

Standing Committee of Officials of the
Ministerial Council on Energy

2006 Comprehensive Legislative Package:

Overview and Response to Expert Panel on
Energy Access Pricing

November 2006

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Glossary

Abbreviations

ACCC	Australian Competition and Consumer Commission
AEMA	Australian Energy Market Agreement - the intergovernmental agreement between the Commonwealth and all of the States and Territories first made in 2004 and amended in 2006
AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
COAG	Council of Australian Governments
Expert Panel	Panel established by MCE in December 2005 to advise on a model to achieve a common approach to transmission and distribution revenue and network pricing across electricity and gas (Final Report delivered April 2006 – see below for internet link to the report)
GPAL	Gas Pipelines Access Law – Schedules 1 and 2 to the <i>Gas Pipelines Access (South Australia) Act 1997</i> , including "Third party access to natural gas pipelines" (Schedule 1) and the National Third Party Access Code for Natural Gas Pipeline Systems (the Gas Code – Schedule 2)
MCE	Ministerial Council on Energy
NCC	National Competition Council
NEL	National Electricity Law, Schedule to the <i>National Electricity (South Australia) Act 1996</i>
NER	National Electricity Rules – Statutory Rules made under Part 7 of the NEL
NGL	National Gas Law, Schedule to the new <i>National Gas (South Australia) Act 2007</i>
NGR	National Gas Rules – Statutory Rules made under Chapter 7 of the NGL
SCO	Standing Committee of Officials reporting to MCE

Relevant MCE Publications

Energy Market Reform Bulletin No. 69 - Revised Timeline for 2006 Legislative Package

<http://www.mce.gov.au/assets/documents/mceinternet/Bulletin6920060823084307%2Epdf>

MCE Statement of Scope September 2006

<http://www.mce.gov.au/assets/documents/mceinternet/Statement%5Fof%5FScopeJuly0620060731114609%2Epdf>

MCE Statement of Approach – A New Legislative Framework for Gas, September 2005 (Statement of Approach)

<http://www.mce.gov.au/index.cfm?event=object.showContent&objectID=51EB99E6-FE2A-8D19-FF72A7C97121A7AD>

MCE "Response to Key Issues Raised in Submissions to the Statement of Approach to the Development of the New National Gas Laws and Rules"

<http://www.mce.gov.au/index.cfm?event=object.showContent&objectID=409F0422-D257-A8DF-34E3098CCCE679B4>

Productivity Commission Review of the Gas Access Regime, June 2004

<http://www.pc.gov.au/inquiry/gas/finalreport/index.html>

MCE Response to the Productivity Review of the Gas Access Regime, May 2006 (PC Response)

<http://www.mce.gov.au/index.cfm?event=object.showContent&objectID=1657B707-AD38-B43A-5CE8B8C11AFBE8E2>

MCE Decision on Review of Decision-Making in the Gas and Electricity Regulatory Frameworks, June 2006

<http://www.mce.gov.au/index.cfm?event=object.showContent&objectID=839F2DC1-AE13-142E-8425FEF5F2E8C822>

Final Report of the MCE Expert Panel on Energy Access Pricing, April 2006

<http://www.mce.gov.au/index.cfm?event=object.showContent&objectID=B0F3AD4C-A1C6-28DB-CB9CC594D2B88090>

MCE Arrangements for Consumer Advocacy in the Energy Sector, December 2005

<http://www.mce.gov.au/index.cfm?event=object.showContent&objectID=2CB6A5A9-EDA6-E716-FD118AA822DD7665>

Energy Market Reform Bulletin No 68 – Release of MCE Statement of Scope – A National Legislative Framework for Gas and Electricity

<http://www.mce.gov.au/index.cfm?event=object.showContent&objectID=C1CF57E4-D8A3-3039-E47E5E40C3F58B8A>

Overview

This document seeks to introduce the legislative changes to the existing gas and electricity access regimes proposed by the Ministerial Council on Energy (MCE). The Australian Energy Market Agreement (AEMA) commits Australian governments to implement a series of reforms to deliver fairer and more effective access regimes for both gas and electricity, achieving commonality where appropriate and focusing on economically-efficient outcomes that are in the long-term interests of consumers.

This reform process will involve two key stages: the "2006 legislative package" with a primary focus on the economic regulation of network access, and the "2007 legislative package" focusing on non-price distribution and retail regulation.

The current stage of the reform program has seen the development of the 2006 legislative package to achieve the following objectives:

- Transfer the governance and institutional arrangements for the gas regime to the national framework, with the Australian Energy Regulator (AER) as the independent industry regulator and Australian Energy Market Commission (AEMC) as the rule-maker and market development body;
- Transfer of electricity distribution economic regulation to the national framework;
- Implement policy changes to the gas regime developed from the Productivity Commission's Review of the Gas Access Regime;
- Implement a common framework for revenue and network pricing building on the advice of an MCE-established Expert Panel;
- Implement an effective merits review mechanism for economic regulatory decisions in the gas and electricity regimes; and
- Strengthen consumer advocacy arrangements for both gas and electricity, including a long term funding model to facilitate consumer engagement with industry.

The MCE intends to achieve these goals within the framework of gas and electricity access regimes, which are intended to be certified under the *Trade Practices Act 1974* and with the aim of implementing the revised legislative framework by 1 July 2007.

