28] Network tariff structures contain the least amount of detail about how network prices will impact a consumer and purely describe how the DNSP will charge for use of the network. Network tariff pricing level refers to both the network tariff structure and the prices attached to each network tariff. Ultimately, network tariff pricing levels will determine how a consumer is impacted by network charges. The distinction between

28 For a discussion on how DNSPs recover transmission charges see section 9.5 below.

network tariff structures and network tariff pricing levels is explored in greater detail in section 6.3.1.

Implementation issues associated with the new pricing framework proposed by SCER are discussed in Chapter 7.

6.2 Stakeholder views on IPART's proposal

The AEMC has already received a number of submissions in response to its initial consultation paper on IPART's rule change request. Generally, stakeholders agree that there is some scope for consultation in the development of network tariffs. However, views are more divergent in regards to where in the pricing process this consultation would be best placed. These are relevant to the consideration of the SCER rule change request.

DNSPs were generally supportive of consultation on the development of network tariff structures, but are not supportive of consultation on network tariff pricing levels. DNSPs acknowledge that consultation on network tariff structures can be beneficial and assist in facilitating better understanding and responsiveness by retailers and consumers to changes in network tariff structures and network tariff pricing levels.[29] However, they highlight that there are a number of inputs in network tariff pricing levels that are uncertain and which can constrain their ability to effectively take into account stakeholder feedback.[30] Therefore, DNSPs consider that any requirements for consultation should be limited to network tariff structures.

Retailers were very supportive of consultation on both network tariff structures and network tariff pricing levels.[31] Retailers submit that the introduction of consultation requirements will lead to more cost reflective and innovative retail tariffs and will allow retailers to pass on network pricing signals.[32] It was submitted that, combined with earlier notification of final network tariffs for retailers, this would improve the ability of retailers to offer competitive retail tariffs, leading to better outcomes in the retail market consistent with the long term interests of consumers.

Similarly, IPART and the AER also supported the introduction of consultation requirements in the network tariff setting process. The AER supports IPART's proposal that DNSPs be required to consult with consumers in the development of the statement of expected price trends, but considers that more detailed information about network

29 ENA, Submission on the rule change request, 5 July 2013, pp. 4-5; Networks NSW, Submission on the rule change request, 4 July 2013, p. 4; SAPN, Submission on the rule change request, 4 July 2013, p. 4; United Energy, Submission on the rule change request, 4 July 2013, p. 5.

30 ENA, Submission on the rule change request, 5 July 2013, pp. 4-5; CitiPower and Powercor, Submission on the rule change request, 4 July 2013, p. 5.

31 EnergyAustralia, Submission on the rule change request, 4 July 2013, p. 20; Origin Energy, Submission on the rule change request, 4 July 2013, p. 4; Lumo, Submission on the rule change request, 8 July 2013, p. 4.

32 EnergyAustralia, Submission on the rule change request, 4 July 2013, p. 20; Origin Energy, Submission on the rule change request, 4 July 2013, p. 4.

tariff structures needs to form part of this consultation.[33] IPART expressed a preference for consultation to be both on network tariff structures and network tariff pricing levels.[34]

In relation to the prescriptiveness of consultation requirements, DNSPs generally favour a more discretionary approach to consultation. DNSPs submit that consultation requirements should give DNSPs the flexibility to determine what degree of consultation is required and how often it should occur.[35] DNSPs further submit that consultation should be guided by the degree to which stakeholders want to, and are able to, be engaged in the network tariff setting process.[36]

In contrast, retailers note that some DNSPs currently consult with retailers on the development of network tariffs, but that the extent of that consultation varies greatly.[37] As such, retailers consider that there is merit in having a standard approach to consultation to establish a minimum standard of information exchange and support the development of an AER guideline to outline how DNSPs should consult with retailers and consumers.[38]

Energy users and consumers also support increased consultation and consumer involvement on the development of network tariffs.[39] To encourage meaningful consultation by DNSPs, the Public Interest Advocacy Centre (PIAC) suggests that DNSPs be required to show the AER how they considered feedback from residential consumers in their annual network pricing proposals.[40]

6.3 Role of a document on network tariffs

The objective of SCER's proposal for the introduction of a PSS is to have a document that sets out network tariffs in advance of the annual pricing process. Such a document could address the consultation and pricing certainty issues raised by both SCER and IPART.

First, if implemented in a process separate from the annual pricing process, greater time would be available for consultation on network tariffs with stakeholders than is currently the case. Second, if this document could continue in effect for multiple years, then it could provide greater certainty over how a DNSP's network tariffs are likely to change during its regulatory period. Third, it would also serve as an early guide to any

33 AER, Submission on the rule change request, 5 July 2013, p. 5.

34 IPART, Submission on the rule change request, 4 July 2013, p. 6.

35 ActewAGL, Submission on the rule change request, 4 July 2013, p. 2; Ergon Energy, Submission on the rule change request, 4 July 2013, p. 10.

36 Jemena, Submission on the rule change request, 4 July 2013, p. 2.

37 AGL, Submission on the rule change request, 12 July 2013, p. 2.

38 AGL, Submission on the rule change request, 12 July 2013, p. 2; Momentum Energy, Submission on the rule change request, 4 July 2013, p. 3.

39 Energy Users Association of Australia, Submission on the rule change request, 5 July 2013, p. 1; Public Interest Advocacy Centre, Submission on rule change request, 3 July 2013, p. 3.

changes that could occur in the DNSP's network tariffs, giving retailers more time to develop retail tariffs to accommodate such changes. It could also provide consumers with more time to plan ahead to adapt to the cost impacts of shifting network tariffs.

The effectiveness of a document on network tariffs will principally depend on two key factors and the trade-offs between them:

- *Content* – the amount of detail the document contains on network tariff structures and network tariff pricing levels; and
- *How binding it is* – how often the document is able to be varied and the extent to which the DNSP can move away from the network tariff structures contained in the document in its annual pricing proposal.

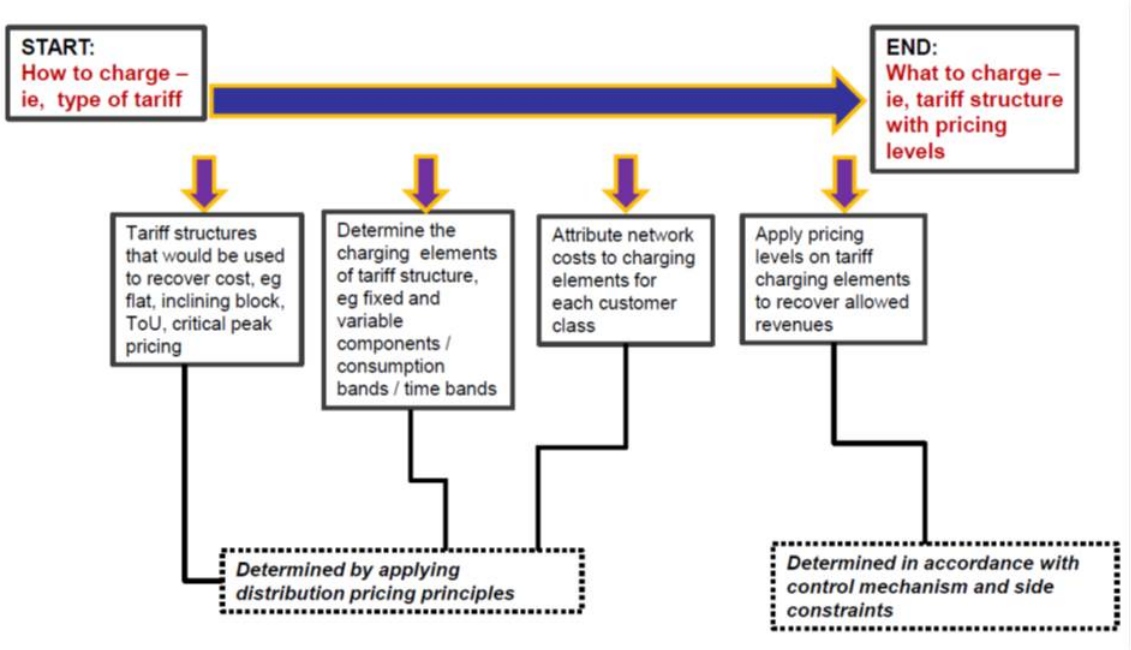
Ultimately, the interaction between these two factors will determine the role of the PSS. The current statement of expected price trends could also be expanded to play a similar role, as proposed by IPART. These factors are discussed in turn below

6.3.1 Content of PSS: Network tariff structures versus network tariff pricing levels

A network tariff is the basis through which DNSPs charge their customers for the cost of providing network services. The charges that are attached to the network tariffs can be viewed as being comprised of four different elements of a process that begins with decisions about how to charge and ends with decisions about what to charge. A schematic representation of this process is shown in Figure 6.1 below.

40 Public Interest Advocacy Centre, Submission on rule change request, 3 July 2013, p. 3.

Figure 6.1 Concept of network tariff structures and network tariff pricing levels



First, at the highest level, are the network tariff structures. Network tariff structures refer to the price structures through which the DNSP is able to recover its allowed revenues as determined by the AER in its regulatory determinations as well as applicable transmission charges.[41] Network tariff structures include flat tariffs, consumption block structure such as inclining block tariffs, time of use or variations of time of use such as peak/off-peak tariffs, seasonal time of use, critical peak pricing, or demand based pricing options ($ per kilowatt hour (KWh) or kilovolt-ampere (kVA) per day). Combinations of these elements may also be adopted. Adopting different network tariff structures allows a DNSP to recover its costs in ways that target different consumers, times of use or levels of demand, among other things.

Network tariff structures are the elements of network pricing that are likely to change the most slowly over time. They also provide the least detail about how network charges will affect a particular consumer. For example, a decision that critical peak pricing is to be used would indicate that high levels of charges will be recovered over a few periods when demand is at its highest. It would not indicate how these periods will be determined or how much would be charged in terms of prices during these periods unless further pricing decisions are made as discussed below.

41 For a discussion on how DNSPs recover transmission charges see section 9.5 below.

Second, at the next level of detail, are the charging elements of the network tariff structures. These relate to decisions about how the DNSP will structure the various components of the network tariff so that it accurately reflects the underlying breakdown of costs of supplying a particular customer or class of customers. For example, if a DNSP had both a fixed and variable cost component, it may decide to structure these components in a certain way so that the breakdown between the fixed and variable costs reflect the respective cost of supplying a particular customer or class of customer.

In determining the appropriate charging elements, a DNSP will have regard to the form of control mechanism it is subject to. For example, a DNSP on a weighted average price cap would take into account the risks from changes in volumes expected to be sold in relation to each proposed network tariff element such as forecasts of customer numbers, volume of energy and maximum demand (where tariffs include a demand charge). A DNSP on a revenue cap on the other hand would not face the same level of volume risk as a DNSP on a weighted average price cap, but simply structure its charging elements in a way that allows it recover its allowed revenues.

Third, there is the way that network costs are allocated to the charging elements. These relate to economic concepts of cost recovery and are developed with regard to concepts such as stand-alone costs, avoidable costs and LRMC.[42]

Finally, at the most detailed level, there is the network tariff pricing levels themselves. This is the actual network tariff that is to be applied, and would be derived from combining the three elements described above. The extent to which the network tariff pricing levels can be set and changed from year to year is dependent on the revenue/price changes allowed by the AER under the control mechanism applicable to each DNSP and the side constraint provisions that limit price changes. It is the network tariff pricing levels attached to the network tariff structures that generate revenues for DNSPs.

