AGL Energy Limited
ABN: 74 115 061 375

72 Christie Street
St Leonards NSW 2065

Locked Bag 1837
St Leonards NSW 2065

T: 02 9921 2999
F: 02 9921 2552
www.agl.com.au

November 28 2012

Philip Weickhardt
Presiding Commissioner
Electricity Network Regulatory Frameworks Review
Productivity Commission
Level 12, 530 Collins Street
Melbourne VIC 3000

By email: electricity@pc.gov.au

Dear Commissioner

Electricity Network Regulatory Frameworks: Productivity Commission Draft Report

AGL thanks the Productivity Commission for the opportunity to comment on its Electricity Network Regulatory Frameworks Draft Report 2012 (the Report).

AGL operates across the energy supply chain and has investments in energy retailing, energy services, coal-fired electricity generation, gas-fired electricity generation, renewables and upstream gas extraction.

AGL recognizes the considerable effort that the Commission has exerted in response to the Commonwealth Government's request to analyse electricity network regulatory frameworks focusing on the opportunities that benchmarking could potentially provide in regulating network businesses. Further, AGL understands the rationale behind the Commission's decision to broaden the scope of its task and include analysis of issues such as market regulatory settings, demand management, time of use pricing, transmission network matters and governance arrangements.

This submission is provided in two parts. This letter provides details of AGL's position on a number of issues raised in the Report including retail policy settings, the Commission's recommendation regarding consumer engagement and benchmarking. Attachment A, provides greater detail on AGL's retail policy position and our position on transmission framework matters raised in the Report.

Benchmarking

AGL notes the Commission's conclusion that 'at this stage, benchmarking is too unreliable to be used to set regulated revenue allowances, but could better inform the regulator's decision'.

From AGL's perspective determining the revenue setting arrangements for natural monopoly service providers in the National Electricity Market (NEM) will always be a difficult and complicated exercise. This is because of the information asymmetries that exist, the fact that each entity is non-homogeneous and the fact that the revenue allocations are forward looking and must take into account projected investments.

Noting this however, AGL supports amendments to existing arrangements where they lead to improved outcomes – including the possibility of lower prices to end use customers. Accordingly, AGL supports the Commission's recommendations aimed at increasing the use of benchmarking in order to gain a better understanding of the reasonableness of proposals and the possibility of circumventing costly regulatory processes if costs – using benchmarking – are deemed to be reasonable.

AGL considers that the inclusion of benchmarking should be seen as another element to revenue setting arrangements for natural monopoly service providers which will better inform decision making.

Retail policy settings

Noting that the Commission's Review extends beyond benchmarking, AGL considers that the efficiency and effectiveness of the NEM could be substantially improved with:

- the removal of retail price regulation and the introduction of price monitoring where competition is deemed to be effective; and

- the introduction of smart meters and dynamic pricing with appropriate safeguards for hardship customers.

The adoption of these settings will improve efficiency, lead to greater product and service innovation and contribute to the better utilisation of energy infrastructure – including electricity networks.

This is not a new approach and the benefits of these settings have been recognised in a number of reviews and assessments over the past decade including the 2002 *Council of Australian Governments Energy Market (Parer) Review*, the *2007 Energy Reform Implementation Group: The Way Forward for Australia*, the *Commonwealth Government's 2012 Energy White Paper* and the Commission's own conclusions, and recommendations, in the Report.

In contrast to the Commission's recommendation, AGL does not support the mandated roll out of interval meters. AGL considers that the roll out of interval meters should occur on a market led basis. Such a model should include features such as the unbundling of network charges.

The benefits of this approach are significant as it allows entities to compete in the provision of this new facility, it allows customers to actively engage with their service provider to ensure that their needs are met and allows the service provider to play a direct role in educating their customer, particularly if the aim is to encourage customers to accept new forms of pricing. As an example, New Zealand has adopted a contestable framework in relation to the provision of metrology services.

Further detail in support of AGL's position on retail policy settings is provided at Attachment A.

