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22 October 2014

John Pierce
Australian Energy Market Commission
PO Box A2449
SYDNEY SOUTH NSW 1235

Dear Mr Pierce

NATIONAL ELECTRICITY AMENDMENT (DISTRIBUTION NETWORK PRICING ARRANGEMENTS) RULE 2014 – DRAFT DETERMINATION

Ergon Energy Corporation Limited (Ergon Energy), in its capacity as a Distribution Network Service Provider in Queensland, welcomes the opportunity to provide a submission to the Australian Energy Market Commission on its *National Electricity Amendment (Distribution Network Pricing Arrangements) Rule 2014 - Draft Determination* (Draft Determination). Ergon Energy's comments in relation the Draft Determination are included in the attached submission.

Should you require additional information or wish to discuss any aspect of this submission, please do not hesitate to contact either myself on (07) 3851 6416 or Trudy Fraser on (07) 3851 6787.

Yours sincerely

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Enc: Ergon Energy's submission

Submission on the *Distribution Network Pricing Arrangements – Draft Rule Determination*

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Australian Energy Market Commission

22 October 2014

This submission, which is available for publication, is made by:

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Introduction

Ergon Energy Corporation Limited (Ergon Energy), in its capacity as a Distribution Network Service Provider (DNSP) in Queensland, welcomes the opportunity to provide comment to the Australian Energy Market Commission (AEMC) on its *Distribution Network Pricing Arrangements – Draft Rule Determination* (Draft Determination).

Ergon Energy is generally supportive of the objectives of the Draft Determination to improve cost reflectivity and efficiency of arrangements and increased stakeholder consultation. However, Ergon Energy is concerned that once implemented as proposed, some aspects of the Rule will not be practicable.

Ergon Energy agrees that existing network tariffs do not accurately signal likely future costs imposed on the network, and on this basis the relevant provisions of the National Electricity Rules (the Rules) need to be amended. However, Ergon Energy suggests that despite this, one of the major obstacles to progressing to more cost-reflective tariffs is the regulatory arrangements which inhibit flexibility in metering technology. As a result of the current regulatory arrangements, the majority of Ergon Energy's customers have accumulation meters which severely limit the extent to which tariffs can be used to signal future costs. The regulation of pricing arrangements will not overcome this obstacle, and the new pricing principles and procedures will not lead to substantial benefits without more flexible arrangements which encourage meter changes.

The electricity sector is increasingly becoming a highly participatory network of interconnected business models that interact with the distribution network and the newly emerging technologies (i.e. diversified energy assets, control systems and end-user technologies at or near the customer's premise). Customers now have an unprecedented level of discretion around how their electricity is generated, where it is generated and how they wish to consume it. They also have a different set of expectations around the value they expect from connecting to the grid, which covers issues such as price, reliability, safety, innovation and flexibility. For example:

- Climate change policies and subsidies for rooftop solar photovoltaic (PV) installations have led to a rapid increase in the number of households and businesses with solar PV. Approximately 1 in 7 households in regional Queensland have solar.
- Whilst electric vehicles (EV) are yet to develop a significant presence in the Australian market, analysis indicates EV sales are expected to be around 20 per cent of new vehicle sales by 2020 and rising to around 45 per cent of sales by 2030[1].
- Businesses – both traditional (retailers and distribution businesses) and non-traditional market participants, such as energy service companies, information service providers, demand aggregators and micro-grid managers – have responded to these changes in expectations and technology, by developing new and innovative ways of selling electricity.

Because of the environment in which Ergon Energy operates – including the relatively high cost to serve customers in a sparse network – the above issues/developments are having a material impact now on the operational and technical demands placed on our network and our interactions with customers. In order to maintain relevance in our network area, the traditional business model of providing an essential service of energy delivery to customers now needs to be more flexible

[1] AECOM. 2012. Impact of electric vehicles and natural gas vehicles on the energy markets. June. p iii.

and able to adapt in a timely manner to reflect a more diverse supply chain and evolving consumer expectations.