This document is designed to be the first in a series of documents released by the MCE Standing Committee of Officials (SCO) that explains the nature of the legislative changes and facilitates meaningful consultation on the exposure drafts of the new National Gas Law (NGL) and revised National Electricity Law (NEL). It builds on the Statement of Scope released in July 2006 and Energy Market Reform Bulletin No. 69 - Revised Timeline for 2006 Legislative Package. It contains a broad overview of the structure of the package and further explanation on how the Expert Panel advice has been incorporated. Additional papers will be released with the relevant exposure drafts of the law and rules including papers on:

- Gas Legislative Framework;
- National Electricity Law Amendments;
- Consumer Advocacy;
- National Gas Rules;
- National Electricity Rules;
- amendments to the Rule change process; and
- regulatory impact statements on remaining policy issues.

The current gas and electricity regimes

The current gas and electricity regimes are co-operative Commonwealth, State and Territory legislative schemes. The Commonwealth and all the States and Territories are part of the gas access regime and all, with the exception of Western Australian and the Northern Territory, participate in the electricity regime.

The present schemes work through “lead” legislation in South Australia:

- the *Gas Pipelines Access (South Australia) Act 1997*; and
- the *National Electricity (South Australia) Act 1996*.

The lead legislation is then applied as the law in the other States and Territories through ‘Application Acts’ that pick up the Schedule/s to the respective South Australian Acts and apply them in their jurisdiction. Western Australia currently enacts its own complementary gas legislation that corresponds to, and applies the Schedules of, the South Australian legislation.

The Commonwealth currently applies the electricity regime to the offshore area through the *Australian Energy Market Act 2004* (the AEM Act) and the gas regime through the *Gas Pipelines Access (Commonwealth) Act 1998*. Following the passage of the 2006 legislative package, both regimes will be applied by the Commonwealth through the AEM Act.

The current electricity and future gas regime gives functions and powers to the AEMC, established by the South Australian *Australian Energy Market Commission Establishment Act 2004*, and to the AER, established by Part IIIAA of the *Trade Practices Act 1974*.

The NEL is established as Schedule 1 of the *National Electricity (South Australia) Act 1996*. Substantial changes to the electricity governance framework were made in 2005 through amendments to the *National Electricity (South Australia) Act 1996*, including the NEL. Further amendments to the NEL (the NEL Amendments), will be made as part of the 2006 legislative package.

The National Electricity Rules (NER) are made under the NEL to provide detailed operational regulatory requirements of electricity transmission and distribution, and have force of law wherever the NEL is applied. They can be amended by the AEMC after a rule-change process defined in the NEL.

Currently the AER regulates electricity transmission, and jurisdictional regulators regulate electricity distribution.

2006 Legislative Package

Gas

The new gas regime will implement the governance arrangements agreed by the AEMA such that the AEMC will be responsible for rule-making and market development, with the AER responsible for economic regulation and enforcement. Additionally, Ministers and the National Competition Council (NCC) will retain their existing roles in relation to coverage. The main policy changes from the existing gas access regime arise from the MCE Response to the Productivity Commission Review of the Gas Access Regime, merits review decision and Expert Panel advice.

For the gas regime, the MCE has decided that the most appropriate mechanism to implement the new governance framework would be a new South Australian Act called the *National Gas (South Australia) Act 2007*. This Act will contain a Schedule called the NGL. This is the same as the legislative model used for electricity.

Consistent with the electricity regime, the NGL will be supplemented by National Gas Rules (NGR) and a limited number of regulations dealing with minor matters and the prescription of civil penalties. The initial NGR will be made by the South Australian Energy Minister on the recommendation of the MCE. Once the initial NGR is made, the AEMC will be responsible for ongoing administration of the NGR, under powers given to the AEMC in the NGL. This new framework will then replace the current *Gas Pipelines Access (South Australia) Act 1997* and the National Third Party Access Code for Natural Gas Pipeline Systems (Gas Code).

With a new NGL, there will need to be new laws that apply the NGL in each jurisdiction. The Commonwealth will amend its *Australian Energy Market Act 2004* in early 2007 for this to occur for the offshore area and to ensure the AER, Australian Competition Tribunal, NCC and Commonwealth Minister can take up their relevant functions under the NGL. States and Territories are expected to progress application Acts through their parliaments during the first half of 2007. The NGL regime cannot be implemented until all application Acts have been passed and are ready to be proclaimed.

Western Australia will continue to implement complementary legislation consistent with the NGL, and differ only in respect to institutional arrangements, namely retention of its local regulator, the Economic Regulation Authority. Western Australia's complementary legislation will only cover gas pipeline access provisions and will not include future changes in respect to national retail and distribution (non-economic) functions. The Western Australian Act will be called the *National Gas Access (Western Australia) Act 2007*. Western Australia will apply the sections of the NGR relating to gas access as made by the South Australian Minister.

The full explanation of the NGL is contained in the explanatory document for the Gas Legislative Framework with some of the high-level policy changes resulting from the Expert Panel explained below. The initial NGR will be released as an exposure draft in the coming weeks and will be accompanied by another explanatory document.

Electricity

The 2006 legislative package will amend the NEL to implement: the changes resulting from the Expert Panel advice; the transfer of distribution economic regulation to the AER; and the MCE decision on merits review. The related amendments to the NEL implementing the details of the transfer of economic regulation of electricity distribution to the AER will be made by the South Australian Energy Minister on the recommendation of the MCE. All new distribution determinations commencing after 1 July 2007 (including the NSW and ACT determinations) will be conducted by the AER. The transfer of the administration of existing distribution economic regulatory functions will take place on a jurisdiction by jurisdiction basis with the implementation of the 2007 legislative package.