The nature and effect of a document that sets out network tariffs is dependent on which level of detail, in relation to the four elements, is included. For it to have any effect at all, it must contain some information on the type of network tariff structures the DNSP would apply. At the most detailed level, it could also include charging elements, network cost allocation methodology and finally, network tariff pricing levels. It therefore follows that the more detailed the information required to be included in a document on network tariff structures, the greater its effect in terms of providing certainty and early notification to retailers and consumers.

If, for example, network tariff pricing levels were included in the PSS this would, depending on how binding the document is, significantly reduce the pricing risk for retailers. However, requiring DNSPs to commit in advance to a particular network tariff pricing level would reduce the pricing flexibility that DNSPs have and therefore increase risk for them. On the flipside, if only network tariff structures were included in the PSS, it would provide less guidance to retailers and consumers on the future

42 See section 9.1 below for further discussion.

direction of network prices, but greater flexibility for DNSPs. Between these extremes, a balance could be to including parts of charging elements and network cost allocation methodology.

In its rule change request, SCER has indicated that the intent of its proposed PSS would be to provide detailed information to assist consumers and other stakeholders to respond effectively to changing prices and structures over the regulatory period by providing information on network tariff classes, network tariff structures and charging parameters. In addition, SCER's rule change request outlines other types of detailed information the PSS could contain, such as:

- how DNSPs have met the pricing principles;
- a breakdown of the network tariff structures that the DNSP proposes to apply;
- expected take up of network tariff structures and allocation of revenue across network tariff structures (which may be based on historical usage);
- changes in network tariff structures over the course of the regulatory control period including;
  - the introduction of new network tariffs, retirement of old network tariffs;
  - an indication as to whether each individual network tariff component would increase by more, less, or about the same as the average change over the regulatory control period;
- expected changes in network charges over the course of the regulatory period;
- expected customer impacts by class;
- how customer consultation, jurisdictional policies and practical constraints (or other relevant provisions in the NER) have shaped proposed network structures;
- how residual costs will be recovered; and
- expected risks and volatility.[43]

Under SCER's proposals, the statement of expected price trends would also be required to be included in the PSS.

Question 2 **Does figure 6.1 reflect the key components of how network tariff structures and pricing levels determined by DNSPs?**

43 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, pp. 8-9.

Question 3	How often are network tariff structures likely to change during a regulatory period and what are some of the reasons for that change?

Question 4	What level of information on network tariff structures and network tariff pricing levels should be included in a network tariff structures document to assist retailers and consumers to understand and respond effectively to changing prices and structures over the regulatory period?

6.3.2 How binding should the PSS be?

The effectiveness of a document on network tariff structures is also determined by how binding it is. This potentially encompasses two elements.

First, the frequency with which a document on network tariff structures could be varied is critical. If a PSS document is determined as part of the AER's regulatory determination for a DNSP, and fixed for the length of the regulatory period, then decisions made on the PSS will have a significant effect on the DNSP.

Removing the ability of the DNSP to adjust its network tariff structures in the PSS as conditions change can potentially expose it to increased financial risks. However, we note that in the context of TNSPs, for example, the pricing methodology is set at the start of the regulatory period and is not able to be varied until the next revenue determination.[44]

Alternatively, it would be possible to allow the DNSP to vary the PSS in order to vary its network tariff structures from time to time, perhaps as often as annually. In this case the DNSP would be tied to a PSS for a shorter period of time, thus reducing its financial risks.

Second, the effect of a document on network tariff structures will be determined by the extent to which it drives the final network prices in the annual pricing process. At one extreme, a PSS could be an indicative document only. In this case the DNSP would not be bound to follow the network tariff structures included in its PSS when it submits its annual pricing proposal. This is the effect of the statement of expected price trends which exists under the NER at present. At the other extreme, the DNSP could be bound to follow the network tariff structures included in the PSS when it sets its annual network prices in the annual pricing proposal, and the AER would approve network prices only where they comply with the PSS document.

---

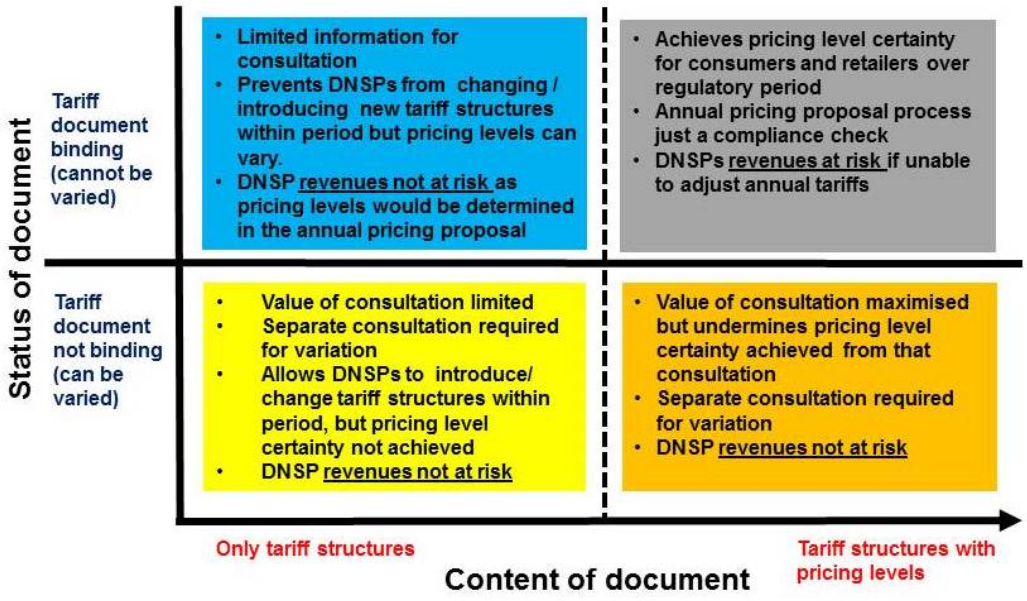
44 The pricing methodology is a methodology that a TNSP applies each year when it allocates its average annual revenue requirement and determines the structure of prices that it will charge for prescribed transmission services (NER clause 6A.24.1).

The binding nature of the PSS may be reinforced by consequences which follow where the AER rejects a DNSP's annual pricing proposal for not complying with the PSS. While this could create greater certainty for retailers and consumers, it also increases risks for DNSPs.

6.3.3 Interaction between the content of a network tariff structures document and how binding it is

There are complex interrelationships between the content of a potential document on network tariff structures and how binding it would be. The following diagram summarises these inter-relationships.

Figure 6.2 Trade-offs between a network tariff structures document and its binding status



The trade-offs shown in Figure 6.2 highlight that if a tariff structures document only contains information on network tariff structures, the value of consultation with stakeholders is limited. This is the case irrespective of whether or not the document is binding on the DNSPs.

Furthermore, where the document contains less information on network tariff pricing levels, DNSPs do not have any revenue risks from having a binding or non-binding document. This is because less information on network tariff pricing levels means that DNSPs would be able to change network tariff pricing levels on an annual basis. Where the document is binding but does not contain network tariff pricing levels, the fact that network tariff pricing levels can vary annually means that the risk to revenue recovery for DNSPs is also minimised.

At the other extreme, where a network tariff structures document contains a greater level of information on the network tariff pricing levels, the revenue risks are different depending on whether or not the document is binding on the DNSPs. A document that contains network tariff pricing levels and is binding on DNSPs is likely to result in significant risks to the revenue of the DNSP. In this instance, DNSPs would not be able to factor into network tariff pricing levels changes in demand conditions, customer numbers and other exogenous factors.

It will be important to keep in mind these trade-offs in this rule change as the benefits of consultation and pricing certainty are considered.

Question 5	**Should DNSPs be able to vary their network tariff structures during the regulatory period? Why or why not?**

Question 6	**If a document on network tariff structures is put in place, should this be an indicative document or should the DNSPs be required to apply it in their annual pricing proposals?**

Question 7	**If a document on network tariff structures is binding on the DNSP, should it be able to be varied and under what circumstances? If so, should it be varied outside or within the annual network pricing process?**

7 Implementation of a Pricing Structures Statement

The previous chapter discussed two key conceptual issues with respect to the content of a document that specifies network tariff structures. In addition to these issues, there are also more detailed issues about which decisions must be made if such a document is introduced in the network pricing framework. These detailed issues are discussed in this chapter.

The chapter is structured as follows:

- section 7.1 discusses how consultation on the PSS could occur at various stages;
- section 7.2 explores the criteria that should be used to approve the PSS;
- section 7.3 discusses incentives for DNSPs to comply with the PSS in their annual pricing proposals;
- section 7.4 discusses potential exemptions to the PSS consultation requirements; and
- section 7.5 discusses when a PSS framework could be adopted in each jurisdiction.

This chapter focuses on the introduction of a PSS, as proposed by SCER in its rule change request. Issues relating to IPART's rule change request were considered in the initial consultation paper. While some of the issues inherent in the proposals are the same, the focus of this chapter is the introduction of the PSS.

7.1 Consultation on the PSS

Currently, there is no requirement to consult on network tariff structures or on network tariff pricing levels. DNSPs have the ability to change their network prices annually. This not only includes changing the network tariff pricing levels, but also the existing network tariff structures or introducing new network tariff structures. Both SCER and IPART submit that the lack of consultation means that interested stakeholders such as retailers and consumers are unable to provide valuable information on the likely impact and effectiveness of the proposed network prices.

Consultation on the development of network prices can assist DNSPs to gain a better understanding of how their network prices will likely affect consumers and how they may respond to the intended pricing signals. It may also give DNSPs an opportunity to learn about the potential impact of their network tariffs on retailers.

Consultation is an important feature of the new network pricing framework proposed by SCER.

7.1.1 Form of consultation

Consultation could take a number of different forms. Consultation could be undertaken by the DNSP or it could be undertaken by the AER.[45]

Consultation on the PSS could occur at some or all of three different stages:

- *Stage 1* - DNSPs could consult with stakeholders when developing their proposed PSS prior to submitting it to the AER along with their regulatory proposals at the beginning of their regulatory determination process;

- *Stage 2* - the AER could undertake stakeholder consultation on the DNSP's proposed PSS as part of the assessment of the DNSP's regulatory proposal; and

- *Stage 3* - DNSPs could consult with stakeholders regarding any amendments they make to their approved PSS over the course of the regulatory period.

As part of these consultation stages, SCER has proposed that the AER develop a consultation guideline that sets out how DNSPs should consult with stakeholders with respect to any proposed or amended PSS (ie in stages 1 and stage 3 above).

In considering whether or not to include all three potential stages of consultation on the PSS, it will be necessary to understand the potential benefits from each stage of consultation compared to the burden and costs of requiring consultation.

In stage 1 consultation, DNSPs will need to engage with retailers and consumers to seek their input in developing the network tariff structures and charging elements that would apply for the upcoming regulatory period. The network tariff structures that the DNSP develops as part of this process will need to be consistent with the distribution pricing principles. As discussed in Chapter 9, significant changes to the distribution pricing principles have been proposed that, amongst other things, includes consideration by the DNSP of consumer impacts from its proposed network tariff structures.

If DNSPs are to continue to be responsible for designing their network pricing arrangements in accordance with their circumstances, then stage 1 consultation would provide the best opportunity for stakeholders to contribute to network tariff development. However, this process will necessarily require the onus to be on the DNSP to consider, and to determine how stakeholders' views should be reflected in the PSS. This gives the DNSP discretion to determine how best to address issues raised by retailers and consumers on its proposed network tariffs. If this stage of consultation works effectively, stage 2 could potentially be used to mediate any issues that were unable to be resolved through the stage 1 consultation. This would likely be the best use of the consultation processes.