Ergon Energy has been pursuing changes to market arrangements that will enable this to happen. Our proposed pathway over the medium term is intended to complement many of the changing market, regulatory and technology changes that we expect to occur. However, Ergon Energy is concerned that its progress in this regard will be severely limited by the rigidities inherent in the proposed Rule.

Ergon Energy is a member of the Energy Networks Association (ENA), the peak national body for Australia's energy networks. The ENA has prepared a comprehensive submission addressing the AEMC's Consultation Paper. Ergon Energy is fully supportive of the arguments contained in their submission.

In response to the AEMC's invitation to provide comments on the Draft Determination, Ergon Energy has focused our submission on the areas of general concern, such as the use of long run marginal cost (LRMC) in pricing, the tariff structure statement (TSS) and transitional issues. Ergon Energy is available to discuss this submission or provide further detail regarding the issues raised, should the AEMC require.

Specific Comments

This section provides detail on Ergon Energy's areas of general concern.

Use of LRMC in pricing

Sub-clause 6.18.5(f)(4) of the draft Rule obliges each DNSP to have regard to the calculation of LRMC at different locations in the network. At a minimum, the impact for Ergon Energy would require separate calculations of the LRMC for the three existing pricing zones, but the diverse nature of Ergon Energy's territory may make it necessary to calculate this cost at a more granular level for sub-systems of the Eastern zone.

Ergon Energy already has one of the most complicated pricing arrangements in the National Energy Market (NEM) with the number of pricing zones and different regions based on transmission creating a myriad of network tariff codes and different pricing arrangements. Further regionalisation would create even more complexity – and winners and losers – depending on the level of localisation the Australian Energy Regulator (AER) would interpret the Rule dictates. Ergon Energy believes there would be substantial additional cost in developing more prices for more locations that would outweigh any potential benefits for customers, especially under current regulatory arrangements.

Ergon Energy also suggests that parts (e) and (g)(1) potentially conflict, because they both purport to define how much revenue should be recovered from a tariff. Part (e) posits a range between standalone and avoidable cost – which infers there are 'joint and common costs' involved in serving different customer classes. For example, Standard Asset Customer (SAC) - small and SAC - large customers both contribute to the need for zone substations and high voltage feeders. However, (g)(1) refers to 'total efficient costs' of serving the relevant customers, ignoring the issue of joint and common costs.

To improve clarity, Ergon Energy suggests deleting (g)(1), as it does not make sense in a network where economies of scope arise.

Metering

Ergon Energy believes that the mandating of LRMC in setting prices is unlikely to lead to significant change for the great majority of customers. Around 99.5 per cent of Ergon Energy's customers (those with annual consumption less than 100MWh p.a.) have accumulation meters. The prices of most were moved from single rate energy in 2013-14 to a three-block structure in 2014-15. Many customers consuming above this threshold also have only accumulation meters.

In light of prevailing benchmark cost of supply and average incremental cost estimates, basing customers' tariffs more closely on LRMC would tend to result in a larger quantum of residual costs. Such costs would most efficiently be recovered by increasing the fixed component of network tariffs, notwithstanding that the AEMC has indicated other tariffing approaches.

Beyond reflecting a relatively low forward-looking LRMC under present network conditions, the implementation of more cost reflective prices for small customers requires smarter meters and prices that target peak period consumption through Time of Use or Demand charging components.

The introduction of metering contestability is unlikely to improve this situation and under current proposals smarter metering is unlikely to be delivered to Ergon Energy's small customers.

Retailers and metering providers will select only high yield customers where it is possible to gain sufficient margin to cover the cost of the meter installation and communications. Moreover, unless Ergon Energy introduces a business requirement to require that a customer whose meter is replaced is automatically transferred to a more cost reflective network tariff, the Retail preference may be to retain the non-cost reflective network price with the upgraded meter.

