



EnergyAustralia™

EnergyAustralia's Submission
to the

Ministerial Council
On Energy

A National Framework for
Energy Distribution and
Retail Regulation

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FINAL

Energy

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OVERVIEW

EnergyAustralia is one of the largest energy suppliers in Australia with 100 years experience. We operate an electricity network of around 22,275 square kilometres, servicing over 3,000,000 people. Our Network distributes electricity to the Sydney, Central Coast and Hunter regions of NSW. We also sell electricity and gas to customers in NSW, ACT, SA, Victoria, and Queensland. We are proud to provide a safe and reliable supply of electricity to over 1.5 million homes and businesses.

As a company with significant electricity distribution and energy retailing businesses, the promise of a more effective, streamlined national regulatory framework is appealing.

The vast majority of EnergyAustralia's network revenues are regulated and, as such, the efficacy of the regulatory framework is essential to facilitate long term investment in infrastructure. Equally important is the ability for the regulatory framework to cater for stable network performance, while minimising any price shocks to customers. We acknowledge that this is no easy task.

We have seen regulation in Australia move from an "incentive based" approach to a forensic approach that "second guesses" management decisions and is characterised by providing little regulatory certainty for investors. The intrusiveness of the framework is moving towards "rate of return" regulation, without any of the regulatory certainty that accompanies such a regime. At the same time, the last ten years of regulation in Australia has been characterised by a focus on delivering cost benefits to consumers without a balanced and consistent approach to long-term customer outcomes.

The result has been under-investment in electricity networks with consumers facing increased reliability risks.

We encourage the MCE to refresh its commitment to incentive regulation as a key component of the national regulatory framework.

Our retail business faces the complexity of differing retail regulation and consumer protection arrangements across the jurisdictions, resulting in significant compliance costs and obstacles to competition.

It is our belief that these inefficiencies can be significantly reduced through national regulatory reform.

Through improved transparency of regulatory arrangements, consistency between jurisdictions, removal of unnecessary duplication and reduced compliance costs we believe the national regulatory reform process will provide an opportunity for substantially improving outcomes for consumers, energy distributors and retailers in Australia.

EXECUTIVE SUMMARY

EnergyAustralia welcomes the opportunity to comment on the Ministerial Council on Energy (MCE) Standing Committee of Officials (SCO) consultation paper on a national framework for energy distribution and retail regulation, prepared by Gilbert + Tobin and NERA (henceforth, the "Consultation Paper"). The development of a national framework provides an opportunity for substantial improvements to the regulation of energy distribution and retail businesses, thereby significantly improving outcomes for consumers, energy distributors and retailers.

EnergyAustralia applauds the Consultation Paper's support for improved transparency of regulatory arrangements, removal of unnecessary duplication and reduced compliance costs. We support the broad objectives and directions espoused in the Consultation Paper, including:

- a national legislative framework for economic regulation;
- consistency, to the greatest extent appropriate, between the regulatory arrangements applying in the electricity and gas sectors;
- national rules for electricity and gas; separate administration and enforcement of the regulatory regime by the AER, in accordance with the Rules; and
- Independent Market administrators making rules subject to approval by the AEMC.

The Consultation Paper is dated May 2005, and expectations from industry were that the paper was originally to be released at that time. Due to the delay in releasing the paper, many of the issues canvassed have been overtaken by, or are otherwise being addressed in, other processes in which EnergyAustralia has been involved in, including the AEMC's review of the Rules for the economic regulation of electricity transmission and the Expert Panel's Review of Revenue and Network Pricing across the Energy Market.

Therefore, our focus in this submission is to identify aspects of the Consultation Paper that require refinement, revision or further development in order to achieve the potential gains from a national regulatory framework for energy distribution and retail.

EnergyAustralia submits that as far as possible, all energy related laws should be incorporated into the national framework. Where jurisdictional difference is appropriate or necessary, provision for the implementation of jurisdiction requirements should be made in the national framework rather than through state based arrangements.

We support the approach of ensuring that the National Electricity Law captures the policy intent of the MCE through the articulation of sound principles and objectives. The National Electricity Rules as administered by the AEMC should enshrine those elements of the regulatory framework required to provide investment certainty and to define the extent of regulatory discretion.

While it is appropriate for the AER to have discretion in developing statements and guidelines, the discretion should be limited in its context and informed by details specified in the Rules. The discretion afforded to the AER should not enable the development of guidelines to go beyond the scope of the operative effect of the Rule.

[Development of an effective distribution regulatory framework](#)

Overall, EnergyAustralia considers the Consultation Paper to be well written and thorough. However, we are disappointed that it is predisposed to delve into the detail of the regulatory framework with little, if any, consideration of the construct of an incentive regulatory regime. EnergyAustralia considers that an effective regulatory framework should include, as a prominent feature, a predisposition towards using the power of well-designed incentives to achieve the desired policy outcomes of the regulatory framework.

This predisposition is sadly lacking in the Consultation Paper, and EnergyAustralia encourages the MCE to refresh its commitment to incentive regulation as a key component of the development of a national regulatory framework.