45 Unlike DNSPs, the AER has certain common law and statutory obligations to take into account submissions made in its consultation process. See for example, NER clause 6.11.1.

SCER's proposal to amend the distribution pricing principles to explicitly include consideration of consumer impacts could encourage DNSPs to undertake better consultation with consumers and retailers without introducing a specific requirement on DNSPs to do so. Since the purpose of the consultation is to determine consumer impacts from the proposed network tariff structures, and if the AER provides guidance on how it will assess the consumer impacts pricing principle (discussed further in Chapter 9), then it follows that it may not be necessary to make stage 1 consultation a mandatory requirement. DNSPs would be likely themselves to undertake appropriate consultation to address the consumer impacts pricing principle.

Stage 2 consultation could provide the AER with an opportunity to determine the extent to which the DNSP's proposed PSS addresses issues raised by stakeholders in stage 1 consultation. If the DNSP has already engaged with consumers in stage 1 then this stage 2 consultation could be more light-handed. Care should be taken to avoid stakeholders electing to engage with the AER instead of directly with the DNSP on the proposed network tariff structures.

The stage 3 consultation process is dependent on whether the DNSP is able to seek variation to its approved PSS. The need for consultation would not materialise during the regulatory period if the DNSP is either not able to propose changes or does not propose to change its network tariff structures through the annual pricing process. SCER has noted that there is a potential risk of an excessive consultation burden and suggests that consideration should be given to allow for circumstances when DNSPs would not need to consult on expected changes in network tariff structures or network tariff pricing levels, for example due to smoothing, overs and unders, or changes in consumption.

Stage 3 consultation serves a similar overall purpose to stage 1 consultation. However, the key difference between the two stages is that stage 3 consultation does not follow the AER's regulatory determination process. Under SCER's proposal, the AER would have only two months from receiving the amended PSS to make a decision on whether or not to approve it. This timeframe has been provided to allow sufficient time for the DNSP to prepare its annual pricing proposal based on the approved PSS. This timeframe may not allow the AER (as opposed to the DNSP) sufficient time to undertake public consultation on the proposed amendments to a PSS during the regulatory control period.

Question 8	**Should DNSPs be required to consult with stakeholders before submitting their proposed pricing structures statement to the AER for approval through the regulatory determination process?**

Question 9	**Is consultation necessary if DNSPs seek to amend their approved pricing structures statement during the regulatory period, as opposed to at the time of the regulatory determination? Are there any circumstances where amendments to the network tariff structures in the annual pricing process should be exempt from consultation on amendments to the previously approved pricing structures statement?**

Question 10	**Is it necessary for the AER (as opposed to the DNSP) to consult with stakeholders before approving any proposed amendments to the pricing structure statement sought by the DNSP?**

7.1.2 Guidance on DNSP consultation

To enable DNSPs to undertake an appropriate level of consultation, SCER has proposed that the AER develop a consultation guideline that sets out how DNSPs should consult with stakeholders with respect to any proposed or amended PSS (ie in stage 1 and stage 3 above).

Consultation guidelines from the AER can be beneficial in ensuring all DNSPs take a consistent approach to stakeholder consultation. It can also provide transparency for stakeholders on what level of consultation to expect from DNSPs. Where the guidelines provide an obligation on DNSPs to consult in a particular way, it would provide more certainty.

It is also worth noting that the AER has recently published consumer engagement guidelines as part of its Better Regulation Program. These guidelines are designed to assist DNSPs to show how they have engaged with consumers in developing their regulatory proposals.[46] The AER's consumer engagement guidelines could be extended to include guidance for DNSPs on how to engage with stakeholders in developing the proposed PSS.

Question 11	**Should the AER be required to provide guidance on the consultation process for DNSPs? Should the guidelines be binding on the DNSPs?**

46 The AEMC recently implemented a new rule as part of the rule determination on network regulation rule change to require DNSPs to demonstrate how it has engaged with consumers in developing its regulatory proposal.

7.2 Approval of the PSS

SCER's proposal is based on the premise that a DNSP's PSS must inform its annual pricing proposals during a regulatory period. It also proposes that the AER should approve the PSS.

7.2.1 Does the PSS need to be approved?

In contrast to SCER's proposal, under the IPART proposal the AER would have no approval role except in respect of the pricing proposal itself.[47] Whether the PSS needs to be approved would change the character of the document. Without approval, there would be no independent check on whether the PSS meets the relevant criteria. Instead, the DNSP would need to be relied on to produce a document that does this. This may produce a document which is less likely to meet its objectives.

On the other hand, while requiring the AER to approve the PSS is more likely to result in a document which meets its objectives, this creates a more time consuming pricing process.

Question 12 Does the PSS need to be approved?

7.2.2 Approval criteria

Under the proposal, the onus would be on the DNSP to develop a PSS that contains network tariffs suitable for its consumers. The AER's role would be to check compliance of the DNSP's PSS with certain criteria outlined in the rules. The most obvious choice for criteria against which to assess compliance of the PSS are the pricing principles. Under this approach, the AER would be required to form a view on whether or not the network tariffs proposed by the DNSP in the PSS are consistent with the pricing principles.

This would also link the PSS and the annual pricing proposal. While the approval of the PSS and the approval of the annual pricing proposals would effectively be two separate processes, both processes will need to apply the pricing principles. This would result in more efficient network tariffs and simplify the annual network pricing process.

47 DNSPs submit to the AER a pricing proposal each year. The pricing proposal outlines the network tariff structures and network tariff pricing levels that the DNSP proposes to charge for the forthcoming regulatory year. Under both rule change proposals, the pricing proposal would apply the binding details outlined in the network tariff structures document.

7.2.3 Consequence where PSS is rejected by the AER

SCER has proposed that if the AER refuses to approve any aspect of a proposed PSS, then the AER's draft decision must include details of the changes required or matters to be addressed before the AER will approve it. The DNSP would have the option of submitting a revised proposed PSS. In its final decision, the AER would be required to either approve or refuse to approve the proposed PSS and set out reasons for its decision. This process is similar to the current process for the regulatory proposal in the revenue determination process.

It is important to consider what the mechanism should be where the AER does not approve a PSS at the final decision stage. The key consideration is whether the AER should be able to amend the PSS to comply with the approval criteria.

Allowing the AER to amend the PSS would mean the AER would need to form a view on what an appropriate network tariff strategy should be for the DNSP.

The outcome of this approach may not strike a good balance between the role of the AER in approving a PSS that complies with the pricing principles and flexibility to allow DNSPs to be responsible for designing their pricing arrangements. It is noted, however, that this currently the approach taken in Chapter 6 of the NER to pricing proposals and in Chapter 6A of the NER to the pricing methodology framework for transmission.

If the AER does not have the ability to amend the PSS, one option could be to default to the network tariff structures contained in the most recent year's annual pricing proposal where the AER rejects a PSS. The key advantage of using the most recent year's annual pricing proposal is that it would minimise the impact on consumers from any significant changes to network tariffs until the DNSP can convince the AER of major changes. However, a substantial disadvantage would be that using network tariff structures and network tariff pricing levels from the previous year may cause the DNSP to under or over recover its allowed revenues. This approach may be more challenging to apply for the first PSS developed by the DNSP.

Question 13	**Should the AER be able to amend a DNSP's PSS? If the AER does not approve a DNSP's proposed pricing structures statement, what arrangements would be suitable for default network tariff structures?**

7.3 Compliance with the PSS

As discussed in section 7.2 above, an important feature of SCER's proposed new network pricing framework is for the annual pricing proposals to be informed by, and be consistent with, the PSS.

Submissions to the initial consultation paper on IPART's rule change request indicate that delays in the AER's approval of annual network prices are frequently due to inadequate pricing proposals initially submitted by some DNSPs.[48] In such situations, the AER requires time to go back to the DNSP for more information. This process can require several iterations with the relevant DNSP.

Some submissions on the initial consultation paper raised the possibility of incentives on DNSPs to submit complete and compliant pricing proposals to the AER early enough for the AER to undertake a full assessment in the shortest possible time. It was noted that such an incentive does not exist currently.

Without an incentive to comply with the PSS and provide a complete pricing proposal in a timely manner, the value of the PSS as well as the timing of a streamlined annual pricing process could be compromised. At the same time, it is noted that there can be genuine circumstances in which a DNSP could have to resubmit its pricing proposal to the AER.

One approach to incentivise DNSPs to comply with their approved PSS would be to impose some form of financial risk on their ability to recover their revenue. This approach would involve limiting the DNSP on what prices it can recover for the relevant pricing year where it fails to submit a compliant annual pricing proposal. For example, where a DNSP's pricing proposal does not comply with its PSS, the AER could be given the power to:

- not approve network tariff pricing level increases where the price path requires real price increases based on the revenue allowance (negative X-factor). Previous year's network tariff pricing levels would apply and DNSPs would have to forgo their additional revenue for that pricing year; and

- approve lower network tariff pricing levels where the price path requires real price decreases based on the revenue allowance (positive X-factor). This could be allowed in full across all network tariff classes.

This approach creates obvious significant financial risks for the DNSP from non-compliance. It may mean that the DNSP cannot recover its allowed revenues from its proposed network tariffs. As a result, it may not enable DNSPs to implement cost reflective network tariff structures.

A similar approach was taken by the Essential Services Commission of Victoria (ESCVIC) when it regulated the Victorian DNSPs. As part of ESCVIC's Electricity Distribution Price Review 2006-10, it outlined the pricing consequences where a DNSP failed to submit its pricing proposal or submitted a non-compliant pricing proposal. This approach included a specified formula that would be applied to change prices in such circumstances. For example, in the first year of the regulatory determination (2006), ESCVIC specified that where a DNSP submits a late or non-compliant proposal:

48 EnergyAustralia, Submission on the rule change request, 4 July 2013, p. 18; AER, Submission on the rule change request, 5 July 2013, p. 4.

"[ESCVIC] will apply the network tariffs approved by [ESCVIC] in December 2004 for 2005, scaled by CPI-X and adjusted for the 2006 S factor (where the X-factor is taken from the 2006-10 Determination and S is calculated as specified in the 2006-10 Determination).[49]"

The AEMC is interested in stakeholders' views on alternative approaches that can be implemented to incentivise DNSPs to comply with an approved PSS in their annual pricing proposals, and submit full and timely information.

Question 14	**What are the risks to the annual pricing process if DNSPs do not comply with their approved pricing structures statement or are late submitting a full pricing proposal?**

Question 15	**How should DNSPs be incentivised to comply with their approved pricing structures statement in their annual pricing proposals? How should compliance incentives be balanced against the financial risks for DNSPs and certainty for stakeholders?**

7.4 Potential exemptions to PSS consultation requirements

SCER's rule change request asks the AEMC to consider:

- if the timing of consultation is compatible with the time at which DNSPs can reasonably be expected to have the relevant information on expected changes in their network tariff pricing levels and their strategy for changing individual charging elements relative to the average change in network tariffs; and
- in order to avoid an excessive consultation burden, if there may be circumstances when DNSPs would not need to consult on expected changes in network tariff pricing levels and changes to individual charging elements (for example due to smoothing, overs and unders, or changes in consumption).

As highlighted in section 6.3, requiring DNSPs to commit in advance to a particular network tariff pricing level would reduce the pricing flexibility that DNSPs have and therefore increase risks for them.