Tariff structural issues

The Brattle Group was engaged by the AEMC for advice on tariff structural issues. Their paper explored several options for recovering residual costs and concluded:

> *If the principle of efficient prices is prioritised, the recovery of residual costs through fixed charges would result.*

Thus, whilst there is a range of options for the recovery of residual costs, the most efficient pricing at a time when LRMC is low would result from higher fixed costs than at present. The AEMC has stated in the Draft Determination that there are alternative ways of recovering residual costs whilst not having high fixed costs.[2] While not incorrect, this is contrary to the principle of efficient pricing.

The conventional economic thinking around the recovery of residual costs is that these costs should be recovered in a manner that has as little impact as possible on customers' decisions regarding use of the service. That is, if tariff components signal LRMC, the remaining tariff components should play no signalling role at all. Hence, the second-part tariff should be set in a way that avoids upsetting or distorting the usage signals flowing from the marginal cost charge. This means that the second-part tariff should, at the very least, not be based on electricity consumption. The best way to do this is to recover outstanding network costs from customers in proportion to their overall willingness to pay for the provision of the distribution network.

Recovering outstanding sunk costs on the basis of willingness to pay means that it is necessary to examine what alternatives customers have to paying for (and receiving) network access. This involves considering options for physical or economic bypass.

Many customers are presently engaging in a form of partial economic bypass through the installation of solar PV units. These units enable customers to consume less grid-supplied power, reducing the extent to which they pay volumetric network charges. As the bulk of network charges to SAC large and SAC small customers are recovered directly or indirectly on the basis of electricity consumption,[3] the result has been that customers with solar PV are contributing less to the recovery of sunk network costs than customers without PV units, even though PV customers would likely place a similar value on network access as non-PV customers. This has provided an artificial (and inefficient) incentive for customers to install solar PV units, because in doing so they can avoid paying the same amount for network access as other customers.

Economic efficiency is likely to be enhanced if much of the residual costs of the network not recovered through marginal cost-based tariffs are recovered from tariffs that reflect the value customers place on network access rather than the amount of electricity customers consume.

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[2] AEMC, Draft Rule Determination – National Electricity Amendment (Distribution Network Pricing Arrangements) Rule 2014, 28 August 2014, p.39

[3] In the case of SAC large customers, charges are notionally largely based on customers' actual demand. But due to metering limitations, demand is inferred from a deemed profile applied to accumulated consumption.

Ergon Energy is concerned that the AEMC's comments regarding fixed charges were not underpinned by economic justification and may lead stakeholders to form a view that more efficient pricing would prioritise consumption based charges over fixed based charges. Ergon Energy sees no economic justification for this in light of the above discussion.

Tariff Structure Statement (TSS)

Ergon Energy notes that the preparation of a TSS, and indicative price schedule for the regulatory control period, are new requirements under the draft Rule. Ergon Energy also notes that the content of the TSS includes several elements currently incorporated into the Pricing Proposal, which will need to be set out in greater detail. For example, the relationship between the tariff charging components, the LRMC and the recovery of residual charges will need to be explained and demonstrated to comply with the pricing principles. The TSS will thus be a substantial document.

The TSS will remain in place for the regulatory control period and, although there are provisions for it to be amended after consultation and with the permission of the AER, Ergon Energy is concerned it is likely to result in stifling the development of tariffs.

The TSS is intended to provide the AER with sufficient information on the DNSP's methodology for determining tariff levels and structures (including indicative prices) to enable stakeholders and the AER to assess whether the DNSP's pricing methodology meets its obligations under the Rules. However, DNSPs will not be able to alter their TSSs at their discretion – they will need to be able to demonstrate to the AER that a variation is necessary to address an unforeseen event and that a change would enable the DNSP to better satisfy the distribution pricing principles. Furthermore, if approved, the DNSP would be required to undertake the entire process again (which could take in the order of 18 months to consult, justify and gain approval), which Ergon Energy views as inefficient in such circumstances.

