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16 October 2014

Richard Owens
Senior Director, Australian Energy Market Commission
PO Box A2449
Sydney South NSW

Dear Richard,

Reference ERC0161 - Distribution Network Pricing Draft Rule Determination

Network Tariff Reform

United Energy appreciates the opportunity to provide this submission in response to the Australian Energy Market Commission's (Commission or AEMC) draft rule determination on distribution network pricing.

We agree that there needs to be a change to how network businesses charge customers through the network tariffs and structures. New, more efficient tariff structures should facilitate better understanding by customers of the drivers of network costs, reduce cross subsidies between different groups of customers and provide efficient signals for new investment by both customers and networks. Network tariff reform is also critical in encouraging important new innovations in the electricity industry that may help to increase the efficiency with which customers consume energy.

We are actively working on the development and implementation of new tariff structures that will reduce the cross subsides between customers and better signal the drivers of network costs. Support from regulators, governments and stakeholders will be critical in making this transition a success. Through this process care needs to be taken by all parties to ensure that:

- It is recognised that we are moving into new territory and all businesses will need to learn iterate
- Distribution Network Service Providers (DNSP), as owners and operators of the networks, retain control of critical network pricing functions and decision making
- The current tariff structures are not replaced with overly prescriptive structures that might work today but don't react to market changes that are increasing in pace and scope
- The difference between the costs that are allocated (LRMC, SRMC, residual etc) and the parameter ($/kwh, $/kw, $/day etc) that is used to allocate those costs to customers are clearly understood

- A one size fits all solutions that fails to address the diverse range of challenges faced by different networks is not adopted

Ongoing engagement and consultation with customers, retailers, regulators, governments and other stakeholders is key to the development and implementation of pricing signals that customers can understand and respond to.

While we do not believe that there are currently any significant barriers to effective network tariff reform in the National Electricity Rules, the rule change process has made an important contribution in highlighted the importance of tariff reform to stakeholders. There is nothing in the rules, nor should there be, to address the key remaining barriers to tariff reform jurisdictional schemes and metering stock.

Rule Change Background

The draft determination relates to a rule change request submitted by COAG, which was developed in response to the Commission's Power of Choice review. The Power of Choice review recommended a number of reforms to provide consumers with better opportunities to make informed choices about their electricity usage. In relation to distribution tariffs, the review concluded that distribution tariffs should provide more efficient price signals.

In light of the above background, the Commission explains the rationale for the draft Rule as follows[1]:

> "The structure of network prices has not kept up with the increased diversity in how people use energy. Advances in technology both on the consumer's side of the meter and the network's side of the meter have given consumers and network businesses more options in how energy is provided and consumed.
>
> The way that network prices are structured needs to catch up with these changes and be flexible enough to adapt to further changes in the future."

The Commission summarises the scope and purpose of the proposed rules in the following terms[2]:

> "Distribution network businesses will be subject to a new pricing objective that network prices should reflect the business' efficient costs of providing services to each consumer. Businesses will be required to comply with new pricing principles when determining the structure and level of their network prices.
>
> The pricing principles address the potential impacts on consumers of a transition to new network prices. They require network businesses to develop price structures that consumers are capable of understanding, and allow network businesses to minimise the impacts of price changes by gradually moving to new network prices over several years.
>
> There will also be more consultation with consumers and retailers in the development of network prices, and the process for setting prices will be more transparent."

In broad terms, there are two elements to the draft rule:

- A new network pricing objective and pricing principles; and
- A new network pricing process with improved consumer consultation.

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1 AEMC, Draft Rule Determination National Electricity Amendment (Distribution Network Pricing Arrangements) Rule 2014, 28 August 2014, page iii.

2 Ibid, page i.

United Energy sets out its views on each of these points in turn. Further detailed discussion of the issues is provided in the attachment to this covering letter.

While we appreciate the AEMC's desire to achieve better pricing signals for customers and reduce the level of cross subsidies that currently exist in network tariffs, we believe the proposed drafting inadvertently creates a number of significant issues and risks delivering outcomes quite inconsistent with the intent, as it;

- Effectively removes the DNSP's discretion in the setting of tariff and prices that result in efficient outcomes and sets a prescriptive formulaic approach to tariff setting. Taken together conflicts between the pricing principles and the Tariff Structures Statement (TSS) approval process may give the Australian Energy Regulatory (AER) the right to step in and set tariffs for a DSNP

- Locks DNSPs into a prescriptive and inflexible tariffs setting mechanism for a five year period with very limited opportunity for adjustment at a time when markets are undergoing wide spread change and where new approaches are required.

We understand the desire of the AEMC and COAG to further encourage network business to change the structure of network tariffs we set out in our submission a number of drafting changes that would address our concerns while still providing a robust rules framework.

Network pricing objective and principles

United Energy fully supports the objective of enhancing network pricing to deliver efficient outcomes for customers and stakeholders. However, the approach adopted in the draft rule risks delivering outcomes that are inconsistent with this objective as summarised in the table below.

United Energy's concern	Comments
1. The pricing objective (6.18.5 (a)) is focused on efficient cost allocation for each customer, not efficient outcomes.	• Whilst there is an assumption that prices that exactly reflect the cost of service should drive efficient outcomes, there may be many reasons, why this does not occur in practice. These include: o Efficient allocation of costs requires consideration of both the costs and the driver of those costs o Changes in customer behaviour after the costs are allocated o Customer willingness and ability to change o Price elasticity of demand • To efficiently reduce cross subsidies that exist between different groups of customers tariffs needs to reflect not only the costs of a customer's current use of the network but also signal efficiently how the costs will change over times should a customer's behaviour change. The signalling of future costs will only deliver efficient outcomes if it reflects the basis on which the costs are incurred. o It may be more important to signal the cost driver (kw, kwh, fixed etc) than the actual costs to drive efficient outcomes • The development of tariffs that reflect the costs at an individual customer level is both inefficient and impractical. • *Consistent with the NEO we believe the objective should be changed to focus on efficient output rather than the efficient allocation of costs.*