The high-level changes resulting from the Expert Panel are discussed below and a full explanation of these changes will be set out in a further paper, to be released shortly with an exposure draft of the NEL amendments. This paper will also outline the high-level approach to the distribution revenue and pricing rules. An exposure draft of the rules is due for release in early 2007 for detailed consultation and comment with another accompanying paper.

Consumer Advocacy

In November 2005 the MCE decided to strengthen the consumer advocacy arrangements in the gas and electricity regimes and is now implementing that decision principally through amendments to the *Australian Energy Market Commission Establishment Act 2004*. The draft changes have been released with this paper with an accompanying explanatory document.

MCE Response to Expert Panel

To provide a sound policy basis for the transfer of economic regulation of electricity distribution and gas transmission and distribution to the AEMC and AER, the MCE commissioned an Expert Panel in December 2005 to advise on a model to achieve a common approach to revenue and network pricing across the energy market. The Expert Panel called for submissions in December 2005 and produced a draft report in March 2006. Following further consultation, it submitted a final report delivering on its terms of reference on 13 April 2006.

The exposure drafts of the NGL and NEL amendments substantially incorporate the key recommendations of the Expert Panel. The Expert Panel recommended the development of a common legislative framework for access pricing in both electricity and gas. Elements of the legislative framework that the Expert Panel recommended be substantially harmonised across the two sectors include:

- Objectives of the regime;
- Scope and form of regulation;
- Regulatory procedures;
- Revenue and pricing principles;
- Information disclosure; and
- Review of decision making.

Further details of how existing MCE decisions will be implemented, and some other aspects of the preliminary MCE response to the Expert Panel, are below. Regulatory Impact Statements on key aspects of the MCE response to the Expert Panel have also been prepared and are subject to consultation with the exposure drafts of the legislation. Consultation and comments will assist the MCE in making their final decision on the legislation and rules to be implemented in 2007.

Objectives of the Regimes

As announced in the MCE Response to the Productivity Commission Review of the Gas Access Regime, the MCE has agreed with the recommendations of the Expert Panel, such that the electricity and gas regimes will be given a common objects clause, and these clauses will be clearly inserted as the object of both the NEL and NGL.

As previously announced, the MCE has decided that, for the NGL:

The objective of this law is to promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas.

For the NEL, the MCE has decided that:

The objective of this 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 price, quality, reliability and security of supply of electricity and the reliability, safety and security of the national electricity system.

The MCE agrees with the Expert Panel that there is no inherent difference between the gas and electricity regimes that requires a fundamental difference in approach,

and that a common objective would have significant benefits in developing a common approach to revenue and network pricing across the energy sector.

The MCE also accepts the Expert Panel's recommendation that the NEL be amended so that the existing national electricity market objective is made a statement of the object of the NEL. In drafting the provisions of the NEL and NGL, the word 'objective' has been used to assist consistent incorporation of the objects clause into the rest of the NEL and NGL.

The primary focus of the Expert Panel's formulation of the objective is economic efficiency. The ultimate purpose is expressed in terms of the long-term interests of consumers. The promotion of efficient investment and efficient operation will encourage productive efficiency, allocative efficiency and dynamic efficiency, and will maximise the long-term interests of consumers.

The objective refers to "efficient investment in, and efficient operation and use of, natural gas services". These services include upstream gas supply and pipeline haulage and interconnection services. The intention is that the application of the objective will involve an assessment of the interests of end-use consumers at multiple levels in the supply chain, not only at the point of final supply, thereby encouraging competition throughout the supply chain. The objective emphasises the adoption of a long-term perspective with respect to consumer interests, and that a critical factor in such a long-term perspective is the impact of decisions on investment in gas infrastructure and services.

The MCE sees alignment between the objectives of the gas and electricity regimes as being an important foundation for the regimes. This will increase the prospect over the long term that the regimes remain closely aligned (even in light of the capacity in both regimes for interested parties to make applications to change the Rules). For this reason, the objects clause is drafted as an objective of the law, rather than as an objective of the market, as was previously the case in the NEL.

Just as the AEMC must test Rule changes against the objective of the law when making Rules, the regulator must perform its functions in a manner that will or is likely to contribute to achieving the objective of the law. The objectives clause therefore is a point of congruence between policy-makers/law-makers (MCE), the Rule-maker (AEMC) and the regulator (AER).

Scope of Regulation

In both gas and electricity, the scope of regulation is by reference to the physical facilities or assets that are subject to the regime. In the NGL, the scope of regulation is determined by the application of the coverage test, whereas in electricity, there is a statutory description of the relevant facilities.

The distinction between the gas and electricity regimes recognises that the characteristics of gas transmission are primarily point-to-point carriage between the gas producer and customer load centre, whereas in electricity, transmission is more likely to be through a meshed network where carriage is not readily traced between a particular generator and customer load centre. The characteristics of gas and electricity distribution are more common as both operate through largely meshed networks.

Form of Regulation

The distinction is drawn between the facilities to be regulated and the services provided by those facilities. Whereas the scope of regulation is determined with

respect to the facilities through the application of the coverage test, the form of regulation to be applied to the services provided by those facilities will be determined with respect to the degree of market power that the service provider may exhibit.

The Expert Panel's proposition is that the greater the market power that an entity has in the market, the greater the potential efficiency loss from the misuse of that market power. The potential for social loss from inefficiency motivates the regulation of energy network services that exhibit substantial market power. The greater the potential for social loss from inefficiency, the greater the likelihood that more intrusive forms of regulation will improve market outcomes. Conversely, where market power is less substantial, the stronger the case for less intrusive forms of regulation, or no regulation at all.

