



Navigating the Australian electricity pricing reform roadmap: First steps

The first steps in one of the holy grails in the Australian National Electricity Market ((NEM), electricity pricing reform, truly commenced in late 2015 with the submittal by each of the Victorian Distribution Network Service Providers (DNSPs) of their Tariff Structure Statements (TSSs). The Australian Energy Regulator (AER) held a public workshop on the TSSs in December 2015, which was well attended by industry and customer representatives. The DNSPs' TSSs and workshop raised some interesting issues regarding future electricity pricing in the NEM.



Background

The requirement for all DNSPs in the NEM to prepare a TSS resulted from changes the Australian Energy Market Commission made to the distribution pricing rules under the national electricity regulatory framework in late 2014. In simple terms, the TSS is a DNSP's medium term tariff plan which, amongst other things, is required to set out the basis and structure of their full suite of network tariffs, which are a key input into electricity retailers' tariff structures that all customers face. The new distribution pricing rules are intended to encourage more efficient use of and investment in the networks, including through better pricing signals and tariff structures focussed on better management of peak electricity demand, the largest network cost driver. DNSPs may deviate from this efficiency goal to:

- manage the customer impacts of transitioning to more efficient tariff structures
- ensure network tariffs are reasonably well understood by customers
- comply with any jurisdictional legislative obligations, such as tariff equalisation policies.

The Victorian DNSPs are the first in the NEM to submit their TSSs for the AER's approval to apply from 2017-2020. Victoria is also the only jurisdiction in the NEM to have 'smart' meters rolled out to the majority of electricity customers, which allows better targeted tariff structures to be developed at the distribution and retail levels, particularly for residential and small business customers in the NEM who generally do not currently face such tariffs. For these reasons, the electricity pricing reform process in Victoria will fundamentally affect what happens in every other jurisdiction in the NEM.



Summary of key issues

The AER's Issue Paper released in response to the Victorian DNSPs' TSSs raises a number of points of interest as follows:

- It supports three part 'demand' tariffs (with fixed, usage and demand charging components) for residential and small business customers and considers them to be more cost-reflective than time-of-use tariffs. However, it queries why the proposed demand tariffs are based on network peak times when the true driver of investment is locational network constraints.
- It appears to favour locational network pricing, although recognises that complementary non-price demand management tools can enable management of locational network constraints where tariffs are likely to be ineffective.

- It questions whether the length of the transition period for residential and small business customers proposed by DNSPs could be shorter (2-3 years versus 4-9 years).
- It considers that customers should have options to manage potential price impacts and thinks the DNSPs' proposed 'opt-out' tariff approach may treat customers inequitably – the AER suggests customers being offered a tariff 'menu' that has multiple tariffs reflecting degrees of cost reflectivity.
- It seeks more information on why the DNSPs have aligned their proposed peak charging windows for demand tariffs, including why there is no demand charge applying on weekends.
- It appears to consider that the estimation of Long Run Marginal Cost (LRMC) used to establish the peak demand charge should include both augmentation and replacement capex.

Synergies' preliminary thoughts

In our view, the key success factor for the electricity pricing reform process is that it achieves the right balance between the development of new network and retail tariff structures that promote efficient use of and investment in the networks and that are relatively simple for customers to understand and can respond to. There is nothing to be gained from developing theoretically pure tariff structures that are unnecessarily complex and/or impractical. This simplicity/complexity trade-off arises in a number of places in the DNSP's TSS and the AER's Issues Paper.

First, the AER appears attracted to locational pricing at the distribution zone level but in our view it is a dead end because national electricity retailers will not develop tariffs with such granularity (also assuming distribution tariff structures would be reflected precisely in retail tariffs).

Second, the relatively long transitional periods proposed by the DNSPs will slow the reform process but make sense in facilitating customer adaptation and minimising price shocks, particularly at the residential and small business level. In our view, it's better to reach the end reform goal somewhat more slowly than possible than not get there at all, which will require good judgement on the part of the AER, DNSPs and retailers.

Third, the AER's apparent attraction to network tariff menu options is unnecessarily complex, will confuse customers and retailers and would be at high risk of failing if implemented. There is years of regulatory practice in support of transitional periods for customers who are moved onto fully cost reflective tariff structures, as is proposed by the DNSPs under their 'opt out' approach. This approach is much more likely to achieve the tariff reform objectives than a complicated tariff menu.

Fourth, the AER is concerned that the DNSPs have adopted uniform peak billing periods, primarily on simplicity grounds, while there are differences across DNSPs in their network peaks. We consider that this early in the tariff reform process, the simplicity of the DNSPs' proposed approach for customers and retailers is likely to outweigh the benefits of network-specific price signals and can be reviewed later.

Overall, we think that the network tariff reform plans set out in the Victorian DNSPs' first TSSs represent a measured, sensible start that mitigates the risks associated with the reform process.