United Energy's concern	Comments
2. The principles (6.18.5. (e) - (j)) require a pinpoint price outcome for each tariff, and undermine a DNSP's role and exercise of judgement in setting efficient tariffs	• Taken as a whole the principles require a single pin point outcome that: o Is based on the Long Run Marginal Cost (LRMC) o Reflects the efficient costs of supplying that customer o Minimises any distortions from LRMC signals o Minimises the impact of any change on consumers • The overall effect of the pricing principles is that the DNSP has no discretion in setting tariffs, which must be calculated according to a prescriptive, approved methodology. • Taken with the provisions in the TSS that allow the AER to set prices in the event that a DNSP has not to fully complied with all the pricing principles (6.12.3.(l)), the draft rule establishes a framework for the AER to step in and set tariffs for the DNSP • As discussed above a prescriptive approach to cost allocation will not necessarily reduce cross subsidies if it does not reflect the drivers of costs and rule changes are not required to facilitate changes to tariff structures that best reflect network costs. o For more than 10 years UE has been charging larger customers on the basis of KVa and demand for use of the network o There was not compulsion in the rules required to make this change, we made it as it best reflects the costs these customers impose on our network. o Over time we expect to see these approaches rolled out to residential customers • *We propose a number of changes to the pricing principles that would allow DNSP's a degree of discretion in setting prices that deliver efficient outcomes*
3. The standalone and avoidable cost principle (6.18.5 (e)) is valid, but it is circumvented by the other principles	• This principle has a sound economic basis, but it is totally circumvented by all the other principles as discussed above, that set a prescriptive approach to a single deterministic price for each customer • Historically in Victoria, this principle was given much greater prominence by the jurisdictional regulator • *We encourage the AEMC to give greater consideration to the application of this principle in the rules, including potentially the extension this provision from the tariff class level to the tariff level to address concerns regarding cross subsidies between customers within a tariff class*

United Energy's concern	Comments
4. Basing prices on LRMC (6.18.5 (f)) excludes the use of Short Run Marginal Cost (SRMC) and other valid pricing approaches	• Pricing according to SRMC has a sound economic basis, and congestion pricing has been much talked about. These approaches, which in some circumstances, may deliver efficient outcomes are prohibited the LRMC principle in clause 6.18.5(f). o SRMC may be an appropriate basis for costing short term constraints. Take for example an area that is likely to experience a constraint on a peak summer day due to an increase in air-conditioning load. An incentive based on the SRMC offered to some households to reduce demand during these peak periods increasing the efficiency of consumption. • The introduction of the TSS will necessitate greater documentation of the methodology employed for determining tariff structures and improved consultation with customers, retailers and stakeholders in the development of network tariff structures. Through this process distributors would have to demonstrate how they have taken the LRMC into account for each service. The additional controls provided by the TSS should make the existing provisions to 'take into account' the LRMC of providing services sufficient to achieve the AEMC's objectives • *We encourage the AEMC to consider reverting to the existing 'take into account' obligations rather than limiting outcomes by requiring tariffs to be explicitly based on LRMC*
5. The only way to minimise the distortion to LRMC pricing signals (6.18.5.(g)(3)) is through a fixed cost.	• We understand the Commission's intention is to provide DNSPs with flexibility in how residual costs are recovered. • Strict interpretation of the provision as drafted will require all residual costs to be recovered through fixed costs as this is the only mechanism which does not distort the LRMC pricing signals • We do not believe that this is appropriate or that it would send appropriate signals to encourage efficient investment or consumption decisions by customers. The AER has also expressed this view in its submission to the Commission. • *We encourage the AEMC consider a revision of 6.18.5.(g)(3) to minimise distortions from efficient patterns of consumption*

United Energy's concern	Comments
6. The principle of minimum distortion from LRMC (6.18.5.(g)(3)) precludes discounting	• The use of discounts or premium prices is a standard approach for encouraging customer to change behaviour in competitive markets. • As the LRMC and cost recovery principles require a deterministic approach to tariff setting, the drafting of the rule prohibits DNSPs from using tariffs as an incentive for customers to adopt more efficient behaviour. Providing incentives to move to more efficient tariffs is a technique used by utilities for decades. Incentives can include: o Offering discounts on some tariffs that better reflect the cost drivers (eg demand tariffs). o Creating a disincentive to stay on less efficient tariffs (eg inefficient flat volumetric tariffs) o Providing rebates for customers who adopt specific behaviours (eg hot water customers or demand reduction) • We question whether successful approaches to changing customer behaviour such as our recent trial of rebates for customer who cut back on consumption during specified periods of peak demand could be rolled out more widely under the prescriptive approach detailed in the rules • *We encourage the AEMC consider a revision of 6.18.5.(g)(3) to minimise distortions from efficient patterns of consumption*

