

8 December 2011

Richard Khoe
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Dear Mr Khoe,

RE: NER RULE CHANGE PROPOSALS ERC0134, GRC0011

Origin Energy (Origin) welcomes the opportunity to comment on the Rule Change Proposal submitted by the Australian Energy Regulator (AER) to the Australian Energy Market Commission (AEMC) in relation to network revenues and the National Electricity Rules (NER) and National Gas Rules (NGR).

Origin broadly supports the AER's proposal. Network prices have increased significantly under the new national framework and Origin has firsthand experience of the impact of these increases on customers. The rules should promote consistent value for money. Some drivers of energy price increases are unavoidable but we would be concerned if customers were regularly paying more than efficient costs. Furthermore, we believe that to address regulatory inefficiency identified by the AER the AEMC must also address the price approvals process.

Efficient forecasts of expenditure and incentives

The revenue framework in Chapter 6 of the NER was intended to give confidence to investors while protecting network users from rent seeking. While distribution has successfully attracted significant private investment from domestic and foreign sources, some \$10 billion in the National Electricity Market as of 2011,ⁱ there is recognition that the framework may be too favourable to network interests, at the expense of network users.ⁱⁱ In our submissions to the electricity and gas revenue reviews Origin has questioned whether the determinations of the AER under the NER and the NGR have delivered the best possible value to customers.

When a network is augmented, renewed and extended this should not automatically lead to increases in average price per unit, even in a context of growing peak demand. Renewed assets deliver improved network efficiency and extensions allow for costs to be spread over more users. Both these factors should put downward pressure on per unit cost.

The CPI-X framework as applied in the United Kingdom makes allowance for a reduction in prices over time due to increased efficiency.ⁱⁱⁱ While an efficiency factor is not a feature of the Australian building block model, a reference to this feature remains, in the negative X term in the price control formula. Yet on all Australian distribution networks

where revenues have been set under Chapter 6, average prices have climbed significantly as networks have been extended and improved, and this trend is yet to peak. This suggests customers may not be getting full value for their investment in all instances.

In addition to the evidence outlined in the AER's proposal, the research of academics Stephen Littlechild and Bruce Mountain further supports the conclusion that the regulatory framework has resulted in some inefficient spending.^{iv} In 2010 Littlechild and Mountain compared the electricity networks in New South Wales (NSW) with those in Great Britain (GB). They found that average revenue per customer in NSW was projected to jump from two times the GB average in 2000 to close to four times by 2014.^v

Littlechild and Mountain's findings bring into question the assertion that Australia's situation uniquely justifies higher per unit distribution costs than comparable networks overseas. The authors demonstrate that conditions on the NSW distribution networks and the British grid are in fact quite comparable, and factors such as reliability standards and customer density do not provide convincing explanations for differences in cost:

- While mandated standards for reliability are comparable in GB and NSW, performance against these standards actually improved on networks in GB but remained largely constant in NSW.
- In relation to customer density, the authors observe that the overwhelming majority of customers in NSW live in a narrow band close to the coast, at a much higher density than the GB average. Customer density is evidently much lower on the Essential network than on those of Ausgrid and Endeavour, but if customer density were a key driver of capital expenditure one might expect a higher asset to customer ratio on the Essential network, yet Essential has lower asset value per customer than the two other NSW networks.

Littlechild and Mountain's findings are significant when considering how to redress the balance of interests between customers and networks. They provide support for an amended approach that gives the AER more scope to benchmark network performance and cost metrics across jurisdictions, based on top-down approaches. Equally, they call into question any assertion that reliability and safety standards must fall in order to reduce capital expenditure per customer.

When outcomes from the monopoly pricing framework do not approximate fair value it reflects badly on the sector as a whole. Customers generally do not distinguish between monopoly and competitive segments of the energy supply chain. Instead, there is a sense that the industry is not delivering consistently on its commitment to value. This is in large part due to shortcomings in the distribution revenue and pricing framework. Customer dissatisfaction narrows the scope for formulating effective public policy at a time when governments arguably need much greater flexibility to respond to energy policy challenges such as carbon and time of use pricing.