Rule making powers

AGL does not support the Commission's proposal to allow the South Australian Minister a 'broad' one shot power to make Rules. AGL considers that all rule changes should be completed by the Australian Energy Market Commission (AEMC) in order to ensure that the process are followed, including the requirement that the Rule gives maximum effect to the National Electricity Obligations.

Further, AGL notes that the Rules already provide the AEMC with powers to expedite Rule changes that have been the subject of extensive review and that this recommendation is in conflict with the AEMC's recommendation in the Power of Choice Review that ministerial jurisdictional powers be removed from all rule making changes.

Consumer representative body

AGL supports the Commission's recommendation that a broadly representative consumer body be created which provides consumers the capacity to be an effective participant in the regulatory process. AGL recognises the merit in such arrangements, particularly the condition that the body is comprised of an appropriately balanced membership, ensuring that the needs of all consumer segments are considered in the advocacy process.

Yours sincerely,

Alex Cruickshank
Head of Energy Regulation

ATTACHMENT A: AGL Detailed Comments: Electricity Network Regulatory Frameworks Draft Review

Demand management

AGL agrees with the Commission's conclusion on the contribution of increased peak demand levels on network investment and rising electricity prices, and we support the use of demand side management tools as a means of curbing peak demand. AGL sees that demand side measures have a role to play in improving the efficiency and capacity utilisation of the NEM. Such measures give customers greater control over how they manage their energy consumption, and have the potential to improve customer engagement in a market which, as the Commission has recognised, has traditionally seen low levels of customer interest.

AGL welcomes and strongly supports the Commission's recognition that the full benefits of demand side participation in the market, including through a move towards time of use network tariffs, are unable to be achieved without the full deregulation of retail electricity prices and the associated removal of retail price caps, and the deployment of smart meters.

We also support the Commission's appreciation of the critical importance of obtaining customer engagement before the benefits of cost reflective pricing and smart meters can be realised.

Removal of retail price controls

The deregulation of retail electricity prices and removal of retail price caps is in the long term interests of the electricity industry and consumers by incentivising efficient investment in electricity generation, promoting competition in retail electricity markets, and benefitting customers through innovative tariffs.

As the Commission has identified, one of the problems associated with the continued regulation of retail pricing is the lack of appropriate user-pays pricing signals. Regulated retail prices are generally based on average cost pricing models, which result in the inefficient and economically sub-optimal cross subsidisation of high energy consuming households by low energy consuming households.

The continued regulation of retail tariffs (other than in Victoria) constitutes a material barrier to improved demand side participation and energy efficiency outcomes in the residential sector. Especially where combined with cost reflective network tariffs that the Commission has recommended, this places immense financial pressure exclusively upon retailers, and significantly stifles any incentives for investment and innovation in the electricity sector. This is particularly problematic in the context of trying to develop new markets which support and enable demand side measures.

Continued regulation of retail tariffs effectively limits the ability of the retail industry to introduce innovative tariffs that provide incentives for consumers to reduce demand during periods of high demand. Simshauser and Downer (2012)[1] demonstrated that the introduction of relatively simple, peak, off-peak and critical peak pricing, combined with smart meters, could significantly improve the utilisation of existing infrastructure. Such an outcome would manifest itself in significant reductions in unit pricing.

For cost reflective pricing to have its greatest impact on addressing peak demand, it needs to apply to the broadest possible group of customers. Its impact and effectiveness is blunted the larger the customer group that is not required to make use of it. The larger the group, the greater the distortionary effects on the market generally, through those customers on time of use tariffs

[1] Paul Simshauser & David Downer, (2012), "*Dynamic Pricing and the Peak Electricity Load Problem*," Australian Economic Review, The University of Melbourne, Melbourne Institute of Applied Economic and Social Research, vol. 45(3), pages 305-324, 09

potentially under-consuming at the expense of those on flat tariffs, hence leading to inefficient and sub-optimal outcomes.

Accordingly it is AGL's view that, assuming the removal of retail price caps, all customers who are not vulnerable should ultimately be placed on cost-reflective time-based tariffs, following a staged implementation process. Such a process could start with mandatory time of use pricing for all industrial and commercial customers and any other non-vulnerable customers who have a smart meter. There should be a predetermined period of time over which the transition to this new form of pricing takes place, during which residential customers could have the ability to revert to a flat tariff for a time, should they choose to.