The market power involved in the provision of any particular gas and electricity service is likely to range from one of substantial market power, such as those where a single service provider is designated to provide the service (e.g. electricity distribution), to those services that are sold in markets characterised by effective competition.

While economic regulation provides benefits in terms of reducing the potential efficiency loss arising from the misuse of market power, it is also recognised that regulation involves costs:

- to the regulated entity;
- to the regulator; and
- to society as a whole through the potential for errors and inefficiency that the regulatory regime itself may induce.

Where actual or potential competition exists for a service, which mitigates the possibility of exercising market power, the need for or level of regulation may be low. The costs of imposing an intrusive form of regulation may exceed any efficiency benefits to be achieved. Hence, the decision on the form of regulation to be applied in a particular circumstance should take into account both the potential benefits in efficiency and the costs of regulation.

Consequently, the Expert Panel recommended (Expert Panel Report, page 57) that the NEL and NGL contain common provisions that require the AEMC, in making Rules that apply the available forms of regulation, to have regard to the presence and extent of market power possessed, and the likelihood of its misuse, by the owners, operators or controllers of the transmission and distribution facilities by which services to be subject to regulation are provided. The NEL and NGL should direct the AEMC to have regard to the following factors when making Rules about the form of regulation to be applied in each instance:

- (a) *barriers to entry* – the presence and extent of barriers to entry in the market in which the services to be subject to regulation are provided;
- (b) *network externalities* – the presence and extent of interdependencies (or 'network externalities') between the services to be provided by each owner, operator or controller of the transmission or distribution facilities by which services to be subject to regulation are provided;
- (c) *countervailing market power* – the extent to which market power possessed by the owners, operators or controllers of the transmission or distribution facilities

by which services to be subject to regulation are provided is likely to be mitigated by countervailing market power possessed by the users of those services;

- (d) *substitution possibilities* – the presence and extent of substitutes, and the elasticity of demand, for electricity or gas, as applicable, in the markets served by the services to be subject to regulation;
- (e) *information asymmetry* – the extent to which users and prospective users of the services to be subject to regulation are likely to have adequate information as a basis for negotiation with the owners, operators or controllers of the facilities by which the services to be subject to regulation are provided; and
- (f) *other factors* – any other factors that the AEMC considers relevant.

These factors have been translated into the NGL and NEL taking into account appropriate electricity and gas terminology. They are known in both laws as the 'form of regulation factors'. The reference to 'other factors' has not been included in the list itself, but is separately referred to when the form of regulation factors are used in the law or rules.

The Expert Panel identified four forms of regulation to be available:

- (a) Control, in the form of:
 - (i) Revenue control;
 - (ii) Price control; or
 - (iii) Hybrid forms of control (eg tariff basket)
- (b) Negotiate/Arbitrate
- (c) Price Monitoring and reporting, without arbitration
- (d) No regulation. (Expert Panel Report, page 44).

The forms of regulation range from intrusive (i.e. Control), which is appropriate where substantial market power is exhibited, to light-handed (i.e. Price Monitoring), which is appropriate where there is little market power exhibited. Of course, where there is effective competition in the provision of a service, no regulation is appropriate.

What is Control Regulation?

The Control form of regulation can be defined as direct setting of a service provider's revenue or price for a service by the AER through a formal determination process.

What is Negotiate/Arbitrate?

The Negotiate/Arbitrate form of regulation can be defined as a two-step process:

- first, seekers of a service and service providers are encouraged to negotiate commercial agreements on price and related terms and conditions for the service in the majority of transactions; and
- second, should commercial negotiations fail, seekers of a service and service providers may:
 - choose to resolve the dispute through private dispute resolution (such as arbitration, mediation, conciliation or expert determination); and/or
 - seek a binding arbitration determination from the regulator (i.e. AER).

Should commercial negotiations fail, the parties may seek arbitration by the regulator either in the first instance or after another form of dispute resolution has been attempted without success.

This approach is modelled on the framework for resolving access disputes provided for under Part IIIA of the *Trade Practices Act 1974*.

Under Negotiate/Arbitrate, service providers may be required to publish the terms and conditions, including price, for the service. This is akin to a Price Monitoring and reporting form of regulation, but the distinguishing feature of negotiate/arbitrate is the binding arbitration, which does not exist under Price Monitoring and reporting.

Negotiate/Arbitrate is not an applicable form of regulation where the service is provided in a competitive market. In that case, the seekers of the service have alternative service providers with whom to negotiate provision of the service.

What is price monitoring?

Price Monitoring and reporting without arbitration relies on information transparency to discipline price, accompanied by the credible threat of more direct regulation should market power be exercised inappropriately. Price Monitoring and reporting involves public reporting by the service provider of the terms and conditions of access to a particular service. The published price and non-price terms and conditions form the basis of commercial negotiation between service provider and the service seeker. Should commercial negotiations fail, the fallback is the published terms and conditions.

Under Price Monitoring and reporting, the regulator monitors published prices, quality of service, service performance and profit. It is likely to be a less costly form of regulation than control or negotiate/arbitrate.

When no regulation is appropriate

No regulation may be appropriate in circumstances where effective competition among service providers has substantially mitigated market power.

MCE consideration and certification

The Panel noted that in the absence of a requirement for negotiation and enforceable arbitration where the arbitrator may require services to be provided to an access seeker, a price monitoring form of regulation would be unlikely to be capable of certification as an effective access regime under the current provisions of Part IIIA of the *Trades Practices Act 1974* and the Competition Principles Agreement (see in particular paragraphs 6(4)(h) and 6(4)(j)). This would mean that the services that are subject to a price monitoring form would be open to an application for declaration under Part IIIA of the *Trade Practices Act*. However, the Panel further notes that in the situations where price monitoring is appropriate, the market conditions would be such that it is unlikely that the relevant service would satisfy the requirements for declaration.