In light of the above, Origin agrees with the AER that the regulator's ability to challenge networks' revenue proposals could be enhanced. As the AER has gathered data through its first round of decisions it should be in a stronger position to benchmark Australian electricity networks, including making thorough comparisons with networks in other markets. Indeed, industry support for a national regulator was predicated on it enabling better regulation through additional information and benchmarking. Origin concurs that the requirement for the AER to disprove each item that is in excess of a reasonable forecast ensures estimates of future costs will have a systemic upward bias.

Origin also agrees that strong incentives are required to ensure distribution businesses spend no more than is necessary and efficient and that excessive capital expenditure is

not rewarded. Origin supports the proposal of the AER to allow automatic pass through for only up to 60 percent of capital expenditure overspend.

Origin also believes that once revenues are determined, price control rules also create avenues for distribution networks to further inflate their revenues above reasonable forecasts, specifically:

- Clause 6.18.15(a) of the NER requires that networks show that expected revenue lies between the “stand alone” and “avoidable cost”. These are economic concepts that would never be breached in the course of normal business. This concept places no practical limits on a distribution network’s revenue as proposed in its price proposal.
- Clause 6.18.15(b) requires a DNSP to prove that each charging component reflects long-run marginal cost (LRMC). This is not a practical way to assess whether a price is prudent or reflects cost. Expenditure decisions are more likely to be made at the level of a tariff class than at tariff level, and assessing LRMC at the level of the tariff class would create more scope to assess whether tariffs are prudent.

Origin notes the case the AER makes for yearly reopeners and contingent capital mechanisms for distribution networks, in addition to the existing pass through mechanism. We don’t believe three separate mechanisms are required to address the risk of unforeseen events, and highlight the incentive this will create for distribution network to devote extra resources in an on-going manner to preparing applications for review under all three mechanisms. Also, if the distribution determination is to be re-opened each year this will make final price outcomes more difficult for network users to predict than is now the case, which underlines the need to reform the pricing notification and approval process, an issue we discuss below.

The efficiency of the regulatory process

The AER has identified in its rule change proposal that the regulatory process is inefficient and doesn’t optimise opportunities for consultation. Origin concurs with the AER’s view and supports the AER’s proposed changes in this regard.

Origin supports the AER’s proposed amendments whereby the AER will be permitted to give less weight to information supplied by the network commercially in confidence. The rules should allow third parties a reasonable opportunity to review all information provided by a network in support of its proposals. The networks are monopolies and only rarely should information be commercially sensitive. Furthermore, the opportunity for third parties to review and provide feedback on information should apply equally to pricing proposals as it does to revenue proposals.

We are of the view that the rule changes proposed by the AER are insufficient to address regulatory inefficiency and that additional rules changes are required in relation to pricing proposals and approvals.

Retail price deregulation has progressed at varying rates in different jurisdictions, but retail prices are generally becoming more cost-reflective. It is an unreasonable quirk of the NER as they have evolved that retailers carry the risk associated with delays in the distribution price setting process. Network revenue is a major input to retail prices, with the network component representing well in excess of 40 percent of a retail price.

Retailers must increase prices to reflect changes in network tariffs or risk making significant losses. Retailers must also understand changes to network tariffs and the structure of network tariffs when formulating retail prices. There is no value in elaborate cost-reflective network tariffs if the retailer has just a few days to adapt its retail prices, since due to time pressures retailers may be forced into applying flat increases and any price signals at the tariff level will be lost. This perpetuates considerable inefficiency in the regulatory process. Under the current rules, a distribution network must:

- submit its pricing proposal for the first year of a regulatory period within 15 days of the final decision;^{vi} and
- submit its pricing proposal for the subsequent years of a regulatory period within two months of the end of the regulatory year;^{vii}
- use *best endeavours* to post its tariffs on its website 20 business days before the commencement of the relevant regulatory year [emphasis added].^{viii}

And the Regulator:

- must publish the proposal upon receipt;^{ix} and
- may request the network to re-submit the proposal within ten days of the determination, if it determines the proposal to be deficient.^x

Origin notes that the obligation on distribution networks to publish their tariffs was modified in version 18 of the Rules to a “best endeavours” obligation.^{xi} In Origin’s view, these five rules do not guarantee a workable price setting process. Specifically, they are deficient in respect of:

- *Timeliness*, the rules do not provide retailers sufficient time to review prices, to model retail prices, and to notify increases in retail prices as required by law and regulation, and the rules are not strictly followed; and
- *Consultation*, as the rules do not allow retailers or other industry bodies an opportunity to respond to the proposed prices.

We address these deficiencies below, and propose that the AEMC might consider expanding the scope of the rule change proposal put forward by the AER to include these matters, since they exacerbate regulatory inefficiency.

Timeliness

The obligation on the AER to publish the pricing proposal upon receipt is linked in the first year to the time of the Final Decision, not to the time the tariffs apply, so the rules do not ensure time for retailers to review and model prices before they apply. While price proposals are a guide to final price outcomes there is frequently considerable discrepancy between price proposals and final outcomes, yet there is only a best endeavours obligation for networks to publish final prices prior to when they apply. There are also shortcomings in relation to compliance, as none of the three key obligations covering notifications has been observed consistently in practice. Table 1 (over) examines whether these obligations have been met in the major NEM jurisdictions.

	CP	PC	JE	SP	UE	ET	EG	EA	IE	CE
Was the proposal for Year 1 published by the AER within 15 days of the Final Decision? [^]	No	No	No	No	No	No	No	?	?	?
Were final prices for Year 1 published 20 business days prior to the commencement of Year 1?	No	No	No	No	No	No	No	Yes	No	No
Was the proposal for Year 2 published within two months of the commencement of Year 2?	Yes	Yes	Yes	Yes	Yes	No	No	No	No	No

* For background see Appendix 1. Indicative.
[^] Question mark denotes documents not dated on AER's website or network's websites.
 Networks shown in order are: Citipower, Powercor, Jemena, SP Ausnet, ETSA, Energex, Energy Australia, Integral Energy and Country Energy.

It is clear from Table 1 that the intent of the NER in relation to pricing notification has been frustrated in practice. Even if the rules were adequate to support a workable process, which Origin maintains they are not, the rules are honoured only in the breach. This suggests that the rules are unworkable and more time is required for price approvals.

Discrepancies between the X factor and final prices arise due to re-balancing and because there are elements in the price formula other than the X factor. While these additional elements are legitimate and recognised in the price formula, retailers can rarely gauge the quantum of their impact. A primary example is the carryover from previous periods, the quantum of which is typically not made public (the details are frequently contained in confidential appendices), nor is the carryover limited to the first year of the revenue period.^{xii} Furthermore, there are features in the rules that exacerbate the discrepancies between the change as expressed in the WAPC formula and the final price outcomes. These include:

- Side constraints: the side constraint is applied to a tariff class (a group of tariff lines) and is less binding on individual tariff lines when each class represents a larger pool of revenue. A tariff that is an outlier in a large class can be increased significantly above the average for that class. Thus, having fewer and larger tariff classes minimises the impact of the two percent constraint. The rules give distribution networks too much discretion to allocate tariffs and customers to tariff classes and thereby to maximise the size of each class. The rules should require that a customer be assigned to a tariff class based on all three of the criteria in the NER (cl.6.18.6), rather than any of those criteria, as is now the case. This will make the side constraint more effective.
- Appendix J of the NSW distribution network revenue decision allows for networks to take into account transfers that happen during the pricing year and to be compensated where these will lead to a reduction in revenue. The AER does not apply sufficient scrutiny *ex post* to statements networks make about the number of customers transferring and the volume implications of these, with the result that networks may over-recover revenue. The rules should require the AER to give close attention to circumstances where there may be double counting of tariff transfers or nominations of tariff transfers that never occurred, or where volumes are understated.
- Discrepancies also arise at the level of individual tariffs, where rebalancing occurs. The AER has interpreted the NER in such a way that rebalancing constraints cannot apply in the first year of a revenue determination,^{xiii} which