The implementation of incentive regulation under the Rules has, for some time, been heading towards a more intrusive and information intensive form of regulation. The fear is that regulators are placing themselves in the shoes of the business and “second guessing” management’s decisions. Furthermore, any ex-post review of management decision making has the benefit of hindsight and in our experience has been used by regulators to put forward an alternative course of management action which was not appropriate in the circumstances. This can negatively influence investment and operational decisions.

The focus of the Consultation Paper appears to be on the translation of the many codes, rules and state based legislative instruments currently in existence into a national framework. While we acknowledge this may be a necessary requirement to achieve a national framework, it is by no means sufficient to ensure the delivery of a more effective regulatory framework for distribution businesses to facilitate long term investment.

While much attention has been devoted to how and when a regulator should exercise discretion, little attention has been devoted to ensuring the regime itself can operate to achieve the MCE’s policy objectives.

The true challenge is to establish transparent incentives that are targeted to deliver the desired policy outcomes. If the policy aim is to encourage long term investment in infrastructure, then a lack of investment certainty, stranding of assets based on forensic *ex post* reviews, steadily increasing information requirements and low rates of return – all of which characterise the current regulatory framework - are unlikely to achieve this policy aim.

It is the alignment of policy objectives to the incentives underpinning the regulatory framework that is sorely lacking and unfortunately seems to have been overlooked in the development of the Consultation Paper.

An example of an incentive mechanism that certainly merits further investigation to assess its relevance for Australia is the “sliding scale” incentive mechanism for capital expenditure adopted by Ofgem in the UK as part of its 2004 Electricity Distribution Price Control Review¹. The workings of this incentive are expanded in Attachment 1 to this submission.

Ofgem’s approach demonstrates a very astute awareness of the type of problems faced by regulators and the businesses in attempting to balance regulatory and commercial objectives in the face of increasing investment requirements.

Given a similar investment climate for energy infrastructure in Australia, we suggest that the MCE initiates a separate, more detailed review into the appropriate incentives to underpin the regulatory regime. This would be a very useful initiative and is strongly supported by EnergyAustralia.

EnergyAustralia’s consistent view, throughout the reform process, has been that the regulatory regime to apply to a distribution business should feature:

- Clear, unambiguous Rules, with separate bodies responsible for developing and applying the Rules;
- A “propose-respond” model, with the obligation that the distributor file its price and service proposal consistent with the Rules; and
- Provision for independent merits review of regulatory decisions.

¹ See for example pages 83-89 of Ofgem’s *Electricity Distribution Price Control Review: Final Proposals*, dated November 2004 (265/04).

Development of an effective retail regulatory framework

The complexity of retail regulation and consumer protection arrangements across the jurisdictions currently results in significant compliance costs to retailers and it is our belief that this can be significantly reduced through national regulatory reform.

We believe the consultation process with industry participants is vital for the success of developing a national framework for retail regulation and would encourage further utilisation of this process to ensure participants can discuss, understand and provide valuable input into the details of the reform process.

In developing a more effective regulatory framework EnergyAustralia believes the MCE should give particular attention to the following areas:

- For consistency, there is a need for the establishment of a standardised threshold level between jurisdictions regarding the consumption at which a person is deemed to be a small end-customer (for example, those with consumption of less than 1 TJ for gas and 40 MWh electricity per annum);
- We believe the current national consumer protection legislation (i.e. Trade Practices Act, Corporations Law and Privacy Act) already provides a National basis for governing the behaviour of retailers in the market, and that further duplication in industry specific instruments is not required;
- EnergyAustralia considers that the current state energy ombudsman schemes are generally working effectively for small customer dispute resolution. However in the interests of greater transparency and accountability, we strongly support the introduction of performance based standards for ombudsmen schemes;
- In order to further protect the integrity of the market, EnergyAustralia believes there remains the need for a national control mechanism to regulate the entry, participation and exit of a retailer from the market, along with a process that ensures retail participants have prudential soundness, risk management and governance policies and procedures in place in order to meet the operational cost and exposures characteristic in retailing energy; and
- We believe that it is appropriate for customers to have pool price risk passed onto them in the event of failure of their retailer, as each customer must bear some responsibility for the quality of the retailer they choose as their supplier. The step-in retailer (SIR) must also have the ability to recover the cost of purchasing energy on behalf of the customers of the failed retailer. We are firmly of the view that the transfer of the existing hedge contracts of the failed retailer to the step-in retailer is not feasible or useful, particularly if these hedge contracts did not prevent the existing retailer from failing. Furthermore, we do not believe that the spot prices should be administered until the step-in retailer secures hedges as the market should be allowed to clear without intervention.

From EnergyAustralia's perspective as a distributor and retailer, the development of a national framework for electricity and gas retailing is supported. Through improved transparency of regulatory arrangements, consistency between jurisdictions, removal of unnecessary duplication and reduced compliance costs we believe the national regulatory reform process will provide an opportunity for substantially improving outcomes for consumers, energy distributors and retailers in Australia.

To provide industry and jurisdictional regulators with more certainty moving forward, EnergyAustralia would recommend the establishment by the Standing Committee of Officials (SCO) of a timeline which sets out the proposed transition and key milestones that will deliver a national framework for distribution and retail regulation.