The MCE's policy is that all reasonable measures will be taken to ensure that the gas regime and the electricity regime embodied in the NGL and NEL respectively are certified as effective access regimes and remain certified. Therefore, the MCE has only provided for two forms of regulation in the NGL – Control (of revenue and/or price) and Negotiate/Arbitrate. The third form of regulation – unregulated- is still available through the application of the form of regulation factors and coverage test, but is not defined in the NGL as it is a default outcome i.e. the absence of regulation.

This is consistent with the current Gas Code and is also consistent with the AEMC's Rules for electricity transmission regulation.

The Panel recommended that:

“the MCE direct the AEMC to undertake a review of the price monitoring option with a view to developing a draft Rule, having regard to the COAG Agreement in clause 2.3 of the Competition and Infrastructure Reform Agreement that the introduction of price monitoring for service provided by means of significant infrastructure facilities should be considered, where this would improve the level of price transparency, as a first step where price regulation may be required, or where scaling back from more intrusive regulation”. (Expert Panel Report, page 58).

Whilst price monitoring without arbitration would be unlikely to be certified, the MCE accepts the Panel's recommendation that this option for light-handed regulation be further investigated in the future.

Application to the NEL

In the NEL, the form of regulation of individual services will be decided by the AEMC through the Rules, or by the AER in specific determinations. The NEL will direct the AEMC to have regard to the form of regulation factors, when making Rules about the form of regulation to be applied in each instance. Where the Rules give discretion to the AER to determine the form of regulation, the NEL will provide that the AER is to be guided by the same form of regulation factors.

For transmission the AEMC has had regard to market power issues in splitting services between negotiate/arbitrate and control through specific function definitions of the services in the Rules. For distribution, the division of services into different categories will for the initial rules be determined by the AER at the time of each determination, having regard to the form of regulation factors recommended by the Expert Panel. The AER will be able to issue non-binding guidelines about these issues. Further explanation of these changes is included in the part of this explanatory paper dealing with the NEL changes and the NER distribution rules.

Application to the NGL

The current gas access regime is a hybrid between Control and Negotiate/Arbitrate regulation. An access arrangement has the core feature of control regulation in that an upfront assessment of appropriate prices for all services sought by a substantial portion of the market for a five-year period is conducted by the regulator. However, the framework has Negotiate/Arbitrate features as these prices are only enforceable through an arbitration wherein the arbitrator is required to apply the reference tariffs in an access arrangement. Arbitration can also set prices where no reference tariff has been set.

The MCE Response to the Productivity Commission *Review of the Gas Access Regime* (MCE PC Response) set out how the existing gas access regime would be amended to include a light-handed form of regulation where no access arrangement was approved, and incentives for new pipelines, including a regime for international greenfields pipelines. The Expert Panel's views have now been taken into account in enhancing the framework that was agreed by MCE in that response.

Service providers of covered pipelines who do not want to be subject to regulation by an access arrangement, can apply to the AEMC to determine whether there is a net benefit in the pipeline being subject to access arrangement regulation or the light-handed regime. The test will simply require the AEMC to have regard to the form of

regulation factors identified by the Expert Panel, and to the national gas objective and any other matters the AEMC considers relevant, in deciding whether a pipeline should be a 'light regulation pipeline' or required to submit a full access arrangement. This means these pipelines are regulated under a more pure Negotiate/Arbitrate framework than the existing gas access regime.

The access arrangement framework and the upfront regulation of individual services sought by a significant part of the market will continue to apply to covered pipelines that are not light regulation pipelines. The NGL will provide that the AEMC may make further Rules about the circumstances in which certain individual services provided by a covered pipeline that requires an access arrangement should be controlled. These controlled services of a pipeline with an access arrangement will still be called 'reference services' as in the current Gas Code.

International greenfields pipelines will be able to apply for a 15-year price regulation exemption, but if the exemption is granted, will have to conform with a number of conditions as is currently the case in Part 3A of the GPAL. The regulation of these pipelines is similar to what the Expert Panel would consider price monitoring.

The NGL will also provide that if a service provider wants certainty for what tariffs it can get from a service, the service provider can choose to include them in the access arrangement (it can also voluntarily submit an access arrangement when none is required).

Under the light-handed regulatory model, the NGL will require service providers of light regulation pipelines to make public the price and non-price terms and conditions of access. These terms and conditions will not have to be approved by the AER. However, the NGL will empower the AER to approve the non-price terms and conditions of access if a service provider desires this (a limited access arrangement). If the form of regulation is a Negotiate/Arbitrate framework with a limited access arrangement, price and non-price issues may be subject to determination by the arbitrator (although the non-price conditions in the limited access arrangement must be given effect). If the form of regulation is a Negotiate/Arbitrate framework without a limited access arrangement (ie the non-price terms and conditions have not been approved by the AER), both price and non-price terms and conditions may be subject to determination by the arbitrator without limitation. Therefore, the regulator, when making an arbitration determination, will be prohibited from arbitrating away from any approved terms and conditions (similar to the current status of an access arrangement), but may make a decision inconsistent with unapproved terms and conditions. It is emphasised that for a light regulation pipeline, it is voluntary to submit non-price terms and conditions to the AER for approval.

Procedural Requirements on the AER

It is important that the framework within which the AER will undertake its economic regulation provides it with clear powers and guidance to make efficient decisions from the perspective of society as a whole. The AER's powers need to be clear, its scope of discretions set out, and the timeliness and transparency of its processes guaranteed. The AER must be accountable for its decisions and the opportunity must be provided to regulated service providers for the correction of potential regulatory error through review mechanisms.