We consider that vulnerable customers should always have the option to revert to a flat tariff.

We agree entirely with the Commission's view that it is necessary for there to be a comprehensive and ongoing process of effective engagement and customer education on such matters as the:

- cost implications of rising peak demand and declining capacity utilisation of infrastructure;
- nature of the new tariff structures and the ways in which customers can capitalise on them;
- communications customers can expect from their retailers, for example alerting them to times of high demand; and
- technological capabilities of their new metering.

There is little point in introducing new pricing structures or technologies unless consumers are actively engaged and feel confident exercising choice with respect to the offers available to them. AGL therefore believes that a joint government, retailer and community sector customer engagement program which targets issues such as those set out above is a critical first step to any further arrangements being deployed.

AGL believes that retailers must play a pivotal role in educating customers, particularly if the aim is to encourage customers to accept new forms of pricing. Within this broader education program, individual retailers could work with their own customer base to educate and inform. It should be left to each retailer to determine the most appropriate methods to inform their customers about the benefits of demand side participation.

AGL strongly cautions against the view that increasing regulation with respect to the information that retailers must provide to their customers is the best option. AGL wishes to reiterate the point that the Commission makes in chapter 12 of its Draft Report in this regard, that stipulating stronger regulation of the sector is likely to suppress the contestability of the market over the longer term. There is already a comprehensive regulatory framework in each jurisdiction which stipulates what information must be provided to customers, and when and how it must be provided. Notwithstanding, many customers feel confused and do not know who to trust to provide them with the most reliable, useful and transparent information when it comes to managing their energy use. AGL believes that all stakeholders have an ongoing role to play in addressing this fundamental issue.

It is critical that the Commission consider how information 'mandated' by different levels of government is confusing customers at the present time. For example, in some jurisdictions, retailers are required by state governments to publish information about the costs of carbon pricing and green schemes on the front page of the electricity bill. At the same time, each electricity bill contains an information sheet from the Commonwealth Government which seems to provide different information about the same topic outlined on the bill. Mandated but inconsistent information presented in electricity bills is leading to consumer confusion.

There needs to be mechanisms in place to ensure that vulnerable customers are protected from any adverse consequences of cost reflective pricing and any associated bill shock. Vulnerable customers should be able to access government programs which provide advice and assistance to them to provide a mechanism for them to manage their consumption patterns. These must be supported by robust assistance frameworks. Current assistance frameworks (including concessions, rebates and grants) are structured and designed on the basic premise of a flat tariff

structure. AGL supports a comprehensive review of assistance frameworks nationally to assess the extent to which current arrangements must be amended to ensure that vulnerable customers are provided with appropriate protections in a dynamic pricing environment.

Such a review should include consideration of the following issues:

- Assistance mechanisms need to be consistent with customers' tariff structures. It would be ineffective for a customer on a time-of-use tariff to receive assistance based upon a flat tariff structure, which does not recognise the impact of the customer's consumption levels and the time at which their consumption takes place on their energy bill;

- The importance of customers making appropriate use of the range of market offerings made available by energy retailers to respond to customers' needs;

- There should be a review of the qualification criteria of assistance schemes to ensure they provide assistance to those customers in greatest need;

- There should be consideration of complementary measures that are targeted at high need – high consumption households; and

- There should be recognition of retailer hardship programs as a key identification method for secondary or complementary measures.

AGL agrees with the Commission's recognition that not all customers will be better off as a result of cost reflective pricing. However we also agree that it is not correct to assume that flat tariffs will always be a better option for vulnerable customers such as those facing financial hardship. AGL considers that an appropriately staged roll out of cost reflective pricing would exempt certain customers such as: concessions recipients; households on energy retailer hardship programs; and customers registered with life support equipment. However it is important to provide these customers with the ability to proactively move to cost reflective pricing if they calculate that it is a beneficial move for them at a particular point in time. It should remain open for these customers to return to a flat tariff should they choose to. This would enable calculation and assessment of the potential impact of cost reflective pricing on concessions customers as comparison data, consumption patterns and potential impacts will be available to customers, the industry and appropriate government departments.