The following section summarises EnergyAustralia's responses to the specific issues raised in the Consultation Paper. These responses are expanded in the main body of the submission.

SUMMARY OF POSITIONS

PART A: Legal Architecture

- The proposed legal architecture appears clear and workable. It promotes regulatory convergence between gas and electricity and provides an appropriate balance between investor certainty and the principle that the jurisdictional government retains a limited, transparent power to intervene in the regulatory process.
- The continued existence of separate gas and electricity laws and rules enables different treatment of electricity and gas regulation; to the extent this is necessary. Subsuming the essence of the various codes, licences, guidelines and other instruments into the NEL and NER is supported in the interests of transparency and simplicity.
- EnergyAustralia submits that as far as possible, all energy related laws should be incorporated into the national framework. Where jurisdictional difference is appropriate or necessary, provision for the implementation of jurisdiction requirements should be made in the national framework rather than through state based arrangements.

PART B: Price Regulation of Distribution

Scope of Distribution Price Regulation

- EnergyAustralia supports the adoption of a standard positive definition of the basic regulated distribution service. This definition should clearly distinguish the basic regulated service from any other services supplied by the regulated entity, including:
 - services that may be excluded from the basic regulated service, but which continue to be subject to a lighter handed form of economic regulation;
 - contestable network services; and
 - other commercial services not subject to regulation.

Price Cap Regulation for Distribution Services

- While EnergyAustralia welcomes further consideration being given to Total Factor Productivity (TFP), we do not support its adoption as a primary regulatory tool at this time. Relatively little discussion has taken place on the key implementation issues such as determining starting prices and the means by which “off-ramp” or re-opener provisions may be invoked under a TFP arrangement. This is particularly important in an environment of increasing investment, where prices under a TFP arrangement may not adequately reflect the higher costs of the additional investment. Not least, is the need to demonstrate that data requirements can be feasibly managed. Until such time as these issues are investigated and solutions to issues demonstrated, TFP is not supported for determining the regulated revenues.
- Regulated revenues or prices need to be sufficient to compensate the regulated entity for all of its efficient capital and operating costs associated with providing the regulated services. In doing so, the regulatory framework must strive to ensure that financial capital maintenance is preserved. The asymmetric consequence of regulatory decisions providing revenues that are under the efficient level must be recognised and addressed.
- EnergyAustralia operates a combined distribution and transmission network business. This business is currently subject to dual AER and IPART regulation and EnergyAustralia would strongly prefer that the transmission and distribution regulatory regimes have sufficient consistency to facilitate a single regulatory determination and price control arrangement.

- EnergyAustralia agrees that the formal application of the regulatory test for distribution would be an extremely onerous and impractical requirement and that alternatives to the regulatory test should be considered.
- We believe it is possible, and desirable, to establish criteria in the Rules that would allow a distributor to meet the regulatory test requirements through a more efficient means, such as adherence to rigorous internal investment processes. The Rules should also specify that the AER be obliged to rely on the incentives in place to deliver efficiencies (through the CPI-X framework) and to accept the business's assessment if it has been conducted in accordance with the internal investment governance process.
- EnergyAustralia believes that the continuation of existing regulatory arrangements in current determinations (including IPART's "D-factor" for the reimbursement of approved Demand Management costs) is essential in the move to a national framework. These arrangements should be recognised by the AER until they expire or until a distributor itself proposes a change to adopt the national regime.

Regulatory Requirements for Tariff Setting

- Side constraints limit the ability to send economic signals to customers through pricing and, in doing so, do not allow customers to face the costs they impose on the network. EnergyAustralia believes that the elimination, or at least minimisation, of side constraints is consistent with the national electricity market objective.

Service Performance Targets

- Where the jurisdictional government has imposed service standards on the network (as is the case in NSW through the business's licence conditions), the economic regulator should be prohibited from imposing additional service standard regulation. Such duplication would result in an additional layer of regulation, with additional compliance and enforcement costs, and scope for inconsistency.
- We should stress, however, that it is entirely appropriate for jurisdictions to set service standards and that a national regime should not seek to impose uniform service standards.
- There is an important corollary for EnergyAustralia as a result of the penalties for which it is liable under the NSW jurisdictional Guaranteed Customer Service Standard (GCSS) scheme. The economic regulator should recognise the reasonable expected value of penalties for failing to meet service standards, together with the costs of administering the scheme. This recognition could be implemented through the creation of positive incentives (i.e. bonuses) of equivalent value to the negative incentives (i.e. penalties) imposed under the jurisdictional scheme.

Process for Regulation of Price Capped Services

- EnergyAustralia's consistent view throughout the reform process has been that the regulatory regime should feature:
 - clear, unambiguous Rules, with separate bodies responsible for developing and applying the Rules;
 - a "propose-respond" model, with the obligation that the DNSP file its price and service proposal consistent with the Rules; and
 - provision for independent merits review of regulatory decisions.
- The Consultation Paper outlines a recommended framework that purports to have elements of the "propose / respond model" as in gas, but is fundamentally based on the "submit / determine" approach found in electricity. The lack of an obligation on the regulator to accept a compliant proposal is a critical omission which renders the model largely ineffective, and in no way represents a "propose / respond" model.
- EnergyAustralia is of the view that the proposed model offers no additional acknowledgement of the business's proposal than the current ineffective

“submit/determine” model and in essence is completely different to the “propose/respond” model currently in place in gas.