The regulatory framework must take into account the risks and consequences of over- and under- investment in transmission and distribution infrastructure. A regulatory environment that is conducive to desirable investments being made in a timely way is important. This means not only appropriate returns in the short term,

but also means that potential investors can be confident that sound and substantial long-term investment decisions can be based on a well-understood and consistent regulatory regime and not rendered loss-making by subsequent regulatory intervention.

Equally important is the predictability of those decisions – that is, the development of an approach that gives energy users and investors in transmission and distribution infrastructure confidence that access and pricing outcomes will be guided by known principles that are applied in a consistent manner.

The MCE adopted the Expert Panel’s recommendation that the NEL and NGL contain common provisions that ensure that the procedures for making network pricing determinations include, inter alia:

- (a) the entitlement of the regulated entity to make a proposal within the Rules determined by the AEMC in relation to revenue/pricing;
- (b) the time within which any such proposal must be made;
- (c) publication of the proposal and related information;
- (d) an opportunity for stakeholder submissions in relation to the proposal and related information;
- (e) publication of a draft decision and the giving of reasons by the regulator;
- (f) the entitlement of the regulated entity to make submissions in relation to that draft determination which may include a revised proposal;
- (g) an opportunity for stakeholders submissions in relation to the draft determination and any revised proposal; and
- (h) the holding of pre-determination conferences. (Expert Panel Report, page 89).

The NEL will do this by requiring AEMC rules to always provide for these matters and the NGL will set out the framework for approving access arrangements to achieve the same effect. The NGL will provide that the AER will have a mandatory 6-month period to make a determination on an access arrangement.

The NGL will provide that the AER be able to extend the period for making a determination by up to 2 months, on a single occasion only, where the decision is of sufficient complexity or difficulty or where there is a material change in circumstances such that it is in the public interest. This essentially adopts the Productivity Commission’s recommendation 11.1.

The NGL and NGR will also adopt the Productivity Commission recommendation 11.2, that the Gas Access Regime will be amended to remove the ‘further final decision’ from the approval process for access arrangements.

The NGL will provide that the mandatory 6-month period to make a determination on an access period will exclude periods during which the AER is waiting for another person to take action. This will include:

- (i) judicial review; and
- (ii) whenever a notice period is running, e.g.

- information has been sought from the service provider;
- submissions have been sought from interested persons; or
- during the consultation period after the draft decision is published.

The NGL will provide that when the AER has not made a determination within the timelines, the existing arrangements will continue to apply and the existing arrangements will remain legally enforceable.

The NGL and NEL will provide that a final determination that was not made by the AER within the timelines, when made, will be a valid determination. The AER will determine how, in a late final determination, any difference in revenue or price between the final determination and the existing arrangements will be recovered / refunded. This would be based on the assumption that the access arrangement should have had effect from the date on which it would have come into effect if it had been made within the timelines (including any period in which the AER extended the timeline). The Rules may deal further with this issue.

The NGL and NGR will adopt the Productivity Commission recommendation 7.6, that section 8.21 of the Gas Code will be amended so that regulators can, at their discretion, undertake less public consultation than is required for a proposed revision to an access arrangement under s2.28. If this discretion is exercised, the regulator will issue a written statement outlining clearly why the reduced public consultation was justified prior to issuing a binding decision under s8.21 that proposed investment in an extension or expansion of a covered pipeline would meet the requirements for incorporation into the capital base. The Productivity Commission recommendation 7.6 was endorsed by the Expert Panel. (Expert Panel Report, page 89).

Models of AER decision-making

The Expert Panel identified three models for the standard for AER decision making:

- (i) receive – determine
- (ii) propose – respond
- (iii) fit-for-purpose

The nature of the regulator’s decision-making power under the receive-determine model is to receive a service provider’s proposal, consider the proposal and submissions made to it by interested stakeholders, and determine in relation to each component an outcome that in the regulator’s view best meets the criteria.

The nature of the regulator’s decision making power under the propose-respond model is to assess a service provider’s proposal and accept it (in whole or in part) unless it fails to meet specified criteria, and only in those circumstances, to determine an outcome that best meets the criteria. That is, there is a presumption of acceptance of the proposal under this model.

Between these two models, there is an approach that acknowledges that in a service provider’s proposal, there is such a range of dimensions (and inter-relationships between these dimensions and revenue and price components) that the regulatory framework should retain the capacity to require the regulator to apply either of these approaches, or a more specific test to different elements of the proposal. The Expert Panel describes this as a ‘fit-for-purpose’ model. The fit-for-purpose model does not give the regulator an absolute discretion to choose between receive-determine or propose-respond for different elements of the proposal. The regulator is guided in its decision-making.

The Expert Panel made a number of comments about the problems associated with the propose-respond model and the Productivity Commission's formulation of it. The Expert Panel explicitly rejected the Productivity Commission formulation on a number of grounds, including regulatory certainty, litigation prospects and the likelihood of a systematic upward bias in the returns provided for infrastructure providers.

The Expert Panel gave three options for implementing guidance to the AER in relation to the standard of decision-making. The options were:

- (i) mandate an outcome in the Law
- (ii) determination by the AEMC via the Rules
- (iii) MCE Statement of Policy Principles.