The intent of the TSS as a useful tool for DNSPs, customers and the AER to explain expected price movements over the period would be appropriate in an environment of market, technological and regulatory stability where reforms aren't necessary to transition and adapt. However, as explained above, we are not in such an environment. The industry needs to be able to move and keep up with the pace of change or is likely to fall further behind. The new technology (storage, mico-grids, EVs etc.) is fast moving, and will quickly surpass slow moving industry pricing reform effort.

Tariff movements

The AEMC has placed increased emphasis on reducing the year on year variations in tariffs by including this as a pricing principle. Also, the TSS and indicative prices are intended to provide customers with information on tariff movements and lock in any structural changes. The AEMC has identified possible exceptions to the rule. However, Ergon Energy notes that modifying the TSS and the direction of prices in a timely manner to cater for an emerging network constraint (e.g. following a major load or generator connection) is unlikely to be practicable under the rules proposed.

In addition, regulatory arrangements for network tariff design and redesign need to be cognisant of the substantial information imperfections and asymmetries that arise both within and between DNSPs and their customers. DNSPs cannot know with confidence exactly how customers will

respond to new tariff structures and customers themselves often cannot reliably predict how they will respond.

Reasons supporting more flexibility in regulatory design

In its most recent public forum, the AEMC requested that network service providers provide examples that would substantiate claims that the current Rule arrangements were inflexible.

Ergon Energy's experience in implementing significant network tariff change is that it is a very dynamic process. For example, in June 2013, Ergon Energy consulted with customers and stakeholders regarding its network tariffs and through this consultation process responded with significant changes to the structure and price relativities that were then progressed six months later. Ergon Energy believes this resulted in significantly better outcomes for all stakeholders, and demonstrates that over a six month period in which there were no step change impacts on the process, flexibility to engage and respond is required to get better outcomes.

Ergon Energy's tariff reform initiatives in 2013-14 were in the absence of step-change external impacts on the tariff environment which can occur during a 5 year regulatory control period. However, if for example, the TSS requirement had been in place for 2010-15, we would have been unable to respond in a timely manner to the Queensland Government directed fundamental change that occurred in 2012 to adopt network plus retail (N+R) retail notified prices. That is, Ergon Energy would not have been able to respond to the legitimate flow-through agendas of the Government, Queensland Competition Authority, retailers and customers in a timely manner because we would have been locked into a TSS that would have been developed in 2009 based on what was known and enabled at that time. It is difficult to anticipate market acceptance of a response from Ergon Energy in such circumstances, that '*we can't respond because we are locked into a pathway determined by the 2009 environment, however we can start a TSS review process which may approve a change which we may be able to implement the tariff-year after change approval, if the necessary enabling capabilities have been put in place by ourselves and other key stakeholders*'.

Looking forward, Ergon Energy anticipates more of these step-changes occurring in the 2015-20 regulatory control period. However, in setting the TSS Ergon Energy is unlikely to know if, when or the scope of these step-changes. Ergon Energy notes, for example, that the Queensland Government is exploring changes to how it applies subsidies for customers in regional Queensland, which will have flow on impacts to our tariff structures and prices.

At the same time, Ergon Energy has an ambitious plan for tariff development based on utilising the process that worked very effectively in achieving significant tariff improvement in 2014-15. Integral to pursuing this program is engaging with customers on our pathway, underlying principles, drivers, rationale, impacts etc. However, tariffs are part of a much broader ecosystem and changes to the tariff roadmap will occur as markets respond to previous tariff change, as we and customers learn more and potentially in response to external shock (e.g. a network based community service obligation (CSO) payment being introduced). As such, reform of tariff structures is a process that needs to be undertaken in an incremental, iterative and ongoing manner, rather than in a five-yearly 'big bang' cycle.