- EnergyAustralia is of the view that the proposed model offers no additional acknowledgement of the business’s proposal than the current ineffective “submit/determine” model and is a serious detraction from the “propose/respond” model currently in place in gas.
- A “propose / respond” model would not only provide much needed investment certainty, but would also assist the regulator by narrowing the range of potential variability among proposals. EnergyAustralia draws the SCO’s attention to the requirements in the National Gas Code on the content of an Access Arrangement, where these requirements have engendered a great deal of comparability among business’ proposals.
- While it is appropriate for the AER to have discretion in developing statements and guidelines, the discretion should be limited in its context and informed by details specified in the Rules. The discretion afforded to the AER should not enable the development of guidelines to go beyond the scope of the operative effect of the Rule.
- EnergyAustralia considers that regulated entities should not be disadvantaged by process delays that are caused by the regulator’s actions. This may include delays where additional time is genuinely required to resolve complex issues; delays arising from ineffective regulatory processes or delays arising from either the regulator’s inability to adequately specify its information needs or their lack of resources.

Information Disclosure

- The regulator should be obliged to set out its information requirements sufficiently in advance, so that information systems and processes can be designed and operated efficiently and at low cost.
- Ad hoc information requests should be exceptional and regulators should be obliged to justify such requests.

Connection and Capital Contributions Requirements

- The Consultation Paper focuses on the calculation of connection and capital contribution charges and is silent on a distributor’s rights to connect customers within its designated territory. The exclusivity of the distribution service territory reflects the fundamental economies of scale inherent in natural monopoly industries. These economies of scale provide significant price benefits to customers and to the economy as a whole.
- In the context of customer connections, contestability arrangements to undertake the connection work, as are currently in place in NSW, are an effective means to deliver the services at lowest cost. While there is room for debate as to the appropriate design of the form of contestability, the principle of its use to deliver efficient outcomes should be recognised and adopted in the proposed national Statement of Requirements.
- EnergyAustralia broadly supports the existing NSW capital contributions arrangements for customers wishing to connect to the network, which provide an important location and load specific price signal. We suggest that these arrangements should form the basis for a national framework.
- EnergyAustralia is concerned that the capital contributions regime excludes contributed assets and contributed funds for the purchase of assets from the regulated asset base, even though a significant taxation liability is accrued. A regulatory solution is now needed to address this anomaly to ensure capital contributions do not destroy value and potentially distort business decision making.

PART C: Consumer Protection

- EnergyAustralia applauds the Consultation Paper's principle that the consumer protection provisions in this process should not duplicate other existing requirements. This will help to ensure that there is not a patchwork of potentially conflicting obligations.
- However, it must be recognised that the proposed rationalisation of consumer protection requirements will require extensive changes to the jurisdictional licence provisions and diverse other requirements, such as the installation inspection regime in place in NSW under the Office of Fair Trading.

Distributor Obligation to Provide Connection Services

- EnergyAustralia believes the “triangular relationship” between distributors, retailers and end-use customers is an appropriate form of contractual arrangement that allocates the rights and legal responsibilities directly between parties.
- It is important for the distribution business to have a contractual relationship with its end use customers to address the physical and technical matters associated with the operation of the network that cannot reasonably be managed by any other party.
- EnergyAustralia supports the development of standard terms and conditions for the supply of standard connection services. We support a deemed customer connection contract, and note that such an arrangement is in place in NSW. There may be rare instances where individually negotiated connection agreements may be needed for larger customers with specialised needs.
- We believe that there should be no obligation to connect services other than “basic distribution services” – the DNSP would (and should) only connect other services where the provision of that service was economically justified.

Distributor Disconnections and Reconnections of Small End Customers

- EnergyAustralia supports the regulation of disconnection and reconnection of small end-customers by distributors. However, regard needs to be given to retailers' rights when making Rules, relating to the circumstances in which a distributor can legally disconnect a small end-customer.
- A distributor should not be permitted to disconnect a small end-customer without the retailer's permission unless there is an agreement with the customer, an emergency situation or a technical/safety issue requiring such action. Any associated liabilities for disconnection should be specified either in the Use of System agreement or Market Operation Rules.
- The jurisdictions currently have regimes in place to address the disconnection, and reconnection, of end customers. A new set of national rules should not be a priority at this time.
- EnergyAustralia believes there is a need to establish a standardised threshold level between jurisdictions to what constitutes a “small end-customer”.

Distributor Small End Customer Dispute Resolution

- EnergyAustralia considers that the state ombudsman scheme in NSW is working reasonably effectively for distributor small customer dispute resolution. Moreover, the state ombudsman offices currently share views and coordinate in such a way that a level of national consistency is being developed.

Retailer Obligation to Supply to Small End-Customers

- EnergyAustralia believe greater clarity is needed regarding the definition of a 'Move-in Customer'.