The MCE accepted the Expert Panel's conclusions

“that it is not appropriate for a global presumption to be adopted in the Law or the Rules in favour of the regulator accepting a regulated entity's proposal” and “that it is not appropriate for the Law to mandate a receive – determine model. The complexity and differing characteristics of each element of a service provider's proposal are such that the Law cannot itself prescribe a single overriding test to be applied by the AER in assessing service provider proposals. These must be determined by the AEMC in the Rules developed for each of the alternative available forms of regulation” (Expert Panel Report, page 90).

The Panel then recommended that *“the AEMC have regard to the analysis of the issues related to propose-respond and receive-determine models in (their) report, the Panel's conclusions and the MCE's response in further developing its draft National Electricity Rule and any review of Chapter 8 of the Gas Code” (Expert Panel Report, page 90).* Accordingly, the AEMC will, in formulating the Rules on individual aspects of regulation, specify the weight to be given to a service provider's proposal and the criteria and basis for the AER to make its decision in line with the statutory economic efficiency test. The AEMC has already engaged in this analysis in making the transmission revenue rules. The MCE has also had regard to the Expert Panel's analysis in developing the initial NGR and the national electricity distribution rules.

Revenue and Pricing

Framework

The Expert Panel recommended that the framework for the provision of guidance on the application of price control should be common across electricity and gas distribution and transmission services. The Panel recommended that the framework should be based on items 15 - 23 of Schedule 1 to the NEL, but modified to facilitate the use of a Total Factor Productivity (TFP) approach where the AEMC finds this to be consistent with the objects clause and so the Rule making test. (Expert Panel Report page 115).

The MCE accepted the Panel's recommendation, except that the MCE adopted a more cautious approach to the introduction of TFP as a methodology for the derivation of maximum allowable revenue or prices, for the reasons explained below. The NEL and NGL will have a common framework for the provision of guidance on access arrangements and the application of price control across electricity and gas distribution and transmission services. The framework will be based on items 15 - 23 of Schedule 1 to the NEL, which refer to electricity transmission regulation. The framework in the NEL and NGL will require the AEMC to make and maintain Rules that address:

- (a) The mechanisms or methodologies for the derivation of the maximum allowable revenue or prices to be applied by the AER in making electricity network pricing determinations and gas access arrangements, which must include the use of a building blocks approach, and allow the use of Total Factor Productivity (TFP) as a regulatory tool to assist in the building blocks approach.
- (b) The principles to be applied, and procedures to be followed, by the AER in exercising or performing an economic regulatory function or power.
- (c) The valuation, for the purposes of making electricity network pricing determinations and gas access arrangements, of assets forming part of an electricity transmission or distribution system and gas transmission or distribution networks/pipelines, and of proposed new assets to form part of an electricity transmission or distribution system and gas transmission or distribution networks/pipelines, that are, or are to be, used in the provision of services that are the subject of an electricity network pricing determination or gas access arrangement.
- (d) Where the building blocks form of control applies, the determination by the AER, for the purpose of making an electricity network pricing determination or a gas access arrangement with respect to services that are the subject of such a determination, of allowances for –
 - (a) depreciation; and
 - (b) operating costs;
 - (c) corporation taxes; and
 - (d) a rate of return on assets.
- (e) The assessment, or treatment, by the AER, of investment in electricity transmission and distribution systems and gas transmission and distribution networks/pipelines for the purposes of making an electricity network pricing determination or a gas access arrangement and the economic framework and methodologies to be applied by the AER for those purposes.
- (f) Incentives for owners, controllers or operators of electricity transmission and distribution systems and gas transmission and distribution networks/pipelines to make efficient operating and investment decisions, including incentive regimes based on guaranteed service levels/customer service performance standards and network service performance incentive schemes and taking into account incentive regimes, guaranteed service levels or minimum service standards (if any) established by jurisdictions.
- (g) The length of the regulatory period (if any) to apply between regulatory reviews or the circumstances in which either the AER or a distribution or transmission system operator may initiate a redetermination.

Revenue and Pricing Principles

The Expert Panel recommended that the NEL and NGL include common network pricing principles and that these be based on section 35 of the NEL. (Expert Panel Report, page 116).

The Expert Panel recommended the development of additional Rule-making criteria (and an obligation on the AER in applying the Rules) that regulatory decisions give explicit consideration to:

- that the service provider should be provided with a reasonable opportunity to recover at least the efficient costs of providing regulated services;
- the risks and costs of both under- and over- investment; and
- the risks and costs of both under- and over- utilisation of existing infrastructure. (Expert Panel Report, page 113)

The Expert Panel recommended that, to the extent the Rules made by the AEMC in accordance with the pricing principles provide discretion to the AER or allow for alternative interpretations in their application, the NEL and the NGL provide for the AER to be guided by the pricing principles (Expert Panel Report, page 117).

The MCE adopted the Panel's recommendations and extended them to also cover the AER when acting as an arbitrator, such that where the form of regulation is Negotiate/Arbitrate (i.e. where no reference tariff applies) the AER must be guided by the revenue and pricing principles when making a determination.

The NEL and NGL will not require private dispute resolution (such as arbitration, mediation, conciliation or expert determination) to be guided by the pricing principles listed below.