As noted in the initial consultation paper, network tariff pricing levels are influenced by a number of factors that are beyond the control of the DNSP. Some of the factors include:

49 Essential Service Commission, *Electricity Distribution Price Review 2006-10*, Final Decision Volume 1 (as amended in accordance with the decision of the Appeal Panel), Statement and Purpose for Reasons, October 2005, pp. 490-491.

- changes in 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 could be difficult for a DNSP to forecast with sufficient certainty the price path of average network prices, and even more difficult to forecast the expected tariff pricing levels and their strategy for changing individual charging elements relative to the average change in network tariffs.

If the PSS includes very detailed information on network tariff pricing levels, it may not be beneficial to require consultation on changes to the pricing levels if the changes are a result of the factors noted above. However, any material changes in network tariff pricing levels resulting from factors outside the control of the DNSP could reduce the certainty that the PSS is meant to provide.

The AEMC is interested in stakeholders' views on whether DNSPs should include a forecast of their expected changes in network tariff pricing levels in the PSS as proposed and whether any changes to these pricing levels should be subject to consultation.

Question 16	**Should DNSPs include forecasts of their expected changes in network tariff pricing levels in the pricing structures statement?**

Question 17	**Should any changes to the network tariff pricing levels included in the pricing structures statement be subject to consultation? If so, what level of materiality should apply to the change?**

7.5 When a PSS framework could be introduced

The framework proposed by SCER implies that the PSS process would ideally begin from the next regulatory determination process of DNSPs. This is because under SCER's proposal, the PSS would apply to a DNSP once it is approved by the AER in the regulatory determination process. The approved PSS would then continue to apply throughout the DNSP's regulatory control period unless the DNSP applies to the AER

to amend its approved PSS through a separate process prior to the annual pricing process to which the amended PSS is to apply.

As discussed in section 7.1, consultation on the PSS will be an integral part of the network pricing process. If the PSS process were to begin to apply to DNSPs from their next regulatory determination, it would allow them to undertake consultation in developing their proposed PSS before submitting it to the AER along with their regulatory proposal. It would also allow the AER's consultation process in the regulatory determination process to be undertaken.

However, given the staggered nature of the timing of the regulatory determinations, the PSS process may not begin for some DNSPs for some time. In addition, the AEMC has put in place transitional arrangements for a number of DNSPs for the commencement of their next regulatory determination process. The table below shows the timing of the next regulatory periods for relevant DNSPs and when the earliest possible start date could be for the PSS if it is introduced from the next regulatory determination cycle.

Table 7.1 Upcoming regulatory periods for DNSPs

DNSPs	Next regulatory period	Regulatory proposals due	Regulatory year from when the PSS could apply*
Networks NSW and ActewAGL (NSW and ACT)	1 July 2014 – 30 June 2015 (transitional year with placeholder determination) and 1 July 2015 – 30 June 2019 (full determination with trueup for placeholder determination)	31 Jan 2014 (placeholder determination 31 May 2014 (full determination)	2015-16
Energex, Ergon Energy and SA Power Networks (Qld and SA)	1 July 2015 – 30 June 2020	31 October 2014	2015-16
Jemena, United Energy, CitiPower, Powercor and SP AusNet (Vic)	1 January 2016 – 31 December 2020	30 April 2015	2016 (calendar year)
Aurora Energy (Tas)	1 July 2017 – 30 June 2022	31 January 2016	2017-18

Note: The next regulatory process timing for most DNSPs is subject to transitional arrangements following the AEMC's final rule determination on the network regulation rule change in November 2012. For the full transitional timetable see AEMC, *Economic Regulation of Network Service Providers,* Final rule Determination, November 2012, p. 265.

* Regulatory year from which the PSS could apply is subject to the need for transitional arrangements following this rule change.

An alternative option is to introduce the PSS process as soon as possible, without waiting for the next regulatory determination process. In this case, the first round of PSSs would not to be subject to an AER consultation process. The DNSPs could be required to consult with stakeholders in preparing their proposed PSS, and once submitted to the AER, the PSS approval could follow the "annual process" as proposed by SCER for when DNSPs seek variations to the approved PSS (this is the stage 3 consultation described in section 7.1.1). While this option would not have the same level of consultation as when the PSS is approved as part of the regulatory determination process, it does have the advantage of providing some of the benefits of the proposed framework sooner. More substantial consultation could then occur as part of the next regulatory determination process.

The option to introduce the PSS process sooner may also not be necessary for all DNSPs. For example, the New South Wales and the Australian Capital Territory DNSPs would already have commenced their full regulatory determination process before the AEMC's final rule determination on this rule change is expected in November 2014. Furthermore, Queensland and South Australian DNSPs would also have submitted their regulatory proposals in October 2014. These timings present some scope to potentially apply the PSS consultation process during the regulatory determination process, although some form of transitional arrangements would clearly be needed if the regulatory determination process has already commenced.

There are a number of other issues that would need to be considered in introducing a PSS process. These include:

- the time the AER would need to develop a consultation guideline for DNSPs to engage with stakeholders in developing their proposed PSS and whether this guideline would need to be in place before a PSS could be implemented; and
- the time DNSPs are likely to need to undertake consultation to develop their proposed PSS.

Question 18	**Should a pricing structures statement process be introduced as soon as possible? If so, what risks are there from having it in place before the next regulatory determination period?**

Question 19	**Does the AER consultation guideline need to be in place before a PSS can be implemented?**

8 Changes to the Timing of the Annual Pricing Process

This chapter discusses potential timing issues of the annual network pricing process that would need to be considered if a PSS is introduced. It highlights some options for how the annual pricing process could operate with a PSS to improve notification of annual network price changes. Timing issues explored in this chapter can affect both TNSPs and DNSPs.

8.1 Timing of the pricing process

One of the key issues identified by IPART in its rule change request is that the current annual pricing process does not always result in retailers and consumers receiving adequate notification of approved network tariffs.

The current annual pricing process can result in inadequate notification of approved network tariffs to retailers and consumers both in the first year of the regulatory control period as well as in subsequent years.[50] The problem is more acute in the approval of the initial year pricing proposal as the regulatory determination process is not finalised until approximately two months before the commencement of the first year of the new regulatory control period. On the other hand for the subsequent annual pricing proposals the revenue is already set and the timing for the annual pricing proposal is less dependent on other processes.

While IPART's rule change request proposes a solution to improving the timing in subsequent years of the regulatory control period, it has deferred a solution to the AEMC on the timing constraints resulting from the initial pricing proposal in the first year pricing process. The timing issue was discussed in more detail in the initial consultation paper on IPART's rule change request.

Submissions from retailers to the initial consultation paper support IPART's view.[51] Retailers highlighted some of the difficulties they encounter when final network tariffs are provided in insufficient time to allow retailers to adjust their retail tariffs, change their billing systems and notify their customers before new price changes take effect.

50 The current NER makes a distinction between the timing of a network pricing proposal made in the first year following a distribution network regulatory determination (initial pricing proposal), and a pricing proposal made in a subsequent year in a regulatory control period (annual pricing proposal). On the other hand for the subsequent annual network pricing proposals the revenue is already set and the timing for the annual network pricing proposal is less dependent on other processes.

51 See EnergyAustralia, Submission on the rule change request, 4 July 2013, p. 2; Origin Energy, Submission on the rule change request, 4 July 2013, p. 2; Lumo, Submission on the rule change request, 8 July 2013, p. 2; AGL, Submission on the rule change request, 12 July 2013, p. 2.

8.1.1 Improvements to the first year and subsequent year pricing process with a PSS

Since the initial consultation paper, further thought has been given to how a PSS might impact the timing of the pricing process. Introducing a PSS in the network pricing framework can provide an opportunity to simplify the pricing process to address issues with inadequate notification of approved network tariffs. If the PSS were to become the basis on which DNSPs prepare their pricing proposals, both in respect of the initial year pricing proposal as well as subsequent year annual pricing proposals, then the approval of annual network tariffs may be a simpler process.

However, as discussed in Chapter 6, much will depend on the content of the PSS, and whether it is binding.

If the PSS contains substantial details on the DNSP's proposed tariff structures, then the annual pricing process would become a matter of assigning different price levels to network tariff structures already established in the PSS. In this case, the DNSP's pricing proposal would only need to identify changes to the pricing levels for each tariff component identified in the PSS. Therefore, DNSPs would not need as much time as they currently do to prepare their pricing proposals. The pricing proposal, would in effect, be a document that provides updates of information on the pricing levels for the relevant regulatory year.

A PSS would also simplify the AER's role in approving annual network tariffs. With a PSS in place, the AER would only need to undertake a "compliance check" of the initial and subsequent annual pricing proposals. That is, the AER would only need to consider whether or not the proposed pricing levels in the pricing proposals comply with the price control mechanism specified in the regulatory determination and the side constraint provisions. The AER would not need to reassess whether the DNSP's proposed network tariff structures are consistent with the distribution pricing principles as long as the proposed tariff structures are based on the approved PSS. Consequently, it may be possible for the AER to undertake its assessment of the DNSP's initial year and subsequent year annual pricing proposals within a shorter timeframe, resulting in earlier notification of approved network tariffs.

Having a PSS in the network pricing framework could therefore provide for a more straight forward and simple approval process of network tariffs each year. A simpler pricing process will create scope for earlier notification of network tariffs if less time is required for DNSPs to prepare their pricing proposals and for the AER to assess them.

In addition, having an approved PSS in place prior to the annual pricing process may also benefit retailers. Retailers would not need as much time to design retail tariffs or change billing systems if they were provided with greater certainty in relation to future network tariff structures through a PSS. However, recently introduced obligations under the National Energy Customer Framework (NECF) would still require retailers to advise their customers of changes to standing offer prices at least 10 business days before commencement of such changes. Therefore, some minimum notification

timeframe for annual network tariff changes would still be necessary to allow retailers to meet their statutory obligations.

The benefits from the PSS to the timing of the annual pricing process assumes a certain level of detail is specified within the PSS. There is a trade-off in terms of timing of the annual pricing process and level of detail specified in the PSS. If the PSS is more detailed, the annual process can be streamlined leading to the benefits discussed above being realised. However, if the PSS is less detailed, there will be less benefits in terms of the timing of the annual pricing process.

The AEMC is interested in stakeholders' views on how the annual pricing process can be adjusted to achieve earlier notification of network price changes within the PSS framework as proposed by SCER.

Question 20	**If a PSS framework were implemented, would this reduce the timing pressures for the DNSPs, the AER and retailers that have arisen from the first year and subsequent year annual pricing process?**

8.1.2 Potential constraints on bringing forward the annual pricing process

With a PSS in the network pricing framework, it may be possible to improve the timeliness of that annual pricing process as proposed by IPART. However, IPART's solution has a number of issues that would need to be resolved for it to be effective. These issues have already been canvassed in the initial consultation paper on IPART's rule change request and submissions from stakeholders have already identified a number of constraints.

There are a number of inputs that go into transmission and distribution pricing that constrain the ability to improve the timeliness of annual pricing process. The two most significant of these are the specification of Consumer Price Index (CPI) in the regulatory determinations and the availability of other key pricing inputs for transmission pricing. Solutions will need to be found for both these issues in order to improve the timeliness of the annual pricing process.

Under the NER, the AER has the ability to specify the timing of the CPI to be used in the control mechanism for both TNSPs and DNSPs. The approach taken by the AER to CPI includes specifying the most recently available CPI figures for transmission and distribution pricing.