- We would like further clarification regarding how the administrative duties of the Jurisdictions and the AEMC would be separated. EnergyAustralia believes it is not appropriate to have the same deemed agreement managed by different bodies.
- Deemed contracts should only be temporary arrangements which allow sufficient time for the customer to move to a standing or negotiated agreement. We believe 6 months to be a reasonable time period.
- A local retailer should have the right to disconnect a move-in customer after this period if sufficient identification details have not been provided to allow the establishment of a standing contract. Such a right would only be exercised after providing written notice to the premise.

Retailer Small End-Customer Market Contracts

- EnergyAustralia considers that consumer protection issues, including cooling off periods, could be appropriately dealt with through general legislative regimes that already deal with fair dealings and misleading and unconscionable conduct.
- We believe that the model Terms for Market Contracts for small end-customers should be limited to circumstances where general consumer laws are not adequate (i.e. disconnection), and in markets where competition is not effective in addressing specific consumer protection issues.

Retailer Small End Customer Marketing

- EnergyAustralia does not support the development by the AEMC of specific Marketing Rules relating to energy contracts as proposed in the Consultation Paper. Such a proposal will increase regulatory costs and complexity, duplicate existing provisions of the national consumer protection regime and provide limited consumer protection benefits.
- The current consumer protection legislation (i.e. Trade Practices Act, Corporations Law and Privacy Act) already provides a national basis for governing the behaviour of retailers and that further duplication in industry specific instruments is not required. In adapting this approach, current jurisdictional codes for marketing would be repealed.
- Any deficiencies identified in the current consumer protection framework should be addressed through the relevant Ministerial Council of Consumer Affairs as necessary.

Retailer Small End-Customer Dispute Resolution

- EnergyAustralia believes that jurisdictionally based ADR schemes are the most effective form of dispute resolution under the current industry arrangements. In the longer term, the merits of a national ADR scheme should not be dismissed.
- The current state ombudsman schemes are generally working effectively for small customer dispute resolution, however national consistency has not been achieved. In the interests of greater transparency and accountability, we strongly support the introduction of performance based standards for ombudsmen schemes.
- EnergyAustralia believes it is vital that ombudsman schemes only focus on small end customers. We note this is not the case currently in NSW.

PART D: Other Distribution and Non-Price Retail Regulation

Business Authorisation

- EnergyAustralia agrees that it is not necessary for an additional distributor business authorisation as part of the national framework. The imposition of obligations through the National Electricity Law and Rules and the consequences for breach of such obligations are appropriate and sufficient.

- EnergyAustralia also agrees that generic requirements in relation to environmental and occupation safety that apply to all businesses should be imposed through the appropriate Federal and State Laws. We recommend, however, that consideration be given to the national framework providing for the issuance of jurisdictional licences. In this way, energy specific licence obligations such as those relating to technical competence, electrical or gas safety and service standards could be issued by the relevant jurisdiction, but under the national framework.
- EnergyAustralia believes there remains the need for a national control mechanism to regulate the entry, the participation and exit of a retailer from the market, along with a process that ensures retail participants meet fundamental requirements (such as commercial and business competencies) necessary to successfully operate.
- Prospective retailers should be required to satisfy the AER that they have the prudential soundness, risk management capabilities and governance policies and procedures in place to operate a viable retail energy business.

Distributor Interface with Retailers

- EnergyAustralia believes that it is important to have a transparent contractual relationship between distributors, retailers and end-customers so that all parties are aware of the rights and obligations of all the participants in the market.
- We generally agree with the elements identified in the Consultation Paper that need to be contained in a Use of System (UoS) agreement and we support the concept that if a negotiated agreement cannot be reached within a reasonable time, a default agreement is deemed to apply.
- To facilitate negotiated agreements, we believe that the foundation elements underpinning a UoS agreement should be provided for in the Rules. In particular, it will be essential for the AEMC to clarify which parties bear the liability for supply interruptions and customer claims for damage or compensation and the extent of that liability.
- We support the development of a nationally consistent regulatory regime to ensure a level playing field for all parties in their dealings. The current jurisdictional differences suggest that the development of a default agreement would not be a trivial exercise and must be predicated on extensive industry consultation.

Interface between Network Service Providers

- While not specifically identified in the Consultation Paper, EnergyAustralia considers that there is a need for a default Connection Agreement between network service providers, to set out the basic terms and conditions between them. Such default agreement should contain the liability arrangements and caps and indemnity arrangements.

Distributor Interface with Embedded Generators

- EnergyAustralia has consistently supported the recovery of a component of TUoS from existing generators, on the basis of providing equity between existing generators and new generation and demand management options, regardless of whether they are located in the transmission network or embedded within a distribution network. The arrangements currently in place in the United Kingdom are believed to be best practice and should be adapted for Australia.
- We support the pricing approach for generators being embedded within the Rules in the same way as for load customers.
- EnergyAustralia believes that the current payment arrangements for distributors to embedded generators, which are proposed to be grandfathered, should also contain the provision to include retailer payments under the national framework. This will ensure the inclusion of existing grandfathered arrangements for some embedded generation that currently passes directly to retailers.