<table>
<tr><th>United Energy's concern</th><th>Comments</th></tr>
<tr><td>7. Minimising the impact of tariff reform on customers (6.18.5.(h)) will slow the pace of tariff reform and leave customers disadvantaged by paying cross subsidies under the current tariff structures worse off .</td><td>
The principles state that DNSPs <u>must</u> minimise customer impact (6.18.5.(h)). This principle has the direct impact of slowing or preventing tariff reform.
Taken literally, this would preclude any material changes in tariffs, especially where the impact on one group of customers on a tariff may be materially different to that of another group of customers on the same tariff.
It may also prevent DNSPs from introducing new 'cost reflective' tariffs that would be attractive for customers who are currently paying cross subsidies as this could have the effect of increasing the costs for customers who remain on historic tariffs.
As customers who are paying cross subsides move off legacy tariffs onto new tariffs more efficient tariffs that reflect their use of the network, the costs of supplying customers on legacy tariffs would increase leading to a reduction in cross subsides and increase in prices for some customers remaining on legacy tariffs
The principle also contemplates a long transition period, that may extend over more than one regulatory period. DNSPs need to be able to determine the pace of change in consultation with customers and stakeholders to best adapt to the changing market conditions (eg new technology). The pace of change should not be detailed in the rules.
Documentation of the proposed network tariffs structures in the TSS should be used to demonstrate how customer have taken into account the impact on customers on the pace of tariff reform. This would likely highlight both the winners and losers from tariff structure changes
The proposed arrangements may also provide opportunities for commercial interests of other market stakeholders to unduly influence the pace and direction of tariff reform.
We encourage that the AEMC amend the rule to require DNSPs to take into account the impact of changes in tariffs on customers and remove any reference to the time period for change from the rules
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United Energy's concern	Comments
8. The customer impact principles 6.18.(f).(2) and 6.18.5.(i). put too much weight on the actions which are outside the control of DNSP's in setting prices	• The draft rule requires tariff design to ensure that: (1) customers are able to receive and respond to price signals (6.18.5(f)(2)); and (2) customers understand the tariff structures (clause 6.18.5(i)). • While these are matters that should clearly be taken into account by the DNSP during the process of setting tariff structures and documented in the TSS, it is essential that the DNSP critical role in setting its own prices and tariff reform is not blocked by self interested stakeholders and customers. • As drafted, these provisions along with the ability of the AER to revise the TSS (as discussed below) mean the AER will play a significant role in interpreting the customer impact principles and determining distribution tariffs. This is not an appropriate role for the AER. • *We encourage the AEMC to amend the draft such that DSNPs are required to take into account these factors in the development of the TSS and tariffs.*

In summary, while United Energy supports the Commission's overarching objective of improving the efficiency of distribution tariffs, we have some significant concerns arising from the draft rule. In the attachment, United Energy has suggested drafting amendments to address the issues set out above, while preserving the goal of ensuring that network tariffs provide more efficient price signals.

Consumer consultation and regulatory approval processes

The Commission proposes a two stage price approval process, in which:

- a TSS is established at the commencement of a regulatory period; and
- annual pricing proposals are reviewed by the AER for compliance with the TSS; the control mechanism; and the rules.

UE generally supports the objective of providing greater strategic direction on the future of tariffs structures and pricing levels as well as increasing the level of consultation with stakeholders, however we are concerned that the approach to the TSS set out in the draft rule change is unduly restrictive. We set out each of our concerns in the table below

United Energy's concern	Comments
1. Locking in tariffs for a period of five years is inappropriate at a time of increasing market change	• The energy markets are currently facing significant and increasing change as new technologies and applications alter the way that customers use energy. Tariff reform is a key step in helping customers to understand how their choices impact the costs of the services provided. • During this period of change while both customers and the DNSP are in the process of learning about the new tariffs it does not make sense for the DNSP to lock in the transition to new tariff structures and tariff parameters for the life of the regulatory determination. This is especially true when the DNSP may not have had the opportunity to trial the new tariffs prior to the regulatory period. • A DNSP needs the ability to test new tariffs before they are applied to large groups of customers. This testing may identify areas where small changes in parameters may result in large increases in efficiency. The drafting of the proposed rule changes does not facilitate learning from the introduction of new tariffs to be incorporated until the next regulatory period with the potential to significantly reduce the efficiency of tariff setting. This may also have the impact of slowing the pace of network tariff reform as the DNSP may take a slower and more cautious approach to tariff reform. • *Any binding element of the TSS should be limited to the approach to tariff structures and transition pathways and not include the parameters or pricing of specific tariffs* • *A DNSP should be permitted to submit a revised TSS for approval if it complies with the pricing objective and principles and consultation has been conducted with stakeholders*
2. The approval processes gives the AER a direct role in tariff setting	• As discussed above the tariff principles, as drafted, are conflicting and overly prescriptive • In the case where the AER believes that a DNSP has not complied with each of the conflicting pricing principles the AER is given the right to amend the DNSP's Tariff Structures Statement • *We do not believe that the AER should have the right to amend a DNSPs TSS and the DNSP should be required to resubmit a revised TSS should the AER fail to approve the initial document*
3. Detailing prices in the TSS may give some stakeholders an undue level of confidence in the published prices	• While prices published in the TSS would represent a DNSPs expectation of future prices there are many factors that may impact on these prices within a regulatory period. • Detailing price levels in the pricing schedule may give some stakeholders an undue level of confidence in the published prices. • *It would be preferable for prices detailed in the pricing schedule that accompanies the TSS to be indicative only with discussion focused on the likely drivers of year on year variation to give stakeholders a better understanding of the likely price paths over the regulatory period*

United Energy's concern	Comments
4. The transition timeline is tight and potentially limits the depth of consultation permitted	• We are in the process of developing our Regulatory Proposal and have been consulting widely with stakeholders on the potential direction and structure for tariffs over the regulatory period. • Even taking into consideration this ongoing consultation, we consider the time period available from the final decision to the date for the submission of the initial TSS is relatively short given the detail required. • There are many stakeholders who will need to be consulted as part of the development of the TSS. We expect that some stakeholders will need to be consulted by a multiple DNSPs across the states. The requirement for all the DNSPs (excluding Tasmania) to submit a TSS at the same time may put undue pressure on some stakeholders and reduce the level of consultation possible by DNSPs. • *The AEMC should consider the appropriateness of the overall transitional time frame*
5. Submitting a full TSS including pricing at the same time as Regulatory Proposal is likely to require multiple revisions	• Should the AER draft and/or final determination on the Regulatory Proposal differ from the submission made by the DNSP the prices detailed in the TSS and pricing schedule will also require change • While consultation on the tariff structures and pathways prior to submission of the regulatory proposal and initial TSS is valuable any detailed consultation on the pricing is likely to be premature. • *The AEMC should consider the appropriateness of consulting on and submitting a pricing schedule prior to the final determination on the DNSP's regulatory proposal*

We also note that the AEMC is proposing a workshop for the 22nd of October to discuss the AEMC's expectations on the pricing methodology content to be included in the TSS propose an alternative transitional approach for the TSS which may address some of the issues set out above.