The way the CPI is applied currently is a key barrier because the regulatory determinations specify the March Quarter CPI for the majority of TNSPs and DNSPs. These figures are generally not available until the last week of April each year. The exception is Victorian networks businesses where the CPI timing is different due to the different definition of a regulatory year, although the principle of the most recent CPI

is applied. To use an earlier CPI figure in the pricing process would therefore require a number of TNSP and DNSP regulatory determinations to be amended

In their submissions to the initial consultation paper, many TNSPs and DNSPs agree that the current CPI specification has implications for the timing of the annual pricing process. Some TNSPs and DNSPs propose that it may be possible to move the annual pricing process forward by allowing network businesses to use an estimate of the current CPI specified in their regulatory determinations, with a mechanism to enable the businesses recover for any variation between the estimated and actual CPI figure.[52]

This view is not shared by all network businesses. Many consider that the current CPI specification restricts their ability to move the timing of the annual pricing process forward, and therefore changes to the timing of the process can only be introduced at the commencement of the next regulatory control period.[53]

Currently TNSPs are required to publish final prices by 15 May each year.[54] In order to be able to improve the timeliness of the annual pricing process for DNSPs, transmission prices will be required to be finalised earlier by TNSPs as they are a key input into distribution pricing. In submissions on the initial consultation paper, DNSPs acknowledged that the availability of transmission pricing is a constraint to finalising their own prices.[55]SAPN argues that if transmission pricing could be bought forward by even a week, this could help in simplifying DNSP pricing.[56]

However, there appears to be a number of pricing inputs that constrain timing changes for TNSPs including: service target performance incentive scheme amounts, inter-regional transmission use of system charges and up to date information on inter and intra-regional settlement residues. The availability of these key inputs into transmission pricing restrict the ability to finalise transmission prices earlier. Submissions to the initial consultation paper also identified these inputs as constraints.[57] They argue that moving forward the date by which transmission prices must be finalised will increase the reliance on forecasts for these key inputs, leading to increased price volatility from year to year.[58]

---

52 For example, see: Aurora Energy, Submission on the Consultation Paper, 4 July 2013, p. 1; United Energy, Submission on the Consultation Paper, 4 July 2013, p. 2; and SAPN, Submission on the Consultation Paper, 4 July 2013, p. 3.

53 For example, see: Energex Limited, Submission on the Consultation Paper, 4 July 2013, p. 1; ENA, Submission on the Consultation Paper, 5 July 2013, p. 4; Grid Australia, Submission on the Consultation Paper, 5 July 2013, p. 2; and SAPN, Submission on the Consultation Paper, 4 July 2013, p. 3.

54 NER clause 6A.24.2(b).

55 See, for example: ENA, Submission on the Consultation Paper, 5 July 2013, p.3; Networks NSW, Submission on the Consultation Paper, 4 July 2013, p. 4; and SAPN, Submission on the Consultation Paper, 4 July 2013, p. 2.

56 SAPN, Submission on the Consultation Paper, 4 July 2013, p. 4.

57 AEMO, Submission on the Consultation Paper, 10 July 2013, p. 1; Grid Australia, Submission on the Consultation Paper, 5 July 2013, pp. 2-3; and Networks NSW, Submission to the Consultation Paper, 4 July 2013, p. 3.

58 Ibid.

While the pricing inputs are important for transmission pricing (and by extension distribution pricing), they may not represent as significant a barrier to moving the annual pricing process forward as the CPI.

The AEMC will consider further how the pricing input constraints for TNSPs and DNSPs can be overcome, including where a PSS is in place, to improve the annual pricing process.

9 Reforms to Distribution Pricing Principles

Previous chapters discussed issues around SCER and IPART's proposal of achieving consultation and certainty in the development of network tariffs. This chapter focuses on issues that are relevant in considering SCER's proposed solutions to problems identified with the distribution pricing principles.

The chapter is structured as follows:

- section 9.1 provides background to the changes SCER has proposed;
- section 9.2 discusses the proposal for using LRMC as the basis for setting network prices;
- section 9.3 discusses additional pricing principles proposed by SCER to support LRMC pricing such as pricing signals for demand at times of greatest network utilisation, locational network pricing signals and recovery of residual network costs;
- section 9.4 discusses other pricing principles proposed by SCER that do not relate to LRMC such as complying with jurisdictional instruments, taking into account consumer impacts, and transaction costs; and
- section 9.5 discusses the recovery of transmission charges by DNSPs.

9.1 Introduction

Cost reflective network tariffs are a fundamental requirement for electricity consumers to receive efficient pricing signals. Efficient pricing signals allow consumers to take into account future network costs of meeting demand when making consumption and investment decisions.

It is important to bear in mind that the extent to which efficient price signals will result in lower future network costs will depend on a number of factors, for example, the extent to which these signals are passed through by retailers in retail tariffs and customers' ability and willingness to respond to price signals.

The role of distribution pricing principles in the NER is to provide DNSPs with sufficient obligation and guidance to set cost reflective network tariffs that promote efficient pricing signals for consumers. SCER considered that the current distribution pricing principles do not provide such obligations and guidance. SCER noted several reasons for this, including:

- not having an explicit obligation in the NER for DNSPs to apply LRMC to set network tariffs;
- lack of guidance in the NER on how DNSPs should interpret the LRMC principle or how it should be reflected in network tariffs; and

- weak incentives for DNSPs on price cap control mechanisms to set network tariff structures that reflect the underlying costs of providing network services.

SCER is proposing changes to the distribution pricing principles to strengthen the obligation and guidance on DNSPs to set cost reflective network tariffs.

The requirement to use LRMC as the primary means of setting cost reflective network tariffs is the most important aspect of the proposed changes to the distribution pricing principles. The purpose of requiring network tariffs to be based on LRMC is to signal to consumers the future (or avoidable) costs of providing network services. Signals about future costs are important because it is these costs that consumers can influence by making choices about their consumption.

Consumption decisions are affected by the choices consumers make about:

- *when they consume* - the degree to which a consumer's consumption is coincident with the demand of all other consumers within the network;

- *where they consume* - the existing level of excess capacity in that part of the network where the consumer is located; and

- *how they consume* - the impact on underlying costs of different types of consumers based on their specific load profiles or specific technologies.

While LRMC provides efficient pricing signals about future costs, it does not capture the total cost of supplying network services. Network tariffs should also allow DNSPs to recover the fixed (or sunk) costs of providing network services, otherwise the financial viability of the DNSP may be compromised. The pricing principles should therefore provide guidance to DNSPs in recovering fixed (or sunk) costs.

In addition, in an environment where innovative new network tariff structures are likely to be introduced due to LRMC pricing, consumers need to be able to understand and respond to the price signals that network tariffs are designed to send. It is therefore important that DNSPs implement network tariffs that are not overly complex and are likely to elicit efficient behavioural responses from consumers in reducing future network costs.

It is against this background that the changes SCER is proposing to the distribution pricing principles need to be considered.

Box 9.1: The application of LRMC-based pricing to consumers with different load profiles and technologies

SCER's proposed rule change concerns overall distribution network pricing, not pricing for consumers with specific load profiles or specific technologies. Furthermore, the AEMC generally adopts a technology-neutral approach that aims to develop market frameworks that promote efficient consumption and investment decisions for all technologies. The AEMC therefore considers that the pricing principles should promote efficient prices that reflect the costs a consumer imposes on the network, regardless of the consumer's load profile or technology.

At the same time, it is important to understand the costs imposed on the network by specific types of consumers, and how the overall framework for distribution network prices is likely to impact them. Efficient prices can result in different network charges for different customers. The following examples illustrate how current network tariffs are often not cost reflective or efficient for customers with different types of technologies.

Network consumers with solar PV installations typically have much lower total usage than other network consumers because they consume energy from the installation during daylight hours. While their total usage is much lower, their peak usage is not typically reduced by as high a proportion because peak periods largely fall outside of times when the sun is brightest and solar PV generation is high. In general, network costs are driven by peak usage. If, for example, consumers with solar PV generation are charged flat or inclining block tariffs, they will pay less than similar consumers without solar PV generation even though they impose similar costs on the network.

In contrast, consumers with air conditioners generally use a higher proportion of their total energy usage during peak times than other consumers. This is because air conditioners represent a large residential load and many consumers switch their air conditioning on at the same time when it is hot. These consumers therefore typically impose a higher cost on the network relative to their total usage. However, under current flat and inclining block tariff structures, these consumers may not be charged in a way that reflects their usage at peak times and therefore the increased cost they impose on the network.

Other technologies that might impose costs on distribution networks in different ways include high energy consuming appliances such as electric heaters, plasma televisions and pool pumps. An increased penetration of electric vehicles also has the potential to significantly increase electricity consumption and impose additional costs on the distribution network.

The framework under which distribution prices are set should reflect the costs imposed on the network by all such technologies, as well as by all consumers with different load profiles. Distribution prices should provide all consumers

with cost reflective network tariffs so that the pricing signals can elicit efficient consumption decisions.

It is also important to note that distribution network prices make up less than a half of a consumer's bill. The overall bill will also depend on other components, such as generation charges and subsidies like feed-in tariffs.

9.2 LRMC as the basis for setting network tariffs

9.2.1 Mandatory requirement to use LRMC

LRMC is the cost of supplying a good or service over a period time when all costs become variable. For distribution services, this includes the cost of the additional infrastructure required to meet a marginal increase in demand.

SCER considers that LRMC has an important role in determining efficient network prices because it can signal to consumers the future costs of investing in the network and it is these costs which consumers can influence by changing their behaviour because they are yet to be incurred.[59] If price signals reflect the consequences of consumption on future network costs, then consumers will have an opportunity to contribute to lowering future network costs and thereby potentially facilitate a reduction in their own network charges.

The distribution pricing principles currently prescribe that DNSPs must "take into account" the LRMC for the service when setting their network tariffs. SCER's rule change request highlights the reasons why this discretionary principle has not led to DNSPs setting efficient network tariffs, based on the AEMC's findings from the *Power of Choice Review*.

The current LRMC requirement was designed on the presumption that price capped DNSPs face a natural incentive to price at efficient costs, however this may not to apply in practice due to the close link between volumes and profits under price caps. A number of other factors were also identified that are likely to have reduced the ability and incentive of DNSPs to set network tariffs in accordance with LRMC, including limits on available metering technology and a lack of clear guidance on how LRMC should be calculated and applied.

Consequently, SCER considers that the LRMC principle should be tightened to a requirement to base network tariffs on LRMC. This will mean that DNSPs will no longer have discretion on whether or not LRMC is the principal basis for their network tariffs. Under the current framework, DNSPs have the flexibility to apply LRMC in a way that they consider appropriate to their circumstances. For example, they can use their own judgement in weighing efficiency against a range of other factors including complexity, transactions costs and the degree to which DNSPs consider consumers will

59 In contrast to sunk costs of the network, which have already been incurred and thus have to be recovered regardless of where consumers locate or the timing of their consumption.

respond to the prices they set. In practice, this flexibility has resulted in DNSPs recovering their costs in multiple ways, with a high proportion of their costs being recovered from non-peak energy usage charges.[60]

Under SCER's proposal, DNSPs will have to demonstrate that their proposed network tariffs are based on LRMC. This is likely to help in facilitating the use of time-based pricing and create greater uniformity amongst DNSPs' approach to network pricing across the NEM. It is also likely to provide more certainty for retailers and consumers around the basis for network pricing. On the flipside, it could reduce flexibility and scope for innovation in DNSP pricing, as well as the ability of DNSPs to tailor their pricing to their specific circumstances.