means changes in network tariffs are most unpredictable in that year. Equally, while the National Gas Rules (NGR) do not address side constraints, the AER has determined it will adopt the same approach in gas as in electricity.^{xiv} (As an example from the NGR, Envestra recently increased their supply charge in Queensland by 52 percent, implying a very significant change in the structure of fixed costs. Retailers cannot anticipate rebalancing on this scale.)

As outlined in Table 2, all the models for retail price setting present difficulties when the retailer does not have adequate time to react to network tariffs. In some cases jurisdictional regulators have been required to re-open retail pricing decisions, creating further administrative burden for the jurisdictional regulator and retailers.

Relevant jurisdictions	Retail price methodology	Issues
South Australia	Network + Retail	Regulated retail tariffs must mirror network tariffs in structure. This creates a delay where the final network tariff structure is not available in time for the commencement of the new retail price determination.
Queensland	Cost index but new proposal for Network + Retail	Currently, a standard cost increase is applied to each retail tariff. Any major rebalancing or unforeseen increases in network tariffs can produce retail prices with negative margins. However, the QCA has proposed a N+R methodology, which will create problems as described in relation to South Australia, above.
New South Wales	Weighted average price cap	While the retailer has the ability to change prices within a basket to align with an average increase, it relies on the network component to set individual tariffs and meet the average. Unpredictable increases can mean some retail prices will deliver a zero or negative margin.
Victoria	Deregulation	Although retail prices are deregulated, retailers could more readily construct their retail tariffs based on the actual network tariffs if these were available in advance.

Theoretically, retailers could delay the increase in retail prices to allow more time for analysis of the network tariff outcome, but the retailer is still liable for the increased network tariffs from the first day the new network tariffs apply. It would seem more reasonable to delay the increase in network prices, since the delay stems from the network pricing process. Alternatively, the rules could require the AER to work within timetables for approving pricing proposals that guarantee a window before the beginning of the regulatory year for network users to analyse prices, in the same way the rules ensure network users have reasonable time to analyse revenue proposals and final determinations.

If retailers change prices based on the estimated increase in network tariffs and these prices under or over recover the actual network element, this leaves the retailer competitively exposed. There is considerable cost and risk involved in re-adjusting prices. This is exacerbated when price increases regularly exceed 15 percent and the discrepancy between the X factor and the final prices can exceed 20 percent in real terms. In 2011-12 ETSA Utilities had an X factor in 2011-12 of around 9 percent, but eventual price rises in excess of 27 percent. This outcome arose in part because the AER was accepted the impact of a Tribunal review that occurred *after* ETSA had submitted its price proposal.

Importantly, this pricing approval process is not in the interests of customers, since the risk will tend to lead to higher price outcomes than would otherwise be the case. When retailers are forced to base final retail prices on draft distribution prices it is more likely they will look to incorporate this pricing risk, which over time will lead to an upward bias in prices. Equally, in situations where the increases in the regulated retail prices needs to be amended a month after to recover an unforeseen increase in network prices, 12 months of increased network revenue is recovered over 11 months, leading to larger step price increase for customers than would otherwise be necessary (this was the case recently in South Australian gas).

The distribution price approval process also poses difficulties in relation to retailers' own regulatory obligations to make notifications of retail price increases. In all jurisdictions, retailers must publish or gazette their new retail prices, as well as providing these to the jurisdictional regulator. Frequently, the retailer must also notify customers directly. The timing of these requirements varies from 10 business days to a month before the prices take effect.