Further detailed discussion of the issues noted above is set out in the attachment. We would welcome the opportunity to discuss this submission with you or your staff at any time. If you have any queries regarding this submission, please contact Kiera Poustie, Policy Analysis Manager, on (03) 8846 9401 or by email at kiera.poustie@ue.com.au.

Yours sincerely,

Andrew Schille
General Manager Regulation

UNITED ENERGY

Attachment: Comments on distribution Network Pricing Draft Rule change

1. Pricing objectives and principles

1.1 Introduction

The Commission explains the purpose of the draft rule changes as follows[3]:

> "The objective of these changes is that network prices better reflect the costs of providing network services to individual consumers. This will allow consumers to make more informed decisions about how they want to use energy services and the technologies they invest in to help manage their energy use."

Currently, the rules governing distribution pricing do not include an overarching objective. The draft rule therefore sets out a network pricing objective and pricing principles, which are summarised in the table below.

Pricing principle	Overview of principle
1. Avoiding cross subsidy between tariff classes –6.18.5(e)	For each tariff class, the revenue expected to be recovered must lie within: • an upper bound representing the stand alone cost of serving the retail customers who belong to that class; and • a lower bound representing the avoidable cost of not serving those retail customers.
2. Basing prices on long run marginal cost – 6.18.5(f)	Each network tariff must be based on the long run marginal cost of providing the service.
3. Recovering total costs efficiently –6.18.5(g)	The revenue to be recovered from each network tariff must recover the DNSP's total efficient costs of providing services in a way that minimises distortions to the LRMC based price signals.
4. Considering consumer impacts –6.18.5(h)	Tariffs are to be developed in line with a new consumer impact principle that requires the impact of annual changes in network prices to be minimised. Network businesses can gradually phase-in new prices over a transitional period.
5. Setting tariffs that consumers can understand –6.18.5(i)	The consumer impact principle also requires DNSPs to set network tariffs that consumers are able to understand. Consultation and information provision by DNSPs will be key activities to facilitate consumers' understanding of tariffs.
6. Meeting jurisdictional obligations –6.18.5(j)	Network tariffs must comply with any jurisdictional pricing obligations imposed by state or territory governments. A network business may depart from the above principles to meet jurisdictional pricing obligations, but must do so transparently and only to the minimum extent necessary.

In the remainder of this section, United Energy sets out its views on the draft network pricing objective and the pricing principles summarised above, with the exception of the final principle on meeting jurisdictional obligations which UE supports.

3 AEMC, draft rule determination, National Electricity Amendment (Distribution Network Pricing Arrangements) Rule 2014, 28 August 2014, page i.

1.2 United Energy's position

1.2.1 Network pricing objective

The Commission's proposed pricing objective is set out below[4]:

> "The network pricing objective is that the tariffs that a Distribution Network Service Provider charges in respect of its provision of direct control services to a retail customer should reflect the Distribution Network Service Provider's efficient costs of providing those services to the retail customer."

The Commission explains the pricing objective in the following terms[5]:

> "The focus of the network pricing objective is cost reflectivity. Cost reflectivity in relation to network tariffs has three key components:
>
> (i) Sending efficient signals about future network costs.
>
> (ii) Allowing a DNSP to recover its regulated revenues so that it can recover its efficient costs of building and maintaining the existing network.
>
> (iii) Each consumer should pay for the costs caused by its use of the network.
>
> Taken together, these three components of cost reflectivity should result in an outcome where the network prices that each consumer faces reflect the costs that particular consumer causes through its use of the network."

United Energy has two concerns with the pricing objective as drafted and the Commission's approach:

1. It focuses on efficient cost allocation, not efficient outcomes; and
2. It requires the cost allocation to be tailored to each customer.

We note that the National Energy Objective (NEO), set out in the National Electricity 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 draft rule focuses on efficient cost allocation rather than efficient outcomes. United Energy's view is that, consistent with the NEO, the draft rule should focus on the actual objective, efficient outcomes, rather than the means by which that goal is to be achieved.

Furthermore, it is widely understood that at any point in time, prices may differ from the level implied by a mechanical cost allocation process as customers change their behaviour. The real world practice of promoting discounts or charging premium prices is an important operational tool for any commercial

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4 AEMC, draft rule, National Electricity Amendment (Distribution Network Pricing Arrangements) Rule 2014, 28 August 2014, clause 6.18.5(a).

5 Ibid, page 15.

enterprise may also impact this allocation. Pricing provides the primary means for encouraging changes in customer behaviour, with the objective of reducing overall costs to the benefit of all customers.

Electricity networks are no different. Indeed, providing incentives to customers to move to more efficient tariffs is a technique that has been used by utilities for decades. Those incentives involve:

- offering discounts on the desired tariff; and
- creating a disincentive for customers to stay on inefficient tariffs,

In contrast, however, the pricing objective as drafted precludes distributors from employing discounting or setting premium charges. Instead, the pricing objective requires prices to be set according to a specified cost allocation process. Such an approach undermines a distributor's ability to influence customer behaviour and deliver more efficient outcomes through innovative pricing solutions.

We also questions if the current drafting of the rules would allow for rebates to customers who have higher than average price elasticity and agree to make changes in behaviour. For example UE conducted a trial in the Bulleen / Templestowe area where customers were offered a rebate for agreeing to reduce their energy consumption at times of peak network demand. Offerings such as this have the potential to provide valuable services to the network, help to reduce future network costs and lead to more efficient outcomes for all network users.

In relation to the second point, the nature of any tariff is that a set pricing structure is applied to a group of customers that have similar - but not necessarily identical - characteristics. A tariff effectively trades off the simplicity of a set pricing structure against the greater theoretical efficiency of a customer-specific pricing. In this context, it is inappropriate for the pricing objective to focus on charges to *each* customer, as tariffs are not designed to achieve a perfect cost allocation for every individual customer.