The NEL and NGL will therefore set out the revenue and pricing principles to give effect to the Expert Panel recommendation to achieve the following:

- (a) provide a reasonable opportunity for a network operator to recover at least the efficient costs of providing services that are the subject of the network pricing determination and complying with a regulatory obligation;
- (b) provide effective incentives to a network operator to promote economic efficiency in the provision by it of services that are the subject of a network pricing determination, including:
 - (i) the making of efficient investments in the network owned, controlled or operated by it and used to provide services that are the subject of a network pricing determination;
 - (ii) the efficient provision by it of services that are the subject of a network pricing determination; and
 - (iii) the making of efficient use of existing assets and proposed new assets that are, or are to be, used to provide services that are the subject of a network pricing determination;
- (c) make allowance for the value of assets forming part of a network owned, controlled or operated by a network operator, and the value of proposed new assets to form part of that network, that are, or are to be, used to provide services that are the subject of a network pricing determination;
- (d) have regard to any valuation of assets forming part of a transmission or distribution system owned, controlled or operated by a network operator applied in any relevant determination or decision; and
- (e) have regard to the economic costs and risks of:
 - (i) the potential for under-investment and over-investment in assets by the network operator; and
 - (ii) the potential for under-utilisation and over-utilisation of the capacity of assets forming part of a distribution or transmission system, and the capacity of proposed new assets.

These have been drafted as the 'revenue and pricing principles' in the NEL and NGL using relevant gas and electricity terminology.

Total Factor Productivity

Regarding TFP, the Panel recommended that the AEMC be directed to undertake a review by 31 December 2008 that addresses:

- The circumstances in which the application of a TFP-based price setting methodology would contribute to the NEL and NGL objectives;
- The data collection arrangements that need to be put in place to facilitate its application; and
- As appropriate, the development of draft Rules to support the application of a TFP-based form of control for any individual or group of electricity or gas distribution or transmission service providers (Expert Panel Report, page 117).

The MCE accepted the Panel's recommendation that such a review of TFP should take place. The MCE appreciates that this would be a significant development in the regulatory framework and therefore the review would need to be thorough and adequately resourced. Therefore the MCE will direct that the review be undertaken of TFP by the AEMC for gas and electricity after the NGL is implemented.

Whereas the Expert Panel recommended that the framework for the provision of price control require the AEMC to make Rules that address the mechanisms or methodologies for the derivation of maximum allowable revenue or prices to be applied by the AER in making a network pricing determination, which may include the use of a TFP approach (Expert Panel Report, page 115), the MCE considered it prudent to first consider the AEMC review report before committing that the NEL and NGL will include provisions that enable the AEMC to make Rules in relation to a TFP-based price setting methodology, as an alternative to the building block approach. Accordingly, the NGL and NEL will prohibit the AEMC from making rules for TFP as an economic regulatory methodology until the MCE makes a regulation for that purpose. Nevertheless, as noted above, the 2006 NEL and NGL legislative package will allow the AEMC to make Rules that permit the AER to use TFP as a regulatory tool to assist in the building blocks approach (i.e. comparisons to benchmarks in assessing operating and capital expenditure).

The MCE's more cautious approach to introducing TFP should not be interpreted as ruling out the methodology. The MCE is aware that in consultations on the Expert Panel's terms of reference and its draft report, a number of submissions commented that further analysis of TFP was required¹. The MCE believes that its policy on TFP will be better informed after the AEMC has undertaken its detailed review and after the other elements of the economic regulation reform package become operational.

Information Disclosure

The MCE agrees with concerns of the Expert Panel about information provision. Accordingly, the NEL and NGL are to include:

¹ See submissions to the Expert Panel's draft Report by Australian Pipeline Industry Association, Citipower and Powercor, EnergyAustralia, Ergon Energy, Integral Energy, AGL and Total Environment Centre.

See also the submissions of EnergyAustralia and Major Energy Users to the Gilbert + Tobin/NERA paper on a National Framework for Energy Distribution and Retail Regulation.

- (a) powers for the AER to obtain information that is relevant to the performance of its economic regulatory functions from any person. These powers are modelled on s 28 of the NEL;
- (b) responsibility for the AER to obtain and compile information and data for using TFP as a regulatory tool;
- (c) the capability for the AER to issue regulatory information instruments to network service providers and their associates to:
 - (i) provide for reports of regulatory accounting information relevant to the economic regulatory functions of the AER;
 - (ii) provide for periodic reports of non financial information relevant to the AER's economic regulatory functions;
 - (iii) provide for the manner in which such information is to be attested by the service provider and be independently audited;
 - (iv) provide for the provision of equivalent information by contractors to the service provider where such information is relevant to the AER's economic regulatory functions; and
 - (v) provide for the disclosure (and protection) of such information, subject to its presentation in a manner that is not materially detrimental to the business or financial interests of the service provider;
- (d) a framework for the AER to have regard to the relevance of the information it requires to be reported, and to the costs incurred by the information provider, and the efficiency and effectiveness of the regulatory process and its objectives;
- (e) a framework for the AER's ability to deal with confidential information and also its general function of performance reporting;
- (e) an ability for the AEMC to make and maintain Rules specifying the scope and content of regular reporting requirements; and
- (f) an ability for the regulatory information instruments to specify the format requirements and timelines for regular reports and information disclosure for regulatory resets/review of access arrangements.

More discussion about information disclosure can be found in the explanatory documents for the NGL and NEL.

Further gas pricing recommendations of the Productivity Commission

The Expert Panel provided further guidance in responding to the remaining recommendations of the Productivity Commission referred to the Expert Panel. The recommendations relevant to the NGL have been picked up in the document that explains the content of the NGL. Recommendations relevant to the rules have been accepted by MCE in developing the NGR consistent with the current governance framework.

Review of decision-making

The MCE has made a separate detailed decision regarding merits review in the gas and electricity regimes. Apart from various definitional differences in the NEL and NGL, merits review will operate identically across the electricity and gas regimes. Reviews will be conducted by the Australian Competition Tribunal, and provisions as to who may apply for review, the grounds for review and the key processes of the review, will be identical.