Relevant jurisdiction	Selected obligations
South Australia	<ul style="list-style-type: none"> • Publish standing prices in gazette, newspaper and on website at least ten business days prior to increase (electricity and gas)
Queensland	<ul style="list-style-type: none"> • Publish in newspaper or send direct customer notification of price increases for market contracts at least 10 business days prior to increase (electricity). • Publish changes in standing prices on website at least 10 business days prior to increase (gas)
Victoria	<ul style="list-style-type: none"> • Gazette and notify regulator of increases in prices for non-market contracts one month prior to increase (electricity and gas) • Publish a newspaper notice including the weighted average price one month prior to increase (electricity and gas)
National Energy Customer Framework	<ul style="list-style-type: none"> • Newspaper publication at least 10 business days prior to increase (electricity and gas).

In contrast to the obligations on the retailer outlined in Table 3, the only obligation on the networks to publish finalised tariffs is a best endeavours obligation to publish within

20 business days of the end of the regulatory year. As outlined above, this obligation was previously binding, whereas now it is only best endeavours, meaning networks are not obliged to release finalised network tariffs until these tariffs apply. To Origin's knowledge this best endeavours obligation has rarely been met. This means the retailer effectively has no notice of the increase in prices.

If a retailer has insufficient time to review network tariffs and meet deadlines for notification, the only option is to absorb the increase in network tariffs until such time as it can make the required notifications. As highlighted, it is unreasonable that a retailer should have to carry all the risk associated with delays in the distribution price setting process, a process over which the retailer has no influence or control.

Consultation

The AER is not in a position to be aware of all the impacts that specific network pricing proposals may have on retail pricing and on customers. Unfortunately, the lack of consultation means retailers and other users have no opportunity to provide these insights. Decisions the regulator makes in relation to pricing approvals have considerable impact on retail businesses and customers. For example, Origin could not bill the time of use tariffs proposed by SP Ausnet where the peak and shoulder periods varied in summer, but Origin had no opportunity to outline these constraints to the regulator.

Origin believes that the pricing proposals should be made available to industry prior to their approval with retailers and large users given an opportunity to comment on these. While there is nothing to stop a network sharing a proposal with a retailer, networks are rarely willing to commit to any information they provide. Network charges make up close to half of retailers costs, so it is unrealistic to expect retailers to have no view on the reasonableness of the proposals.

Rule change proposals:

- *Insert rules to ensure that the AER will have finalised its decision on network revenue with a lead time of at least two months between a 'draft decision' on prices and the first day the prices will apply.*
- *Insert a rule requiring the AER to hold a consultation period on the draft pricing decision, including:*
 - *one week for users to comment upon new prices, and*
 - *one week for the AER to consider these submissions.*
- *Insert a rule requiring the AER to publish the final price decision six weeks prior to the date the new prices will apply,*
- *Insert a rebalancing constraint to limit rebalancing in the first year of a revenue determination.*
- *Insert a rule such that where the result of an appeal to the Australian Competition Tribunal becomes known during the last two months before a network tariff increase it cannot be applied until the following year.*

Now that the AER has completed a full round of electricity price determinations Origin agrees that it is an opportune time to examine the revenue framework. Origin concurs with the proposals of the AER but questions the need for three separate contingency mechanisms for distribution networks.

With the impending application of a carbon price, greater timeliness and consultation in relation to network price approval will benefit customers by ensuring retail prices encapsulate network price signals. The price approval process is clearly not functioning in the manner intended and this has genuine consequences for the regulatory process, impeding the efficient provision of electricity and gas services to customers. If you have any questions in relation to this submission please contact me on (03) 8665 7155 in the first instance.

Yours sincerely

[SIGNED]