In light of the above comments and consistent with the NEO, United Energy proposes the following amended network pricing objective:

> "The *network pricing objective* is that tariffs set by DNSPs charges in respect of its provision of standard control service to retail customers should be set to promote efficient provision and use of electricity network services."

United Energy also recommends that the rules should clearly state that it is the DNSP's role to set network tariffs. The ability to set prices is fundamental to any commercial enterprise, as it is the primary mechanism for influencing customer behavior in order to deliver more efficient outcomes.

1.2.2 Principle 1: Avoiding cross subsidy between tariff classes

Clause 6.18.5(e) of the draft rule requires that for each tariff class, the revenue expected to be recovered must lie on or between:

(1) an upper bound representing the standalone cost of serving the retail customers who belong to that class; and

(2) a lower bound representing the avoidable cost of not serving those retail customers.

The Commission makes the following comments in relation to this principle[6]:

> "In part, the difficulty with the avoidable and standalone costs concept stems from the fact that the current pricing principles only require DNSPs to allocate network costs to groups of consumers with similar characteristics, i.e. at a tariff class level.
>
> The Commission considers that these standalone and avoidable cost bounds are not sufficient on their own to set efficient prices, which is why the additional pricing principles discussed above and below have been added. However, these standalone and avoidable cost bounds continue to have value and have been retained as a pricing principle to safeguard against large cross-subsidies between different tariff classes. For example, this principle would limit cross-subsidies between residential and business consumers if they were assigned to different tariff classes."

United Energy agrees with the Commission that applying the standalone and avoidable cost principle at a tariff class level may not provide sufficient guidance in relation to individual tariffs. However, as an alternative to adding additional pricing principles to address this issue, the application of the standalone and avoidable cost principle could be extended to each tariff. As noted above, the standalone and avoidable cost principle was previously applied at the tariff level in Victoria.

In this regard, it is useful to recall the extensive debate previously conducted in Victoria in relation to tariff design and the extent to which guidance should be provided by the regulator. While this debate was conducted many years ago, the following observations made by the Victorian regulator remain relevant today[7]:

> "The Office noted in the Draft Decision that it is of the view that tariff setting is primarily the responsibility of the distributors, within the overall tariff basket control on distribution prices and constraints on the rebalancing of tariffs in any one year. However, the Office has set out criteria that the distributors' tariffs should satisfy if they are to provide economically efficient market signals. Tariffs for distribution services must lie between the following upper and lower bounds:
>
> - tariffs for each customer should be above the avoidable cost to service that customer; and
> - tariffs for each customer should be below the cost of providing the service on a stand-alone basis to that customer.
>
> Within these bounds, there is a range of potential tariff structures that would recover the sunk costs of the distribution network, without distorting signals for efficient usage and investment."

United Energy agrees with the views expressed by the Victorian regulator, and we note that they remain relevant today. In particular, there are always conflicting objectives in setting tariffs, and therefore it is preferable to avoid rigid cost allocation guidelines[8]:

> "In practice, there is no single 'right answer' to tariff setting. The assessment of tariff structures typically involves reference to costs and consumption patterns as well as principles of economic efficiency and equity. These are often in conflict. The need to balance these principles together with various practical difficulties

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6 AEMC, draft rule determination, National Electricity Amendment (Distribution Network Pricing Arrangements) Rule 2014, 28 August 2014, page 18.

7 Office of the Regulator-General, Electricity Distribution Price Determination 2001-05, Volume I, Statement of Purpose and Reasons, September 2000, page 196.

8 Ibid, Page 198.

(including information deficiencies and transactions costs) means that in practice tariff setting is necessarily a pragmatic exercise, to which there is always more than one acceptable outcome.

The Office therefore considers that an approach that emphasises transparency and general principles is more appropriate than one that adopts rigid tariff guidelines that mandate specific cost allocation principles. The Office also continues to believe that tariff setting should remain the responsibility of the distributors, within the bounds established by the regulatory controls, and that it would be inappropriate for the Office to take the responsibility for tariff structures."

United Energy concurs with the Victorian regulator's observations. While it may not be the Commission's intention, the specific nature of the additional principles (discussed below) will effectively mandate a cost allocation approach of the kind previously rejected by the Victorian regulator. As a consequence, the inclusion of these additional principles effectively overrides the standalone and avoidable cost principle. Furthermore, as discussed later in the submission, United Energy is also concerned that the distributor's role in setting tariffs is undermined by other aspects of the proposed rule, to the detriment of all stakeholders.

In view of these considerations, United Energy considers that greater prominence should be given to the standalone and avoidable cost pricing principle by:

- extending its application to individual tariffs, rather than only at the tariff class level; and
- ensuring that other pricing principles do not mandate a 'pinpoint' pricing outcome.

1.2.3 Principle 2: Basing prices on long run marginal cost

Clause 6.18.5(f) of the draft rule requires each tariff to be based on the long run marginal cost as set out below:

Each tariff must be based on the long run marginal cost of providing the service to which it relates, with the method of calculating such cost and the manner in which that method is applied to be determined having regard to:

(1) the costs and benefits associated with calculating, implementing and applying that method as proposed;

(2) the extent to which retail customers that are assigned to that tariff are able to receive and respond to price signals;

(3) the additional costs likely to be associated with meeting demand from retail customers that are assigned to that tariff at times of greatest utilisation of the relevant part of the distribution network; and

(4) the location of retail customers that are assigned to that tariff and the extent to which costs vary between different locations in the distribution network.

For the purpose of this provision, long run marginal cost is defined as:

The cost of an incremental change in demand for direct control services provided by a Distribution Network Service Provider over a period of time in which all factors of production required to provide those direct control services can be varied.