Ergon Energy notes that a potentially unintended drawback of the draft TSS provisions is that they raise the barriers to incremental reforms to tariff structures, particularly *within* regulatory control periods. The requirement in 2014 to lock in and be accountable for achievement of a TSS places Ergon Energy in a dilemma: to populate it with what we know we can achieve and what is enabled

currently; or put in a path which we think will probably be achievable but has realisation risk and dependencies of inputs that are beyond our control.

Ergon Energy suggests that the TSS has two very large risks:

- initial tariff ambitions in the 2015-20 regulatory control period will be much more conservative based on a tendency to a no or low risk position in terms of making accountable commitments out to 2020; and
- where unanticipated changes occur over the 2015-20 regulatory control period, there will either be no response or very slow response.

Ergon Energy is firmly of the view that under the TSS regime, our network tariff outcomes will be substantially inferior to those associated with being able to continue the highly responsive and market engagement process we have currently been progressing. Ergon Energy believes this will be particularly to the detriment of customers.

Ergon Energy supports a TSS being incorporated into the 5 year regulatory review process. However, to lock this down and be held accountable for its realisation locks down one of the key interfaces distributors have with the market (our prices) to a projection made at one point in time which will become increasingly stale and inappropriate. More flexibility must be available.

A preferable framework that removes regulatory obstacles and promotes flexibility

Ergon Energy understands that the policy intent behind the obligation to comply with an approved TSS is to increase the transparency of network tariff-setting and to prevent changes being made without adequate stakeholder consultation and advance notice. Ergon Energy believes these objectives can be met without placing as many obstacles to welfare-increasing reforms as embodied in the draft Rule.

Specifically, Ergon Energy proposes an amendment to the draft Rule that permits DNSPs to make within-period changes to their tariff structures that are inconsistent with their TSSs subject to the following conditions:

- the DSNP must inform stakeholders of its intention to change tariff structures within the regulatory control period and provide stakeholders with indicative structures, tariff levels and estimated stylised customer impacts;
- the DNSP must conduct public consultation on its proposed tariff structure changes and inform stakeholders of amendments to its proposed changes arising as a consequence of the consultation process;
- the DNSP must prepare an application to the AER demonstrating:
  - how the DNSP has responded to stakeholder concerns raised during consultation; and
  - how the proposed tariff structure changes comply with the pricing principles;
- if the AER is satisfied that the DNSP has satisfactorily undertaken these steps, the AER would be obliged to permit the DNSP to make the relevant tariff structure changes, but only for the remainder of the current regulatory control period. The AER's process would occur in a timeframe consistent with other Rules requirements i.e. 40 or 60 days;
- if the DNSP wished to carry over any new tariff that was not specified in its TSS into a new regulatory control period, the DNSP would need to ensure that its TSS for the new period was modified to provide for that new tariff. This would ensure that any new tariff structure adopted within-period was eventually required to fulfil the same requirements as any tariff proposed at

a regulatory reset. This would mean that the DNSP could not use the making of within-period changes as a means of circumventing the normal process for new tariff structure development.

While maintaining a consultative and transparent approach, our proposal would facilitate more timely and fit-for-purpose reforms to network tariff structures than that likely under the draft Rule.

Transitional arrangements

Ergon Energy suggests the transitional arrangements conflict with the current regulatory proposal requirements. Preparation of the first TSS and indicative price schedule is required by 30 June 2015. Therefore, Ergon Energy would be required to prepare these documents concurrently during the final stages of submitting its Regulatory Proposal (due 31 October 2014) and the AER's Draft Determination (due 30 April 2015). Given the significant content and preparation required for the TSS and indicative price schedule, this would appear an unrealistic expectation as a transitional arrangement. Furthermore, it does not provide adequate time for meaningful engagement with customers. As such, Ergon Energy suggests delaying the proposed transitional arrangements for a period of at least six months.