If DNSPs are required to move to the mandatory use of LRMC for determining their network tariffs, then there may be an impact on existing network tariffs if DNSPs are not currently basing network tariffs on LRMC. This may impose costs on DNSPs which are not already using an LRMC based approach. There could also be increased risk for all DNSPs that a pricing proposal would be rejected by the AER. Since LRMC would be a requirement rather than a guiding principle, the AER would need to take a stricter approach to assessing whether pricing proposals are compliant. This may also increase costs for DNSPs.

Under SCER's proposed Rule change request DNSPs will have to take into account the impact on customers of changes to network tariffs through the PSS, consumer consultation and the pricing principles. DNSPs will have to balance network tariff changes to comply with the LRMC requirement and these obligations. These obligations are discussed in section 9.4.2.

Finally, a requirement to base prices on LRMC could create a conflict with jurisdictional instruments where these require prices to be set on other bases than LRMC. This would be the case even if SCER's proposal of a requirement to comply with jurisdictional instruments is not accepted. DNSPs could be placed in the position of having to comply with one requirement but thereby being unable to comply with the other. This potential inconsistency is discussed further in section 9.4.1.

Question 21 **What would be the likely impacts on customers of making an LRMC approach mandatory?**

Question 22 **What would be the impacts on DNSPs of making an LRMC approach mandatory? Does it result in increased compliance risk?**

60 See Productivity Commission, *Electricity Network Regulatory Frameworks*, inquiry report, Volume 2, 9 April 2013, pp. 430-432.

Question 23 **How limited will DNSPs be in basing prices at LRMC if they must first comply with jurisdictional instruments?**

9.2.2 Implementation and guidance

Components of LRMC

The approach to LRMC could be considered at a number of different levels.

First, at the highest level, is the overall definition of LRMC. Since LRMC is a broad concept, a definition would set out its application to network tariffs. The *Power of Choice Review* suggested one such definition:

> "the present value cost of bringing forward network capital and operating costs to meet a particular user's sustained incremental derived demand for the relevant network service"

At the second level is the methodology. There are a number of potential methodologies that could be used for calculating LRMC. Some of these were set out in a supporting paper by Price Waterhouse Coopers in the *Power of Choice Review* and in the directions paper and technical report for the potential generator market power in the NEM rule change.[61] For example, some of the well accepted LRMC methodologies include:

- the perturbation approach (also known as the "Turvey" approach) that focuses on how future costs change as a consequence of a permanent change in demand;
- the average incremental cost (AIC) approach which essentially calculates the amount needed to recover the total incremental costs of new capital expenditure and both new and existing operating costs required to satisfy future demand; and
- the long run incremental cost (LRIC) approach that calculates the annualised cost of the next proposed investment measured relative to incremental demand. The LRIC approach encompasses a number of conceptual variations such as the long run average incremental cost method, total service long run incremental cost method and total element long run incremental cost method.[62]

No one methodology has been accepted by all commentators. As noted in the *Power of Choice Review*, most DNSPs use an AIC approach to determine the LRMC even though it has the property of dampening price changes over time relative to other approaches that more precisely attempt to capture LRMC.

---

61 See: http://www.aemc.gov.au/electricity/rule-changes/completed/potential-generator-market-power-in-the-nem.html

62 See for example: Marsden, Jacob and Associates, *Estimation of Long Run Marginal Cost (LRMC), A report for the Queensland Competition Authority*, November 2004.

Given the divergent views and approach, an important consideration is whether a single methodology should be fixed or whether it would be appropriate to provide for multiple methodologies that could be available to be used.

At the third level, there is the detailed implementation and application of LRMC. This refers to the inputs used to calculate LRMC, the levels at which LRMC is calculated, the method of applying LRMC to prices and the consistency of its calculation and application.

Guidance on the components of LRMC

If no guidance is provided on the above issues, DNSPs will be able to develop their own methodology, application and implementation approaches. This will allow DNSPs the flexibility to tailor the introduction of LRMC pricing to their own business's costs, customers preferences, technology levels and capabilities. On the downside, it will likely result in divergent approaches and reduced certainty for DNSPs, the AER and consumers in the implementation stage. For example, DNSPs submitting their first PSS under the proposed rules would face a risk that the AER may not accept the proposed methodology or application of LRMC.

If guidance is to be provided, there are different ways this could be achieved. First, guidance could be provided in the rules. Guidance within the rules would provide the highest level of certainty to DNSPs, the AER and consumers. It could also guarantee a uniform approach which would allow the AER to assess all DNSPs' proposals on a consistent basis and provide customers with certainty regarding implementation. However, prescription in the rules would limit DNSPs' flexibility and its associated benefits. Further it could also cause procedural difficulties as the rules may not provide an appropriate format for the detailed methodological instructions that may be required for the calculation and implementation of LRMC.

Alternatively, guidance could be provided through an AER guideline. This could apply whether single or multiple methodologies were permitted and whether a definition was set out in the rules or not. An AER guideline would provide benefits through certainty to DNSPs, the AER and consumers. Furthermore, an AER guideline would be more flexible than prescription within the rules. An AER guideline could be updated on a regular basis, incorporating new methodologies and strategies for calculating and implementing LRMC. It could also provide guidance on areas related to LRMC, such as the extent to which consumer impacts, jurisdictional instruments and the requirement to avoid transaction costs affect LRMC pricing.

The optimal level of guidance may comprise some combination of prescription within the rules and an AER guideline. For example, the AEMC in the *Power of Choice Review* recommended that the rules contain a definition of LRMC and instruct the AER to produce a guideline relating to its other components. This might provide the benefits of increased certainty through defining the mandatory requirement of LRMC while allowing flexibility through a guideline.

Question 24	Should LRMC be defined? If so, what level of detail would be appropriate?

Question 25	Should one methodology apply to calculating LRMC or should multiple methodologies be allowed? Which is/are the most appropriate methodology(ies)?

Question 26	Should the AER be required through a guideline to specify the methodology or methodologies of calculating and applying LRMC?

9.3 Additional principles related to cost reflectivity for efficient pricing signals

To encourage efficient pricing, SCER has proposed additional distribution pricing principles to support the requirement to base network tariffs on LRMC. These include:

- having regard to additional costs associated with demand at times of greatest network utilisation;
- having regard to the extent to which the LRMC of providing network services can vary by location; and
- network price should be based on drivers of network costs to the maximum extent possible.

Unlike the LRMC requirement, these principles would not be mandatory. DNSPs would only have to consider them. These proposals are discussed in more detail below.

SCER also notes that LRMC pricing is unlikely to result in DNSPs recovering the total cost of providing network services. SCER therefore considers that a principle regarding the recovery of residual costs is required. This is also discussed in more detail below.

9.3.1 Pricing signals for demand at times of greatest network utilisation

SCER considers that LRMC pricing should take into account the additional costs of meeting demand at times of greatest utilisation of the network and for which investment is most likely to be contemplated.

The quantum of LRMC for providing a network service (primarily transporting energy) to a particular consumer is in part dependent on the degree to which a consumer's consumption is coincident with the demand of all other consumers within the network, and thus requires the shared network to be augmented.

Network augmentation to provide for peak demand represents a significant component of network costs. For example, around 20-30 per cent of the $60 billion of electricity network capacity in the NEM is used for less than 90 hours a year, and capital expenditure to accommodate peak load growth accounts for around 45 per cent of approved total expenditures in the distribution network.[63]

Under SCER's proposed rule, in addition to the requirement to base prices on LRMC, DNSPs are further guided to reflect the costs of meeting demand at peak times in determining network prices. This principle acts to support the mandatory requirement to base prices on LRMC in that DNSPs only need to 'have regard' to this principle in developing their network tariffs.

This principle should allow DNSPs some flexibility with regard to its introduction based on the individual DNSP's costs and technological impediments. For example, both energy and capacity based approaches could be consistent with signalling LRMC and have advantages and disadvantages. The proposed pricing principles do not prescribe one form over the other, and encourage DNSPs to innovate and tailor tariffs to their own costs and characteristics.

A DNSP could therefore choose to implement time based network pricing through energy charges. An energy based LRMC charge could involve a time of use price, for example. This would involve different charges depending on the time at which energy is consumed.

Demand or capacity based charges can also be used to reflect peak demand. While typically this has not been done for residential consumers, wider penetration of sophisticated metering technology will make this possible. Such charges may be even more reflective of the key cost drivers in the network, given that the core service a distributor provides to its consumers is capacity not energy. A capacity or demand based charge can be structured in a number of different ways, for example:

- in a way that reflects a consumer's (or a group of consumers) assessed contribution to coincident system peak demand when it occurs; or
- in a way that reflects the maximum capacity used by, or expected to be used by, a particular consumer over some defined period (daily, monthly or annual peak).[64]

Importantly, the extent to which DNSPs can implement time based pricing is limited by consumers' metering capability. DNSPs will be able to introduce time based pricing as applicable metering is rolled out. An important question will be how LRMC based pricing applies to consumers that have limited metering capability. For example, for consumers with simple, type 6 accumulation meters, will LRMC based pricing result in a change in the balance between fixed and variable charges, and can it be applied to block structure tariffs or only two-part tariffs?

---

63 Australian Energy Regulator, *State of the Energy Market 2012*, December 2012, p. 15; AEMC, *Fact sheet: Demand side participation and prices*, March 2012.

64 AEMC, *Power of choice review - giving consumers options in the way they use electricity*, Final Report, 30 November 2012, Appendix E, pp. 50-51.

The impact on consumers of the implementation of time based prices is also important. As consumers face flexible prices that are closer to the drivers of network costs, those consumers that impose higher costs on the network are likely to pay higher bills while those consumers that impose lower costs will face lower electricity bills.

SCER's proposal deals with the potential for consumer impacts through both the consultation requirements in the PSS and the pricing principle requirement to take consumer impacts into account which is discussed in section 9.4.2. It is also worth noting that all consumers are likely to benefit from lower overall prices in the long run from lower network expenditure to meet coincident peak demand.

Question 27	**What is the impact of coincident peak demand on network costs and how are these additional costs currently recovered in network tariffs?**

Question 28	**How should LRMC pricing reflect additional costs associated with coincident peak demand and what are the practical impediments to DNSPs adopting tariffs that reflect coincident peak demand?**

9.3.2 Locational network pricing signals

Similar to the issue of LRMC reflecting additional costs of coincident peak demand, SCER considers that LRMC pricing should take into account the extent to which LRMC varies by customer location.

The marginal costs of networks will vary by location as well as by time. Marginal costs can vary by changes in location within a distribution network. This is because peak demand and the network augmentation it drives are not necessarily related to whole of system peak demand. Instead, they are often related to localised peak demand. To provide efficient, cost reflective prices these localised augmentation costs need to be reflected in LRMC based prices. This will send efficient signals to consumers by reflecting future augmentation costs to existing consumers and allowing potential consumers (particularly large business consumers) considering where to locate within the network to take into account the costs of locating in different areas.

It is important to note that similar to time based LRMC pricing, metering technology will play an important role in the extent to which locational pricing signals can be incorporated into network tariffs. DNSPs would also need to implement changes and develop expertise within their own systems to measure localised area peaks and then develop appropriate network tariffs for consumers based on calculated LRMC for those areas.

Another potential barrier to locational pricing is jurisdictional policies. Currently, some jurisdictions do not permit locational network tariffs to be used for residential consumers. As a result price signals could remain a limited proxy for LRMC.