The Commission explains the rationale for the above provisions in the following terms[9]:

> "Under the current pricing principles, when DNSPs have taken into account LRMC in tariff setting, it has not produced meaningful price signals to consumers because DNSPs' calculation and application of LRMC have not focussed on the drivers of network costs. For example, when DNSPs have taken into account LRMC, they have typically calculated network wide LRMC by voltage level and then compared LRMC estimates to non-time varying tariffs. These tariffs have not sent network cost signals to consumers because they do not target the specific locations and times of peak demand which drive network costs.
>
> There is a risk in specifying that DNSPs must base network tariffs on LRMC, but not specifying the method for doing so, that DNSPs may continue to calculate network wide LRMCs and apply LRMC estimates through non-time varying tariffs. To provide guidance to DNSPs when calculating and applying LRMC, the NER should include factors to be considered to target the key drivers of network costs.
>
> [...] It is important that DNSPs have the flexibility to make appropriate trade-offs between these factors."

United Energy accepts the Commission's view that some DNSPs may not have produced meaningful price signals in their application of the LRMC principle in the current Rule and notes that this discussion is relevant to both the costs and the parameters used for allocating those costs. United Energy also concurs with the Commission's view that DNSPs should have flexibility in making trade-offs between the factors specified in clause 6.18.5(f).

United Energy's principal concern is that the requirement that tariffs must be based on LRMC is a significant change from the current rules, which only require LRMC to be taken into account in setting tariffs. The practical effect of clause 6.18.5(f) is that tariffs will be calculated in accordance with the LRMC approach specified in the approved pricing methodology. Although additional principles (which we discuss shortly) may require the calculated tariff to be adjusted, the tariff must be based on the LRMC.

As already noted, United Energy does not support a mechanical approach to tariff setting, even if the approach is based on a sound economic principle. In particular, United Energy considers that:

- There is no single 'correct' economic principle for tariff setting. It is also noted that potentially viable alternatives to LRMC are not permitted under the proposed rules. For example, short run marginal cost or avoidable cost are acceptable alternatives to LRMC pricing. In fact, the AER's submission to the Commission's consultation paper pointed to SRMC as the superior technical approach[10]:

  > "With respect to the short and long run aspects of efficient pricing, the theoretical optimum is to set prices on the basis of Short Run Marginal Cost."

- Importantly, as noted in section 1.2.1, there may be sound reasons for tariffs to deviate from the price level implied by a standard cost allocation in order to encourage efficient changes in customer behaviour.

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9 AEMC, draft rule determination, National Electricity Amendment (Distribution Network Pricing Arrangements) Rule 2014, 28 August 2014, page 106.

10 AER Submission to AEMC Consultation Paper, December 2013, page 3.

We also note that the addition of the TSS with requirements to set out the methodology for calculating LRMC and explain how the proposed tariffs have deviated from the LRMC calculations should provide sufficient control to addresses the AEMC's concerns regarding the historic use of LRMC. In light of the above comments, United Energy's view is that the draft provision should be amended as follows:

> Each tariff must ~~be based on~~ take into account the long run marginal cost of providing the service...

1.2.4 Principle 3: Recovering total costs efficiently

Clause 6.18.5(g) of the draft rule requires the revenue expected to be recovered from each tariff to:

(1) reflect the total efficient costs of serving the retail customers that are assigned to that tariff;

(2) when summed with the revenue expected to be received from all other tariffs, permit the DNSP to recover its expected total revenue in accordance with the applicable distribution determination; and

(3) comply with sub-paragraphs (1) and (2) in a way that minimises distortion to prices signals for efficient usage that would result from the tariffs that comply with the pricing principle set out in paragraph (f)

United Energy notes that the Commission intends to provide the DNSP with flexibility in recovering residual costs in a manner that minimises distortions in the LRMC price signal. In particular, the draft determination makes the following observations[11]:

> "The underlying principle that minimises distortions to efficient usage decisions is to assign residual costs to tariff components in inverse proportion to consumers' responsiveness to that tariff component. Brattle and NERA's reports both emphasise that this is the key for recovering residual costs efficiently.
>
> [...]
>
> While the examples in the Brattle and NERA reports are indicative only, they highlight that in minimising distortions to efficient usage decisions there is no one specific approach that should be applied in all circumstances.
>
> In particular, analysis from both reports demonstrate that this principle does not require that residual costs are recovered though increases to fixed charges.
>
> [...]
>
> The ideal method of minimising distortions to the efficient pricing signals sent to consumers from LRMC based tariffs depends on each DNSP's network and consumer characteristics, and the types of price signals being sent. The draft rule provides the flexibility for DNSPs to tailor their approach to these circumstances by not requiring a specific approach to minimising distortions to efficient usage signals."

While United Energy appreciates the Commission's intention to allow flexibility in the method for recovering residual costs, ultimately the AER will be required to implement the rule as drafted. We also note that the AEMC discussion above relates to 'efficient usage decisions' rather than efficient cost

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11 AEMC, draft rule determination, National Electricity Amendment (Distribution Network Pricing Arrangements) Rule 2014, 28 August 2014, pages 120-121.

allocation. We have highlighted the difference between these two approaches in our discussion on the objective. It is important to note that the AER has expressed the following view on the method that minimises distortions to price signals[12]:

> "[…] it appears to us that the approach that would least distort efficient pricing and demand is to recoup residual costs as fixed components in tariffs, and to attempt to cost reflectively apportion some of these costs. This approach could address what appears to be the ultimate goal of Ramsey pricing, to target inelastic demand, without leading to what we see as potential problems of strict interpretation of that approach."

United Energy notes that the AER has expressed what may be regarded as a standard view that minimising the distortions in the price signals is best achieved by recovering the residual costs through fixed charges. If the Commission intends to provide DNSPs with greater discretion in relation to the recovery of residual costs, then it is important that this description is expressed in the pricing provisions of the rules. At present, the proposed drafting could be interpreted reasonably as requiring residual costs to be recovered through fixed charges.