It is important that retailers be entitled to be charged a flat tariff by distribution companies should retailers' customers opt to be on or return to a flat tariff. While AGL supports as comprehensive a deployment as possible of mandatory cost-reflective tariffs, we recognise that there should be a period of transition during which customers are able to revert back to a flat tariff if they choose. Further, we consider that this option should remain for vulnerable customers. It is very important in these circumstances that there is consistency in the costs faced by retailers and distribution companies, and that retailers do not face the cost exposure of paying time-varying network tariffs to distribution businesses while being unable to pass this on to its retail customers. Accordingly, it is very important that distribution companies be required to revert to a flat network tariff where a customer elects to be on a flat retail tariff.

Roll out of smart meters

AGL supports the development of technology that facilitates demand side participation by enabling customers to better manage their electricity consumption. However AGL's view on the metering model that should be adopted to create the greatest efficiencies differs from the metering model put forward by the Commission.

The contestable metering model that AGL supports, as described below, will drive the investment that will lead to additional metering features being made available in order to enhance the retail product offerings of retailers in the market. It will further serve as an incentive for retailers to roll smart meters out to customers, and enables such meters to be viewed as a form of competitive advantage to these retailers.

The customer's meter is a critical element of the energy market and is the key means by which the relationship between a customer and other energy services providers is facilitated.

AGL considers that retailers should be the Responsible Person for all meter types. Retailers, as the Financially Responsible Market Participant for customers' sites, have the financial responsibility both from a market settlement and energy supply perspective (and in practical terms, it is the responsibility of retailers to ensure customers provide access to meter readers). Accordingly, it is in retailers' interests to ensure that customers' meter provision occurs efficiently and meter data services are accurate.

The following are key features of the contestable metering model that AGL proposes:

- Meter provision and meter data service provision should be contestable in order to drive innovation, increase efficiencies, and lower costs. There should be no exclusivity in the provision of metering services to customers, and customers should not be locked into purchasing particular types of technologies. AGL does not support, under any circumstances, a monopoly roll out of meters. We draw the Commission's attention to the monopoly roll out by distribution businesses of smart meters in Victoria as a clear example of the problems associated with such an approach.

- As the Commission would be aware, this roll out was required to be performed by distribution businesses and was done using proprietary technology and with no competitive access. The Victorian distribution businesses also control the particular smart meter functionalities that are available for use and the performance of the technology, and therefore the services that can be provided to customers. For example, although remote re-energisation /de-energisation are functionalities that are currently enabled in smart meters in Victoria, it is at the distributors' discretion as to whether the remote capability is used or not. Further, distribution companies' service level agreements with retailers are based upon distribution companies making 'best endeavours', which is difficult for retailers to enforce and reduces the quality of the services available to customers. AGL considers there to be considerable risk that such a proprietary approach will stymie future market developments and benefits to customers, including greater competition and innovative consumer products.

- Any meter provision to a customer needs to be based on providing value to the customer, and needs to provide an incentive for the customer to engage with and support the services and benefits that smart meters enable. A contestable, as opposed to a mandated, metering model provides the most simple mechanism for customer understanding and participation as it as it enables a value driven proposition for the customer which is driven entirely at the customer's choice.

- There is a need to unbundle metering costs from distribution use of services charges. Experience has shown (for example in New South Wales and Queensland) that where metering services are bundled with network supply charges, customers are required to pay two forms of metering charge should they wish to change their meter. This clearly has the effect of stifling consumer choice and competition generally in the provision of metering services and risks compromising the business case for a market driven roll out of smart meters.

- Meter provision and meter data service provision should be provided by entities that are ring fenced from other regulated activities also carried out by related entities. This not only ensures that, where distribution businesses wish to compete in meter provision or meter data provision markets, they are not able to use regulated revenue to compete in unregulated activities, but it is also a step towards achieving interoperability of metering standards and protocols.

- Open access should be provided to metering installations by meter providers to meter data services providers, and interoperability protocols in place between industry participants whereby various competitive products and services are able to be offered on the same

meters. The underlying principle should be to retain the meter at the customer's premises unless the meter does not have the technical capability to support the product that the retailer has agreed to provide.