Question 29	How important are locational pricing signals for distribution networks? Are locational pricing signals for some types of customers more important than others?

Question 30	What are the practical impediments to DNSPs adopting tariffs that reflect locational pricing signals?

9.3.3 Drivers of network costs

SCER has also proposed a new pricing principle that network charges should be based on the drivers of network costs to the maximum extent possible. This could be seen as a reinforcement of the LRMC basis for network pricing. On the other hand, LRMC should already incorporate the drivers of network costs and LRMC-based pricing should result in network prices which reflect such costs.

Question 31	Is an additional principle required to further encourage network prices which are based on the drivers of network costs to the maximum extent possible?

9.3.4 Recovery of residual network costs

SCER has proposed to retain the existing principle relating to the recovery of total costs. This principle recognises that tariffs based on LRMC are unlikely to recover the total costs of the network. The residual sunk costs of the network must also be recovered, otherwise the financial sustainability of the DNSP may be compromised. This principle provides that the residual network costs must be recovered in a way that least distorts demand.

SCER proposes that, in considering its rule change proposal, the AEMC should consider at least two general approaches to recovering residual costs.

The first approach is the Ramsey pricing approach, which is similar to the current approach. Under Ramsey pricing, sunk costs are most efficiently allocated to consumer charges with the lowest price responsiveness, therefore causing the least distortion to demand. In the case of DNSPs, this results in recovery through fixed charges as most consumers require connection to the grid and are therefore very price insensitive to changes in fixed charges.

The second approach is "postage stamp" pricing. Under this pricing approach, unit charges that do not vary with consumption or location are applied as widely as possible so as not to affect existing utilisation of the network.

To guide the decision on which pricing approach should be included in the NER, SCER suggests that three factors should be taken into account:

- allowing for recovery of residual costs in a way that does not distort or undermine flexible pricing, where flexible pricing is available;
- potential impacts on particular classes of consumers; and
- the appropriate balance between potential impacts on particular classes of consumers and efficient pricing.

In the *Power of Choice Review*, the AEMC favoured changing the NER to a postage stamp approach. This was based on the concern that Ramsey pricing could encourage DNSPs to shift costs onto less price-responsive consumers or consumer classes. However, under the current Ramsey pricing approach this has not occurred because DNSPs have largely recovered residual costs through the fixed charges of all consumers.

Ramsey pricing would appear to achieve the three factors outlined by SCER. 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.

SCER also proposed consideration of multiple approaches being permitted in the NER. The benefits of such an approach would be to provide DNSPs with flexibility to tailor their approach to their own costs and consumer preferences. The detriments would be reduced certainty to consumers and retailers and a lack of uniformity across DNSPs. Further, this approach could result in price shocks to consumers if a DNSP chose to change the method of recovering residual costs, although this would likely be limited through the proposed PSS, consultation requirements and consumer impact pricing principle.

Once an approach or approaches is determined it is important to consider how it is applied. For instance, the approach could be specified in the NER or the NER could require compliance with a more detailed AER guideline. Currently, the single approach, which is similar to Ramsey pricing, is specified within the NER. However, if DNSPs are allowed flexibility to choose between multiple approaches there may be benefits in additional guidance through an AER guideline.

Question 32 **What are the pros and cons of using a Ramsey pricing approach or a postage stamp pricing approach?**

Question 33 **Are there any other pricing approaches that should be considered to recover residual network costs?**

Question 34 **Should an approach or approaches be specified in the NER or an AER guideline?**

9.4 Other pricing principles

SCER has proposed three additional pricing principles which do not directly relate to LRMC. These are:

- a requirement to comply with jurisdictional instruments;
- taking into account the impact of (cost reflective) network tariffs on consumers; and
- a minor change to the existing clause regarding the need to take into account transaction costs.

The third change is a minor amendment. SCER proposes to change the current requirement for DNSPs to have regard to transaction costs associated with a tariff to a requirement for DNSPs to have regard to transaction costs associated with implementing the tariff. This is likely to have little effect. The other changes are discussed in detail below.

9.4.1 Compliance with jurisdictional instruments

SCER has proposed that, operating in tandem with the pricing principles, there should be a requirement that distribution prices comply with relevant jurisdictional instruments. By way of explanation, SCER notes that DNSPs may be limited in the extent to which they can base prices on principles such as LRMC by jurisdictional requirements or practical constraints.

There are a number of examples of jurisdictional instruments that may impair a DNSP's ability to price according to, among other things, LRMC:

- The Victorian Government orders for Victorian DNSPs on the implementation of the tariffs for Advanced Metering Infrastructure (AMI) – the most recent order made on 19 June 2013 provides instructions to DNSPs on how and when AMI network tariffs are to be assigned and the permitted time consumption bands.[65]
- The Queensland Government's Uniform Tariff Policy where regional consumers in Ergon Energy's distribution network face the same network charge through regulated retail prices as consumers in Energex's distribution network.[66]

65 Victorian Government Gazette, *Advanced Metering Infrastructure (AMI Tariffs) Order, No. S 216*, 19 June 2013: http://www.gazette.vic.gov.au/gazette/Gazettes2013/GG2013S216.pdf

66 Queensland Competition Authority, *Regulated Retail Electricity Prices 2012-13*, Final Determination, May 2012.

As the NER are currently drafted, there is no direct inconsistency between the operation of such instruments and the pricing principles. This is because the pricing principles are not mandatory. If, however, any of the pricing principles were to become requirements, such as SCER's proposal in respect of LRMC, it would be unclear how such a requirement would operate with respect to a potentially inconsistent jurisdictional instrument.

For example, it may be the case that pricing in accordance with LRMC would mean for a particular DNSP that consumers on the outskirts of a city should have higher tariffs than those in the centre of the city, given the higher cost to serve. On the other hand, a jurisdictional uniform tariff policy may require that all consumers with similar load profiles have equal tariffs, regardless of distance from the city centre. An inconsistency would then exist. This could create uncertainty and ambiguity.

A potential solution to this inconsistency could be to confirm in the rules that the jurisdictional instruments have primacy. The rules could state that DNSPs must comply with the LRMC pricing requirement but that this is subject to compliance with jurisdictional instruments. This would require DNSPs to price based on LRMC to the maximum extent possible given policies implemented by jurisdictional governments.

While the inconsistency would be resolved, it may be that an obligation to comply with a particular jurisdictional requirement is inconsistent with the NEO. As discussed above, pricing on the basis of LRMC is the approach most likely to result in cost reflective pricing. Any approach that detracts from LRMC-based pricing could result in tariffs which are less cost reflective and therefore less efficient.

On the other hand, jurisdictional governments can be expected to be attuned to what consumers are seeking, and willing to pay for, in respect of distribution networks and pricing. Pricing on an LRMC basis may be incompatible with particular social objectives or may impose costs that are too great. For example, where a certain approach to pricing requires a roll-out of smart meters, a jurisdictional requirement might reflect a balance between the benefits of that type of pricing and the impact on consumers.

SCER has proposed that where jurisdictional instruments and other practical constraints affect a DNSP's ability to price in accordance with the pricing principles, the DNSP should bring this to the AER's notice when the AER is approving prices.

Question 35	**What jurisdictional instruments or requirements could limit the ability of a DNSP to comply with any requirement to base tariffs on LRMC (including where that LRMC may vary with customer location or with different local peak demands)?**

Question 36	**What are the potentials impacts of a NER requirement for DNSPs to comply with jurisdictional instruments?**

9.4.2 Taking into account consumer impacts

The current principle in clause 6.18.5 (b) (2) (ii) requires DNSPs, in determining tariffs, to have regard to whether a consumer is able or likely to respond to the price signals represented by the tariff. SCER proposes to replace this principle with a new, broader, principle that requires DNSPs to have regard to the potential impacts of the tariff on consumers.

This change reflects three concerns under the current provisions.

Firstly, as currently worded, this clause could encourage DNSPs to shift their costs onto consumer classes they consider least likely to change their behaviour in response to an increase in their charges. This issue is discussed in section 9.3.4.

Secondly, for cost reflective, efficient pricing to be effective consumers must be capable of understanding the charges that they receive and then be able to respond to those charges. This requires the DNSP to take into account more than just the efficiency properties of tariffs. For example, residential consumers have little to no familiarity with demand based tariffs and therefore may not be able to respond to the incentives provided until they better understand how the incentives work. SCER proposes that this new principle will mean that DNSPs are likely to address such considerations when developing tariffs.

Thirdly, in the change to cost reflective pricing, bill shocks may occur for some consumers. This principle will encourage DNSPs to take into account the impact of these shocks on consumers. This may lead to DNSPs undertaking a transition to efficient prices to reduce such shocks.

The changes proposed by SCER substantially broaden the existing principle, leaving it potentially open to interpretation in how it should be applied. This may create uncertainty. SCER suggests that the way DNSPs are to comply with this principle is principally through SCER's proposed new consultation framework on the PSS.[67] In this regard there could be a role for the AER to alleviate uncertainty through a consultation guideline that indicates when the AER will accept the consultation and responses to consumer views as complying with the proposed rule.

There is also the possibility that the practical effect of an expanded consumer impacts principle could be limited where there is mandatory LRMC based pricing That is, the principle could have little effect where it would result in anything other than LRMC-based pricing.

The AEMC is interested in stakeholders' views on whether an expanded consumer impacts principle is appropriate and, if it is, whether additional requirements/guidance should be set out in a supporting AER guideline.

---

67 Under this consultation framework, as discussed in Chapter 7, DNSPs would be required to develop a PSS that would detail the impacts on consumers, and this must be informed by the views of stakeholders.

Question 37	**Should a requirement for DNSPs to take into account the impact of tariffs on consumers be included in the pricing principles?**

Question 38	**If a requirement is included, does the proposed principle provide enough guidance on how it is to be complied with, or would an AER guideline be useful?**

Question 39	**If a requirement is included, does the proposed principle conflict with other principles within the NER?**

9.5 Recovery of transmission charges

Under the NER, DNSPs are also responsible for passing on transmission charges from TNSPs to customers. Clauses 6.18.2(b)(6) and 6.18.7 of the NER require DNSPs to set prices to recover revenue they pay TNSPs for transmission use of system services. However, there is no requirement that DNSPs do this in an efficient, cost reflective way. That is, while TNSPs are obligated to set efficient charges through their approved pricing methodologies, currently there is no requirement for DNSPs to pass on these price signals to customers.

Large commercial and industrial customers would be more exposed to the transmission pricing signals because their network charges would include site-specific network costs. However, this may not be the case for the majority of smaller customers such as s residential and small business customers since identifying specific upstream network costs for them would be extremely difficult as majority of their network usage is from shared network assets. Transmission charges for large commercial and industrial customers typically represent a higher proportion of network charges compared to smaller customers. Small customers do not see the transmission charges because there is no requirement for network prices to be broken down into distribution and transmission components.[68]

The AEMC is interested in stakeholders' views on whether network tariffs should reflect transmission pricing signals, and if so, what would the most appropriate way achieve this for different types of network customers.

Question 40	**Should network tariffs reflect transmission pricing signals? If so, what would the most appropriate way achieve this for different types of network customers?**

68 Under Clause 6.23(a) of the NER large customers may request a breakdown of charges into distribution and transmission components.

10 Changes to How Tariff Classes are Determined

This chapter discusses issues relevant to SCER's proposed changes to how the current NER operates to guide DNSPs in determining tariff classes. The chapter is structured as follows:

- section 10.1 provides a summary of the current provisions relating to how DNSPs should assign customers to tariff classes; and
- section 10.2 highlights some issues to consider in evaluating SCER's proposed changes to the tariff class provisions.