We do not support this approach and recommend the removal of (1) and (3) from the draft rule.

1.2.5 Principles 4 and 5: Considering consumer impacts

These principles address two matters, namely:

- minimising the impacts of price changes on customers; and
- providing prices that are easily understood.

These matters are dealt with separately in two clauses of the draft rule, as noted below.

Clause 6.18.5(h) requires a DNSP to minimise the impact on retail customers of changes in tariffs from the previous regulatory year having regard to:

(1) the desirability for tariffs to comply with pricing principles referred to in paragraphs (f) and (g), albeit after a reasonable period of transition, which may extend over more than one regulatory period;

(2) the extent to which retail customers can choose the tariff to which they are assigned; and

(3) the extent to which retail customers are able to mitigate the impact of changes in tariffs through their usage decisions.

Clause 6.18.5(i) requires the structure of each tariff to be reasonably capable of being understood by retail customers that are assigned to that tariff, having regard to:

(1) the type and nature of those retail customers; and

(2) the information provided to, and the consultation undertaken with, those retail customers.

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12 AER Submission to AEMC Consultation Paper, December 2013, page 6.

We recognise the importance of engaging with our customers and other stakeholders. We are actively engaging with our customers on many aspects of our business including our future tariff strategy.

We also agree that it may be appropriate to phase-in tariff changes in order to manage price impacts on groups of customers, and to provide customers a reasonable opportunity to change their behaviour in response.

However, United Energy is concerned that the draft principles will have a material and inappropriate impact on how tariffs are set. In particular, clause 6.18.5(h) requires the DNSP to minimise the impact on retail customers. The outcome that best satisfies this requirement is no change to tariffs. Evidently, this would stifle tariff reform and lead to inefficient outcomes - contrary to the basic intent of the Commission's rule change. It is also unclear who the tariff change should be minimised for as a change in tariff may result in reductions or increases for different groups of customer staying on that same tariff. For these reasons, United Energy considers that the proposed drafting is inappropriate. Instead, the rule should establish the starting point as the DNSP's proposed tariffs, which may be modified in light of an assessment of customer impacts.

Similarly, in relation to clause 6.18.5(i), United Energy accepts that each tariff should be reasonably capable of being understood by retail customers. However, the current drafting has much wider implications for how tariffs are set. In particular, a customer or retailer may successfully persuade the AER that a proposed tariff is either difficult to understand (clause 6.18.5(i)) or does not provide the customer with sufficient opportunity to mitigate the impact of the tariff through their usage decisions (clause 6.18.5(h)(3)). This raises concerns about the potential for commercial interests to unduly influence the progress and direction of tariff reform - a matter discussed in more detail below.

In our view, taken with the ability of the AER to amend the TSS as set out in 6.12.3.(l) the principles undermine the DNSP's tariff setting role. United Energy's position is that a DNSP must be the final arbiter of whether a particular tariff structure is appropriate. We note that in real-world competitive markets, customers are not able to determine their supplier's pricing arrangements. Customers' views will shape and influence the pricing policies of suppliers, however, there are sound economic and commercial reasons why suppliers ultimately determine their own prices. We note that our position is consistent with that of the Victorian regulator (cited earlier), who determined that:

- tariff setting should remain the responsibility of the distributor; and
- it would be inappropriate for the regulator to take responsibility for tariff structures.

United Energy accepts that tariff design should be affected by the extent to which:

- customers are able to receive and respond to price signals (clause 6.18.5(f)(2)); and
- customers understand the tariff structures (clause 6.18.5(i)).

However, while these are matters that should be taken into account by the DNSP, it is essential that DNSPs retain their pricing role. United Energy is concerned that as drafted, the proposed rule may inadvertently place customers and retailers in the role of driving tariff reform – in circumstances where they may have their own commercial agendas. This consideration underscores the need for the rule to be drafted in a way that preserves the DNSP's tariff-setting role.

In a similar vein, clause 6.18.5(h)(1) provides for a "reasonable" period of transition, which may extend over more than one regulatory period. The rule is unclear as to how a reasonable period would be determined. It would be undesirable if this ambiguity were to result in commercial interests ultimately determining the timeframe for tariff reform, or the AER making a determination on such matters. As previously noted, the pace of tariff reform is a matter for DNSPs to decide in consultation with their customers and other stakeholders.

The draft rule should accommodate an approach to tariff setting and stakeholder engagement that is much more closely aligned to how competitive markets operate. Accordingly, United Energy proposes the following drafting amendments to clauses 6.18.5(h) and 6.18.5(i).

> A Distribution Network Service Provider must ~~minimise~~ take into account the impact on retail customers of changes in tariffs from the previous regulatory year having regard to:
>
> (1) the desirability for tariffs to comply with pricing principles referred to in paragraphs (f) and (g), albeit after a reasonable period of transition (which may extend over more than one regulatory period);
>
> (2) the extent to which retail customers can choose the tariff to which they are assigned; and
>
> (3) the extent to which retail customers are able to mitigate the impact of changes in tariffs through their usage decisions.
>
> The structures of each tariff ~~must~~ should be reasonably capable of being understood by retail customers that are assigned to that tariff, having regard to:A Distribution Network Service Provider must ~~minimise~~ consider whether the structure of each tariff ~~must be~~ is reasonably capable of being understood by retail customers that are assigned to that tariff, having regard to:
>
> (1) the type and nature of those retail customers; and
>
> (2) the information provided to, and the consultation undertaken with, those retail customers.

2. Pricing process

2.1 Overview of proposal

The draft rule contains a new process and new timeframes for setting network prices. New consultation processes will require distribution businesses to demonstrate to the AER how they have consulted with consumers and retailers in developing their price structures.

The table below provides an overview of the key aspects of the proposed process.