- Retailers should be able to deal with any accredited meter data provider of their choice. Should a customer wish to change retailers, the customer's meter would not automatically need to be churned as interoperability protocols and open access would allow retailers and their meter data providers to be able to access the meters of other retailers/meter providers. This would enhance the level of product innovation able to be exercised by retailers, and prevent inefficient wastage caused by automatic meter churn where this is technologically unnecessary.

- There should not be a regulated or mandated treatment of exit fees associated with meters. Mandating exit fees introduces a barrier to entry in relation to metering services, and with effective interoperability protocols in place, meter churn would only take place if the existing meter at the customer's site was incapable of supporting the particular product sought by the customer. The fees associated with changing a meter should be viewed as just one part of the commercial terms of retail product offering agreed between the customer and their retailer. Accordingly, it is up to these parties to agree to the amount of any exit fee associated with upgrading a meter where this is necessary due to the technical incompatibility of the existing meter to support the particular retail product that has been agreed to. Furthermore, there are no grounds at all for exit fees to be charged for the replacement of Types 5 and 6 manually-read meters. These meters are aged assets and have been paid for by customers through metering services charges from distributors. In addition, the stipulation of exit fees risks compromises the business case for any market driven roll out of smart meters.

- Technology alone is not sufficient to support the widespread acceptance and utilisation of demand side measures. Technology must be seen alongside other equally important factors, particularly the need to educate customers about the benefits of demand side participation and to obtain their support to adopting a more proactive approach to their electricity consumption through making use of new technologies and product choices.

Transmission Reliability

In considering alternative transmission planning arrangements AGL notes that the Commission has focused on transmission planning arrangements to meet customer reliability targets. AGL considers that this is appropriate as the focus of the Commission inquiry is on improving the efficiency of electricity network regulatory frameworks.

However, the proposed reliability planning changes – to implement the Victorian planning model nationally – must also consider impacts on the network connection process. AGL's experience in connecting wind generators in the NEM has shown that negotiating connections in Victoria is significantly more complicated and protracted, and hence more costly, than in the other NEM regions.

For the reasons outlined below, AGL considers that if the Victorian model were to be implemented AEMO should only be involved in planning decisions and not the connection negotiations or the associated procurement process.

Network connection

Network expansion for access is a "competitive market" process where transmission access for generators (and large loads) generally requires:

- a connection agreement to be negotiated between the connection applicant and the Network Service Provider (NSP) for expansion or augmentation to the shared network (this process is subject to light handed regulation as the NSP is a monopoly supplier); and

- a contract between the connection applicant and a contractor for connecting lines and assets between the shared network and the generation assets (this is a commercial arrangement not subject to regulation).

The first step in negotiating a connection agreement with an NSP is to establish a scope of work, cost and the construction timeline. In all regions except Victoria this is a bilateral exercise between the connection applicant and the NSP, i.e. the asset owner that is also the planner. Determining the scope of work is where the NSP can act as a monopoly and create delays and additional costs[2]. Subsequently the NSP calls for competitive tenders for shared network expansion i.e. in a similar manner to competitive tendering carried out by the Australian Energy Market Operator (AEMO) in Victoria. There is a competitive market for construction of transmission assets in Australia. The contractors undertaking this work can be the same as those constructing the connecting lines for the connection applicant.

In Victoria, where the network planner and the network asset owner are separate entities, connection agreements have to be negotiated on a trilateral basis. This is a direct consequence of the way the relationship between the planner AEMO and the asset owner SPAusnet has been established. AEMO ultimately acts as the NSP and becomes interposed between the applicant and the asset owner which can significantly delay the negotiation of a connection agreement due to complications in communication of technical matters, assigning risk and the complexity of the legal documents required. Such delays can significantly add to a project costs.

The Commission has concluded that the Victorian arrangements be implemented so that AEMO is the planner, independent from the asset owner, for all NEM regions but modified so that the NSP calls for competitive tenders is more likely to lead to efficient transmission investment and has recommended that the Victorian transmission model be implemented nationally. AGL agrees that this is an appropriate change for reliability augmentations which occur in a much more expanded time frame, but with respect to connections is unlikely to be of significant benefit. In AGL's view it is the contractual relationship between AEMO and the NSP and the connection applicant and the way the Victorian model has been established that has been the root cause of many of the the major problems identified.