Balancing Regime & Settlements Effecting Customer Transfer

- EnergyAustralia believes that the market settlement and transfer system in electricity is working effectively and notes that consistent business-to-business information protocols are being developed nationally.
- The Consultation Paper recommends that the Rules for balancing systems, supply consumptions reconciliation and settlements and customer transfer should be made or approved by a party independent of the market participants. It is unclear whether VenCorp, GMC or REMCo satisfy are envisaged as being 'independent market participants' under the Rules. Further clarification is required on this issue.
- EnergyAustralia believes that the recommended consultation process relating to changes to the Gas Retail Market Rules should not be limited to those parties who made a submission to an Independent Market Administrator.

Metering

- While the Consultation Paper seeks national consistency, NEMMCO has already developed default metrology procedures that cover meter types 1-7. This draft procedure was prepared by the NEM Metrology Reference Group (MRG) and to this end, a draft National Metrology Procedure already exists for meter types 1-7. We support legislative requirements for all jurisdictions to comply with these procedures moving forward.
- EnergyAustralia has a particular concern regarding contestability in the provision of remotely read metering for smaller customers, as a consequence of the ACCC's 2005 metering derogation decisions. The current arrangements add greatly to the business risk of DNSPs introducing Advanced Metering Infrastructure and can only serve to delay its introduction and the availability of its substantial benefits for both customers and DNSPs.

Load Shedding and Curtailment

- EnergyAustralia believes that the National Electricity Rules already provide an effective national approach to load shedding and curtailment and that no change is warranted.

Retailer Failure Arrangements

- EnergyAustralia believes that arrangements should exist for a retailer to "step-in" in place of a failed retailer to ensure continuity of supply to customers and to maintain the integrity of the wholesale market.
- The step-in retailer must have the ability to recover the cost of purchasing energy on behalf of the customers of a failed retailer. We believe it is appropriate for customers to have pool price risk passed onto them in the event of failure of their retailer, as each customer must bear some responsibility for the quality of the retailer they choose as their supplier.
- EnergyAustralia is of the view that the AEMC should go to the market for quotes for the provision of this service (similar to the current processes of going to the market for reserve capacity and black start support).
- The main concerns from a distribution business perspective are to ensure that customers remain supplied with electricity or gas, the distribution business does not suffer financial harm as a result of a retailer failure and the burden placed on the step-in retailer is not so dramatic as to cause a cascading retailer failure.

Jurisdictional Directions

- We recognise that there may be some circumstances in which a jurisdictional direction is appropriate. To ensure that these directions do not undermine the attainment of a national framework, it is important to have a defined scope as to the circumstances to apply when a jurisdictional direction can be issued. Further, the issue of such directions should be transparent, including their justification.

- We do not believe it is appropriate to limit the jurisdictions that could specify the values to be included by the AER in the regulated asset base (to Victoria and South Australia only) through a jurisdictional direction. There are equally valid circumstances in other jurisdictions, including NSW, where a similar jurisdictional direction may be warranted.

1. INTRODUCTION

EnergyAustralia welcomes the opportunity to comment on the 'National Framework for Energy Distribution and Retail Regulation', a paper prepared by NERA Economic Consulting and Gilbert + Tobin (henceforth, the "Consultation Paper").

EnergyAustralia supports the development of a national framework for electricity and gas distribution and retailing. Through improved transparency of regulatory arrangements, consistency between jurisdictions, removal of unnecessary duplication and reduced compliance costs we believe the national energy reform process will provide an opportunity for substantially improving outcomes for consumers, energy distributors and retailers in Australia.

EnergyAustralia believes the consultation process with industry is vital for the success of developing a national framework for distribution and retail regulation. We would support the establishment of an industry working group by the Standing Committee of Officials (SCO) to allow participants to discuss the details of the proposed framework as a means to ensure the best possible outcomes are achieved.

In this submission, EnergyAustralia has provided a detailed response to what we believe to be the key issues in the Consultation Paper affecting its distribution and retail businesses. This submission closely follows the structure of the Consultation Paper.

EnergyAustralia's consistent view, throughout the reform process, has been that the regulatory regime to apply to a distribution business should feature:

- Clear, unambiguous Rules, with separate bodies responsible for developing and applying the Rules;
- A "propose-respond" model, with the obligation that the distributor file a price and service proposal consistent with the Rules; and
- Provision for independent merits review of regulatory decisions.

The Consultation Paper is dated May 2005, and expectations from industry were that the paper was originally to be released at that time. Due to the delay in releasing the paper, many of the issues canvassed have been overtaken by, or are otherwise being addressed in, other processes in which EnergyAustralia has been involved, including²:

- The AEMC's review of the Rules for the economic regulation of electricity transmission;
- The Expert Panel's Review of Revenue and Network Pricing across the Energy Market;
- The recommendations and findings of the Productivity Commission (PC) Review of the Gas Access Regime, and the MCE's response to those recommendations;

² There are a myriad of processes and review not specified below that nonetheless impact on the development of a national framework to apply to distribution regulation. This includes, but is not limited to, the October 2004 Joint Jurisdictional Review (JJR) of Metrology Procedures and NEMMCO's June 2005 clarification of the principles to be applied when developing changes to Chapter 7 of the Rules.