10.1 Current provisions

Under the current network pricing framework, DNSPs have to assign customers to tariff classes. They are then required to set network tariffs for each tariff class in accordance with the distribution pricing principles and other applicable provisions in the NER.

The current tariff class provisions in clause 6.18.3 of the NER require DNSPs to allocate every customer to one or more tariff classes and provide guidance on how customers should be grouped into those tariff classes. The current NER require DNSPs to have regard to the following factors when assigning customers to different tariff classes:

- the need to group customers together on an economically efficient basis; and
- the need to avoid unnecessary transaction costs.[69]

As the NER currently apply, DNSPs have some discretion in how to balance the factors required in grouping customers into tariff classes. As a result, DNSPs have to date taken a variety of approaches in assigning different customers to different tariff classes. For example, tariff classes have been constituted by reference to voltage level, customer type, tariff structure or capacity. How customers are allocated to tariff classes is important because provisions in the NER relating to distribution pricing principles, side constraints, and information provision to customers all rely on the tariff classes that DNSPs determine.

10.2 Issues to consider

The SCER rule change request proposes to make it mandatory rather than discretionary for network customers to be grouped on an economically efficient basis without unnecessary transaction costs. SCER has proposed this change to provide greater clarity and certainty on how DNSPs should define their customers into different tariff classes.[70]

---

69 NER clause 6.18.3(d)(1)-(2).

70 SCER rule change request, 18 September 2013, p. 10.

An important issue to consider in evaluating SCER's proposed changes to the tariff class provisions is whether making the existing guiding factors mandatory will provide sufficient clarity and certainty.

Grouping customers on an economically efficient basis can potentially provide a very broad scope for how tariff classes are defined. This is because economic efficiency is a concept and the current provision in NER provides little guidance on its application to defining tariff classes. Arguably, if "economically efficient basis" is retained in the NER, then DNSPs would continue to retain significant discretion in determining how broadly or narrowly they apply these provisions in defining tariff classes. For example, it is arguable that the current methods of assigning customers to tariff classes – by voltage level, customer type, tariff structure or capacity – could all be considered to be on an economically efficient basis because they all represent groups of customers that generally impose similar costs on the network on average across the tariff class. Consideration of how DNSPs and the AER currently apply the economically efficient basis provision may help in considering its application as a mandatory requirement.

There are potential benefits if the requirement is interpreted strictly. That is, if the principle results in limits on the methodology or methodologies for assigning customers to tariff classes, then customers, DNSPs, retailers and the AER would all have increased certainty and uniformity over the assignment of customers. On the downside, this would reduce the flexibility and discretion of the DNSP, potentially restricting the DNSP from tailoring assignment of customers to tariff classes to best suit its individual circumstances. It may also result in increased costs to the DNSP in having to change from its current methodology to a new methodology.

Another important issue to consider is whether making the method of constituting tariff classes mandatory (particularly if this is interpreted strictly) will result in conflicts with jurisdictional instruments. If a jurisdictional instrument requires customers to be assigned to tariff classes in a manner inconsistent with economic efficiency then there would be a direct conflict between the tariff class provisions in the NER and the jurisdictional requirement.

Question 41	**Is the change to a mandatory requirement to group customers into tariff classes likely to achieve the desired outcomes?**

Question 42	**Is the change to a mandatory requirement to group customers into tariff classes likely to result in inconsistencies within the NER or with any jurisdictional instruments or requirements?**

11 Changes to the Operation of Side Constraints

This chapter discusses issues relevant to SCER's proposed changes to the operation of side constraint provisions. The chapter is structured as follows:

- section 11.1 provides a summary of the current provisions relating to side constraints; and
- section 11.2 highlights some issues to consider in evaluating SCER's proposed changes to the side constraint provisions.

11.1 Current provisions

The current side constraint provisions seek to limit price changes to consumers over time. They are intended to limit the magnitude of tariff changes from year to year, thereby reducing price shocks for consumers.

There are four key elements to the current side constraints in the NER:

- the tariff categories to which they apply;
- the years in which they apply;
- the type and magnitude of the constraint; and
- certain exceptions to the application of the side constraints.

The first element requires the side constraints to apply at the tariff class level. This allows DNSPs discretion to re-balance individual network tariffs within a tariff class by more than the constraint as long as this is compensated by other network tariffs within the tariff class increasing by less than the constraint.[71]

The second element specifies that the side constraints apply to network tariff increases from one regulatory year to the next within a regulatory period. This provision does not apply the side constraints in the first year of a regulatory period as the tariff change in the first year would be from tariffs from the last year of the previous regulatory period (ie, the constraint does not apply between regulatory periods).

The third element sets the constraint at CPI-X plus 2 per cent when prices are rising in real terms and CPI plus 2 per cent when prices are falling in real terms between two regulatory years. When prices are rising the 2 per cent constraint is relative to CPI-X. The X-factor is set by the AER to allow the DNSP to recover its revenue. The effect of this is that prices are free to move to recover the revenue allowance set by the AER, but

71 The side constraints apply at the tariff class level and apply to the increase in weighted average tariff revenue. DNSPs are therefore allowed to increase individual tariffs by any amount above the side constraint limitation (subject to the pricing principles) as long as they have a compensating decrease in other tariffs within the tariff class. The compensating decrease must be such that the weighted average revenue from the tariff class increases by less than the side constraint.

price rises beyond this are limited by the 2 per cent side constraint. The CPI plus 2 per cent magnitude restricts the DNSP's ability to adjust the weighted average tariff revenue of tariff classes over time.

Under the fourth element, the NER currently allows the side constraints to be disregarded to the extent the additional revenues from certain approved adjustments to the DNSP's revenues after the revenue determination would cause the tariffs to increase by more than the side constraint. A further clause also specifies that the side constraints do not limit the extent that a tariff for customers with remotely read interval or other time-based metering technology may vary according to time or other circumstances of the customer's usage.

11.2 Issues to consider

SCER's rule change request raises two specific aspects of the current side constraint provisions. These relate to:

- extending the application of the existing side constraints so they apply across regulatory periods; and
- removing the clause that states that the side constraint provisions do not limit tariff variations referable to time or other circumstances of a customer's usage for customers with remotely read time-based interval metering technology.

The fact that the SCER rule change request only addresses these two aspects of the side constraint provisions means that the AEMC is not able to undertake a broad ranging review of side constraints as part of considering this rule change request.

11.2.1 Side constraints applying across regulatory periods

This proposal would mean that DNSPs would be subject to side constraints in the first year of each regulatory period, ie across regulatory periods. Side constraints across regulatory periods would aim to ensure that the prevailing prices at the end of each regulatory period form the basis of those at the beginning of the next period.

It will be important to consider whether the proposed changes would actually be required. Under the PSS pricing framework proposed by SCER, DNSPs will face binding requirements in terms of consultation, tariff structures and tariff levels. If a PSS framework was in place, the PSS for any new regulatory period would need to be approved by the AER. This would mean that any changes in tariff structures or levels in the first year of the new regulatory period would be subject to the same scrutiny and consultation requirements as changes that occur to the PSS within the previous regulatory period. Implementing a PSS may itself allow sufficient regulatory control over the movement of prices between periods to make further side constraints unnecessary.

Furthermore, the proposed requirement for DNSPs to take into account consumer impacts is likely to reduce the need to expand the existing side constraint provisions. Similar to the PSS, this requirement may itself allow sufficient regulatory control over price movements.

There is a potential inconsistency between the proposed change and other changes, such as the proposed mandatory obligation for DNSPs to set network prices based on the LRMC. If a DNSP is currently pricing in a different manner to LRMC, it may be required to significantly change tariffs to meet the LRMC requirement, which is likely to change its weighted average revenue. Applying a side constraint may slow the implementation of new tariff structures or prices that achieve LRMC.

There are also some practical implementation issues that need to be considered for the side constraints to work across regulatory periods as intended by SCER. For example, X-factors would need to be calculated for the first year of the regulatory period.

The AEMC seeks stakeholders' views on these, and any other implementation and consistency issues likely to arise from the application of side constraints across regulatory periods.

Question 43	**Is the proposal to apply side constraints across regulatory periods likely to materially benefit consumers by protecting them from price shocks?**

Question 44	**Is the proposal to apply side constraints across regulatory periods likely to lead to inconsistencies with other requirements in the NER?**

Question 45	**Are there likely to be implementation issues in applying side constraints across regulatory periods?**

11.2.2 Extending side constraints to customers with time-based meters

In its rule change request, SCER notes that while clause 6.18.6 (e) of the NER specifies that DNSPs are able to set time-based tariffs, this clause appears redundant. This is because neither price capped nor revenue capped DNSPs are prevented from structuring their tariffs as they see fit under the current NER, provided their overall revenue constraints are adhered to.

SCER also states that this particular clause has the potential to create confusion as it could be read to mean that consumers with smart meters are not subject to the overall side constraint provisions.

SCER is proposing to remove clause 6.18.6 (e) from the NER in order to clarify that the side constraint provisions should apply to consumers on interval meters as well as accumulation meters.

Question 46	**Should network tariffs of customers with interval meters or other types of time-based meters be subject to side constraints?**

12 Lodging a Submission

The Commission has published a notice under section 95 of the NEL for the consolidated rule request inviting written submissions. Submissions are to be lodged online or by mail by **19 December 2013** in accordance with the following requirements.

Where practicable, submissions should be prepared in accordance with the AEMC's Guidelines for making written submissions on rule change proposals.[72] The AEMC publishes all submissions on its website subject to a claim of confidentiality.

The AEMC is expecting a significant number of submissions. In order to be given full consideration, submissions must be received by the close of the consultation period. **Submissions that are received after this time may not be given full weight.**

All enquiries on this project should be addressed to Zaeen Khan on (02) 8296 7800.

12.1 Lodging a submission electronically

Electronic submissions must be lodged online via the Commission's website, www.aemc.gov.au, using the "lodge a submission" function and selecting the project reference code "ERC0161". The submission must be on letterhead (if submitted on behalf of an organisation), signed and dated.

Upon receipt of the electronic submission, the Commission will issue a confirmation email. If this confirmation email is not received within 3 business days, it is the submitter's responsibility to ensure the submission has been delivered successfully.

12.2 Lodging a submission by mail

The submission must be on letterhead (if submitted on behalf of an organisation), signed and dated. The submission should be sent by mail to:

Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Or by Fax to (02) 8296 7899.

The envelope must be clearly marked with the project reference code: ERC0161

Except in circumstances where the submission has been received electronically, upon receipt of the hardcopy submission the Commission will issue a confirmation letter.

If this confirmation letter is not received within 3 business days, it is the submitter's responsibility to ensure successful delivery of the submission has occurred.

72 This guideline is available on the Commission's website.

Abbreviations

AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
AIC	average incremental cost
AMI	Advanced Metering Infrastructure
Commission	See AEMC
CPI	Consumer Price Index
CPP	critical peak price
DNSPs	distribution network service providers
ESCVIC	Essential Services Commission of Victoria
IPART	Independent Pricing and Regulatory Tribunal
kVA	kilovolt-ampere
KWh	kilowatt hour
LRMC	long run marginal cost
NECF	National Energy Customer Framework
NEL	National Electricity Law
NEM	National Electricity Market
NEO	National Electricity Objective
NER	National Energy Rules
PSS	Pricing Structures Statement
PV	photovoltaic
rules	See NER
SCER	Standing Council on Energy and Resources
TNSPs	transmission network service providers