In relation to connections, the Victorian model offers no advantage with respect to providing competitive offers when compared to the other regions regardless of which party calls for tenders and has a significant disadvantage as the connection process is longer and more likely to cause project delays. For these reasons, AGL has proposed national implementation of the South Australian model and supports implementation of the modified form of the South Australian arrangements, as proposed by the AEMC in the Transmission Framework Review 2nd interim report. The focus of the AEMC in the transmission framework review was on expediting connections, not on reliability planning.

If the Victorian model is to be applied nationally in addition to AEMO not being involved in the procurement process for connections their relationship with the NSP must be restructured so that AEMO maintains overall planning oversight with respect the determining the scope of work but with no direct involvement in the connection negotiation process. The connection contract must be negotiated directly between the NSP and the connection applicant as is currently the case in the regions other than Victoria.

Efficient use of interconnectors

The Commission has sought participants views on the extent to which state based hedging distorts the incentives of generators and large loads in relation to generator location, hedging market liquidity and generator market power.

[2] There are currently issues with information asymmetry and lack of incentive for the NSP to deliver timely connection assets in these regions however in response to issues raised by participants the AEMC in the TFR has proposed some reforms which when implemented will provide connection applicants with increased access to competitive tender information which increase confidence in the workably competitive nature of the connection market.

Incentives for generator location

AGL does not consider that the state based hedge market is distortionary. It is more efficient for generators to locate as close as possible to their load and the most efficient outcomes will be achieved if generators are incentivised to minimise the total delivered cost of energy from fuel source to the load centre. Price differentials between regions also support cost minimization by providing locational signals and generators have an incentive to locate in a higher priced region. Price differentials or congestion between regions indicate the value to be obtained in augmenting interconnectors, noting that it is not always efficient to build out all congestion. Further, the AEMC Optional Firm Access model – if implemented – will provide additional generator locational signals to assist in efficient generator location.

Liquidity in the hedging market

If the market for hedging products were to become national, liquidity and substitutability may increase at the expense of economic efficiency as it would require overbuilding of transmission and interconnectors to support nationally traded hedge products. For a generator in one region to be competitive in another region would require the socialisation of these additional transport costs. For example, if the additional transmission cost is recovered on a user pays basis it is unlikely that a generator in region A will be competitive in region B because it will need to charge a higher price in region B to recover its transmission costs.

Issues of market power

The Commission has suggested that in order to address generator market power it may be necessary for centralised regulatory access to generator's historical hedge positions. This has been justified on a hypothetical example of a generator in a vertically integrated business exercising market power through a reduction in its hedge position and then offering its capacity at high prices.

Firstly this example is highly improbable for the following reasons:

- All retailers ensure that their retail hedge position is covered by sufficient generation capacity either contracted externally or by an internal transfer if vertically integrated.
- If a vertically integrated business knows when a price spike is likely to occur it will ensure that the retail hedge position is covered by sufficient generation capacity – either contracted externally or by an internal transfer. (To the extent that a gentailer owns generation capacity it is hedged if that plant is operating, if it is not operating it will not benefit from the high prices).
- A gentailer will not purposely allow a generator it owns to reduce hedge cover and expose the retail position to high prices.

Secondly a generator (either stand alone or as part of a gentailer) can only exercise market power if demand is such that generator is the marginal generator, this is regardless of hedge cover. This is a feature of the market design to encourage new entrants.

Generator market power either arises as a consequence of:

- market structure which would be addressed through the CCA by the ACCC;
- where there are barriers to entry;
- constraints in the network arising from insufficient transmission investment; and
- market design whereby some generators may have transient market power at times of high demand.

AGL considers that market power can be detected or determined in the absence of knowledge of hedge positions. The Commission recommendation invites regulatory review into participants' hedge positions (which includes contract volumes and prices) which effectively becomes a review of the commercial decisions made by these participants. AGL considers that such an outcome is unnecessary.