- The Australian Government's response to the PC Review of the National Access Regime review and the provisions of the Trade Practices Amendment (National Access Regime) Bill 2005;
- The objects clause and pricing principles proposed for the National Access Regime and the certification criteria;
- The MCE Statement on NEM transmission reforms; and
- The MCE's SCO Discussion Paper titled *Review of Decision-Making in the Gas and Electricity Regulatory Frameworks* and the subsequent Regulatory Impact Statement.

Therefore, our focus in this submission is to identify aspects of the Consultation Paper that require refinement, revision or further development in order to achieve the potential gains from a national regulatory framework for energy distribution and retail regulation.

While the Consultation Paper goes some way to addressing EnergyAustralia's preferred regulatory model, we note that merits review – a key aspect – is outside the terms of reference for this review.

Overall, EnergyAustralia considers the Consultation Paper to be well written and thorough. However, we are disappointed that the paper delves into the detail of the Rules with little, if any, consideration of the construct of an incentive regulatory regime. EnergyAustralia considers that an effective regulatory framework should include, as a prominent feature, a predisposition toward using the power of well-designed incentives to achieve the desired policy outcomes of the regulatory framework.

This predisposition is sadly lacking in this Consultation Paper and EnergyAustralia encourages the MCE to refresh its commitment to incentive regulation as a key component of the regulatory framework.

EnergyAustralia considers that the crucial issue in reviewing the distribution and retail framework is the design of the incentive regime and, in particular, the operation of the CPI-X mechanism. The implementation of incentive regulation under the Rules has for, some time, been heading towards a more intrusive and information intensive form of regulation. The fear is that regulators are placing themselves in the shoes of the distributor and, inappropriately, influencing investment and operational decisions.

2. AN INCENTIVE REGULATION FRAMEWORK

This section outlines EnergyAustralia's concerns over the lack of attention throughout the national regulatory reforms generally given to the incentives underpinning price regulation. As the Consultation Paper formally excludes retail pricing, this section is written from the perspective of EnergyAustralia's distribution business.

The crucial issue in the review of the Rules relating to distribution revenue is designing an incentive regime that aligns the interests of consumers with the commercial interests of businesses. This requires a careful reconsideration of the CPI-X incentive regime, together with the interaction of the lower level incentives on capital and operating expenditure and standards of service.

The RPI-X price caps initially introduced by OFFER in the UK in the early 1990's encouraged the Regional Electricity Companies to improve profits by cutting costs as they were able to keep the higher returns generated from these reductions for the remainder of the regulatory period. The businesses cut costs accordingly and history shows that they rapidly raised profits.

However, in the UK many network assets have now reached the end of their useful life and require replacement. In addition, businesses are required to take on new responsibilities such as connecting more distributed generation to their low voltage networks. It was apparent in the UK that the incentives to reduce costs are no longer sufficient and that the price caps needed to allow for increasing investment. As discussed later in this submission, Ofgem has responded to this need by developing an innovative capital investment incentive mechanism.

The investment climate in the Australian energy sector is not dissimilar, with high levels of expenditure required to meet demand growth and to replace ageing assets to ensure safe and reliable networks. To this end, the regulatory regime in Australia also needs to respond to the changing investment climate by ensuring incentives are provided within the CPI-X form of regulation to attract efficient investment to the industry.

The current regulatory framework in Australia, however, does not provide such incentives; rather it represents an overly complex array of mechanisms developed under the Rules that differ between jurisdictions. The regime appears more focussed on compliance with rules rather than on delivering effective outcomes.

The experience so far in the electricity industry has seen regulators placing themselves in the shoes of the distributor and placing increasingly greater influence on commercial planning and operational decisions. For example, in the most recent transmission revenue determination processes, the trend has been for greater information requirements and forensic analysis, and has involved:

- a focus on costs rather than on performance outcomes achieved;
- repeated intensive investigation into capital expenditure programs. Capital expenditure projects are subject to review ex ante (to set the revenue allowance) and ex post (to assess efficiency or prudence). They are also subject to the regulatory test;

- intrusiveness through attempting to second guess the capital expenditure requirements of the business and then to reassess the allowed capital allowance ex post;
- a failure to adequately address the legitimate need for a business to spend on unforeseen events;
- a mini-determination approach to contingent projects (in transmission), whereby incentive schemes are applied to individual projects. This has the potential for exponential growth of regulatory intervention and compliance; and
- an overly complex carry-over mechanisms for operating expenditures.

If the economic justification for regulation is to replicate outcomes that would be expected in a competitive market, then it is arguable that monopoly regulation in Australia has failed through its “second guess management” approach.

EnergyAustralia notes that other countries with regulatory regimes based on “incentive regulation” have taken considerable steps to address the need to attract investment. In particular, the Ofgem “sliding scale” capital investment incentive implemented in the UK is a recent example of a regulator designing incentives to attract efficient investment. Appendix 1 of this submission outlines Ofgem’s innovative, options-based form of regulation.

EnergyAustralia is very interested in the merits of the incentive mechanism designed by Ofgem and it is clear from its recent Consultation Paper on transmission revenue determination, that the AEMC is also aware of its features. While it is still early days in its introduction, the Ofgem sliding scale mechanism, or a variant thereof, warrants further investigation to assess its suitability for the Australian regulatory landscape.