Aspect of process	Overview
Development of network prices	Network prices will be developed under a new two-stage process: • Each DNSP must develop a tariff structure statement (TSS) that sets out its network price structures. The TSS is approved by the AER as part of the regulatory determination process and applies for the five year regulatory control period. • Each DNSP must then develop its annual pricing proposal, based on its approved TSS. The proposal must be submitted to the AER for approval on an annual basis. The AER will check the annual prices for compliance with the TSS, pricing principles and other rules requirements.
Consultation	As part of developing its prices, each DNSP is required to describe how it has consulted with retailers and consumers on the design of network prices, and sought to address their concerns. The AER must invite stakeholder submissions on the TSS.
Timeframes	The timeframes for the annual pricing process will also be amended so that final network prices are notified to consumers and retailers at least six weeks before they commence. To allow this to occur, DNSPs must submit their annual pricing proposals earlier. TNSPs (other than those in Victoria) must publish their prices earlier; and the AER must approve network prices within 30 business days.

We provide the comments below noting that the AMEC will propose an alternative approach to the implementation of the TSS at a workshop in Mid October.

2.2 United Energy's position on the pricing process

United Energy generally supports the AEMC's proposed two stage pricing process, in which the TSS is established at the commencement of the regulatory period, and annual pricing proposals reviewed by the AER for compliance with the TSS, the control mechanism and the rules.

United Energy is concerned, however, that the proposed approach for updating the TSS is unduly restrictive and the information required is overly detailed. Before addressing these issues, it is useful to note that the TSS includes the following information:

(1) the tariff classes into which retail customers for direct control services will be divided during the relevant regulatory period;

(2) the policies and procedures the DNSP will apply for assigning retail customers to tariffs or reassigning retail customers from one tariff to another (including any applicable restrictions);

(3) the structures for each proposed tariff;

(4) the charging parameters for each proposed tariff; and

(5) the pricing methodology that will be used to set each tariff in each annual pricing proposal of the DNSP during the relevant regulatory control period.

(6) must be accompanied by a pricing schedule which sets out, for each regulatory year of the regulatory control period, the indicative price levels determined in accordance with the tariff structures statement

The draft rule limits the DNSP's ability to amend the TSS, by prescribing certain conditions that must be met in order to change a TSS. In particular, the draft rule specifies that to amend a TSS, there must be an event that:

- is beyond the reasonable control of the DNSP, and
- could not have been reasonably foreseen by the DNSP at the time the TSS was approved.

In addition, the DNSP must demonstrate that amendments to the TSS that are proposed in response to that event would, or would be likely to, result in a TSS that materially better complies with the pricing principles and other NER requirements than the DNSP's current TSS.

United Energy understands that the restrictions in amending the TSS are intended to provide certainty to retailers and customers regarding tariff structures. In United Energy's view, however, a proposal to change the TSS should be addressed on its merits. In particular, the test should be whether the proposed changes are likely to deliver a net efficiency improvement. Such a test would naturally consider any detriment arising from frequent and unexpected changes to the TSS.

The energy markets are in a period of change and all parties will need to learn about the customer impacts of new tariff structures. During this period of change while both customers and DNSP's are in the process of learning about the new tariffs it does not make sense for DNSPs to lock in the transition to new tariff structures and tariff parameters for the life of the regulatory determination.

DNSPs need the ability to test new tariffs before they are applied to large groups of customers. This testing may identify areas where small changes in the charging parameters would result in large increases in efficiency. The drafting of the proposed rule changes does not facilitate learning from the introduction of new tariffs to be incorporated until the next regulatory period with the potential to significantly reduce the efficiency of tariff setting.

Locking the tariff parameters in for a five year period creates significant risk for both distributors and retailers and in the event that tariff charging parameters do not function as expected and result in under or over recovery, significant fluctuations to annual prices levels may occur. This may also have the impact of slowing the pace of network tariff reform as DNSP's take a slower and more cautious approach to tariff reform.

United Energy considers that the draft rule applies an unduly rigid and inappropriate test to determine whether a change to the TSS should be allowed. In particular, under the draft rule if the DNSP could have foreseen the proposed change, the change would not be allowed even if it were likely to deliver significant efficiency improvements. There is no logical basis to forego efficiency improvements simply because the DNSP could have identified them sooner.

In light of the above comments, United Energy's view is that the charging parameters should not be binding and that amendments to the TSS should be allowed if they would promote the achievement of the network pricing objective. As already noted, such a test would assess whether the potential benefit of change outweighs the detriment of introducing unanticipated amendments to the TSS. Naturally we would expect to consult on any amended TSS in a manner similar to the initial TSS.

2.3 Transitional arrangements

United Energy notes that all networks, with the exception of TasNetworks will be required to submit their TSS to the AER by 30 June 2015, which will be seven months from the date of the Final Rule Determination in November 2014. The date for the AER approval of the TSS for the Victorian networks is 30 April 2016, and 30 October 2016 for NSW, the ACT, Queensland and South Australian networks.

While United Energy, has been consulting with our customers and stakeholders on our future tariff strategy as part of our regulatory proposal consultation, we consider that the proposed timeframe for AER approval is very challenging, especially given the scope of the TSS.

We also note that there are many stakeholders who will need to be consulted as part of the development of the TSS. We expect that some stakeholders will need to be consulted by a multiple DNSPs across the states. The same timing for submission of the TSS by the majority of DNSPs may put undue pressure on some stakeholders and reduce the level of consultation possible by DNSPs.

We recommend that the AEMC consider these issues when presenting its revised transitional approach.

2.3 Regulatory approval timeframes

The TSS is required to be submitted at the same time as a DNSP's regulatory proposal. In the event the AER requires changes to a DNSP's regulatory proposal at the draft and / or final decision stage, a revision of the TSS will be required for consistency.

We believe that there is significant value in consulting on tariff structures and transition pathways prior to the submission of the regulatory proposal. Consulting on actual pricing levels is premature prior to the final regulatory determination

We recommend the AEMC consider the detail required in the TSS at different stages of the regulatory determination process.