Steven Macmillan
Regulatory Manager

Appendix I - Timelines for release of pricing decisions

	Was the proposal for the first year published by the AER within 15 days of the final decision?	Were final prices published 20 business days before the commencement of the relevant period?	Were price proposals published in the second year within two months of the commencement of the third year?
Citipower	No Final Decision: October 2010 Publication: no earlier than November 22 2010	No Final prices approved by AER: 13 December 2010 Prices apply: 1 January 2011	Yes Proposal submitted October 31
Powercor	No Final Decision: October 2010 Publication: No earlier than November 22 2010	No Final prices approved by AER: 13 December 2010 Prices apply: 1 January 2011	Yes Proposal submitted October 31
Jemena	No Final Decision: October 2010 Publication: No earlier than November 23 2010	No Final prices approved by AER: 13 December 2010 Prices apply: 1 January 2011	Yes Proposal submitted October 31
SP Ausnet	No Final Decision: October 2010 Publication: No earlier than November 22 2010	No Final prices approved by AER: 13 December 2010 Prices apply: 1 January 2011	Yes Proposal submitted October 31
United Energy	No Final Decision: October 2010 Publication of proposal: No earlier than November 22 2010	No Final prices approved by AER: 13 December 2010 Prices apply: 1 January 2011	Yes Proposal submitted October 31
ETSA	No Final Decision: 6 May 2010 Publication of proposal: No earlier than 11 June	No Final prices approved by AER: 18 June 2010 Prices apply: 1 July 2010	No Initial Proposal: 30 April 2011 Subsequent proposal following ACT decision: 20 May 2011 Prices Apply: 1 July 2011
Energex	No Final Decision: 6 May 2010 Publication of proposal: No earlier than 24 May	No Final prices approved by AER: 4 June 2010 Prices apply: 1 July 2010	No Initial Proposal: 29 April 2011 Subsequent proposal following ACT decision: 23 May 2011 Price apply: 1 July 2011
Energy Australia	Unclear Final Decision: 30 April Publication of proposal: Dates not shown on AER website or Networks' website	Yes Final prices approved by AER: 28 May 2009 Prices released by EnergyAustralia: 2 June Prices apply: 1 July 2009	No Proposal: 9 June 2010 Prices Apply: 1 July 2010
Country Energy	Unclear Final Decision: 30 April Publication of proposal: Dates not shown on AER website or Networks' website	No Final prices approved by AER: 28 May 2009 Prices released by Country: 4 June 2009 Prices apply: 1 July 2009	No Proposal submitted to the AER: 3 June 2010 Prices Apply: 1 July 2010

Integral Energy	Unclear Final Decision: 30 April Publication of proposal: Dates not shown on AER website or Networks' website	No Final prices published by Integral: 11 June 2009 Prices Apply: 1 July 2009	No Proposal submitted to the AER: 2 June 2010 Prices Apply: 1 July 2010
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- i In 2011 the private networks had regulated asset value in excess of \$10 billion.
- ii See for example:
- iii In specifying an efficiency gain, the UK model adapts aspects of a “rate of return” model to a price cap model. See *Electricity Market Reform: An International Perspective*, F.P. Sioshansi and W. Pfaffenberger, 2006, Elsevier, p.122, and “Transforming the Electricity Sector - Climate Change Review 2011” Ross Garnaut, 2011, p.40.
- iv “Finding the balance - the rules, prices and network investment”, speech given by Andrew Reeves, Chairman of the AER, to the Energy Users Association of Australia, Energy price and market update seminar, 20 June 2011; “Comparing electricity distribution network costs and revenues in New South Wales and Great Britain”, Bruce Mountain and Stephen Littlechild, Electricity Policy Research Group, University of Cambridge, Working Paper 0930, 2010; “Transforming the Electricity Sector - Climate Change Review 2011” Ross Garnaut, 2011.
- v Littlechild, op cit.
- vi NER, 6.18.2(a)(1)
- vii NER, 6.18.2(a)(2)
- viii NER, 6.18.9(b).
- ix NER, 6.18.2(c)
- x NER, 6.18.8
- xi Compare NER version 17 clause 6.6.5(a) with NER version 18 with clause 6.18.9(b).
- xii For example, ETSA’s “EDPD” factor, which applied in the second year of the revenue period and increased prices by 6.24% in real terms on average.
- xiii See AER Victorian Electricity Draft Determination, p.60, which cites NER 6.18.6(b).
- xiv In 2011 the AER determined it would apply its decision on side constraints from the decision on Victorian electricity distribution networks to gas distributors. See Envestra South Australia Draft Decision, p.205.