Given the timing of this review at the commencement of a new era in the regulation of monopoly infrastructure in Australia, we would suggest that the MCE allocates sufficient time to review the incentives underpinning the current regulatory regime to assess whether they will lead to the delivery of the overall policy objectives.

A separate more detailed options paper on the appropriate incentives underpinning the regulatory regime would be a useful initiative and strongly supported by EnergyAustralia.

3. LEGAL ARCHITECTURE

EnergyAustralia supports the legal architecture proposed in the Consultation Paper. Of note, EnergyAustralia supports:

- The role of elected governments to form policy; and
- The separation of the Rule making and Rule administration bodies.

Within the context of the principles in the Consultation Paper, EnergyAustralia supports the general principles of:

- Avoiding duplication in the Rules of other legislation (eg consumer protection rules) unless those requirements have been shown to be unsuitable or insufficient to the energy industry.
- Ensuring the benefits from regulation outweigh its costs;
- Promoting national consistency and consistency between gas and electricity transmission and distribution while allowing for divergence where appropriate;

However EnergyAustralia recommends that the National Framework be expanded to include provision for jurisdictional issues rather than continue with state based legislation for such matters licensing.

EnergyAustralia supports the initiative to promote national consistency, and consistency between electricity and gas, *where appropriate*. Importantly, EnergyAustralia believes it is important to make sensible decisions on when national and inter-energy consistency is appropriate, and, perhaps more importantly, where it is not.

4. PRICE REGULATION OF DISTRIBUTION

4.1. THE SCOPE OF DISTRIBUTION PRICE REGULATION

4.1.1. Basic regulated distribution service

The Consultation Paper proposes the NEL/NGL should include the following definition for basic regulated distribution service:

“Regulated Service is a metered or unmetered service at or near the boundary to an existing network to provide connection and conveyance services and to deliver energy to that point of connection.”

EnergyAustralia applauds initiatives to define the scope of regulated services. In the absence of a clear definition, there is scope for regulatory creep, where more and more services become regulated. However, there would be a need to refine this definition to retain the current arrangements in NSW for contestability of connection works. The definition needs to make a distinction between shared network service (regulated) and dedicated connection service (contestable).

EnergyAustralia supports a framework in which the scope for regulation aligns with the broader policy objective of access regulation. In this regard, EnergyAustralia considers it is reasonable to refer to the provisions of s44H of the *Trade Practices Act 1974* for guidance on the nature of services which should be subject to core regulatory oversight and therefore included in the definition of a Regulated Service:

(a) that access (or increased access) to the service would promote competition in at least one market (whether or not in Australia), other than the market for the service;

(b) that it would be uneconomical for anyone to develop another facility to provide the service;

(c) that the facility is of national significance, having regard to:

(i) the size of the facility; or

(ii) the importance of the facility to constitutional trade or commerce; or

(iii) the importance of the facility to the national economy;

(d) that access to the service can be provided without undue risk to human health or safety;

(e) that access to the service is not already the subject of an effective access regime;

(f) that access (or increased access) to the service would not be contrary to the public interest.

The Consultation Paper suggests that definitional criteria should be set out in the Rules:

The proposed criteria for services to be included within the scope of distribution regulation are that:

(i) the service is a natural monopoly (uneconomic to duplicate) AND access to the service will promote competition in a related market; or

(ii) the service is one for which there is no effective competition.

The proposed criteria for exclusion are:

(i) the service is a natural monopoly (uneconomic to duplicate) BUT access to the service is not expected to promote competition in a related market; or

(ii) the service is either one for which there is or is likely to be effective competition OR for which it is expected that, absent regulation, there would be effective competition.

EnergyAustralia considers that these criteria approximate, generally, the policy criteria embodied in the Trade Practices Act. However, EnergyAustralia is concerned that there are services currently provided by energy networks that would be regulated under the proposed criteria, that would not be subject to access regulation according to the policy of open access generally. Moreover, new services are being developed, which could be captured by these criteria but would not be captured under the policy initiatives associated with access to essential infrastructure.

It will be important, then, to develop an exhaustive definition of the services that are subject to economic regulation, to provide certainty to both businesses and customers alike. It will also be important to develop a list of services which are exempt from detailed economic regulation of the "basic" regulated service (now known as "excluded services") but nonetheless subject to a lighter form of regulatory oversight (such as price monitoring). Services that do not fall on either of these two lists would be, by definition, not subject to regulatory oversight.

EnergyAustralia considers that the current framework in NSW, in which a defined list of services are deemed to be either "excluded" or not regulated, and all other services are deemed to be regulated, is unsatisfactory. This form of definition specifies that any new service, whether or not subject to any form of economic or commercial discipline, would become a "basic" regulated service.

EnergyAustralia considers that it is inappropriate to subject a service to regulation under this type of default arrangement. A more reasonable framework would provide the AEMC with the ability to add to the list of "excluded" services on an as-needed basis. We note that this would differ from IPART's current approach of establishing an "exhaustive" list of excluded services.

For a service to be subject to economic regulation, it should be subject to some form of coverage or declaration analysis using criteria consistent with those in the *Trade Practices Act*.

EnergyAustralia agrees with the approach taken in the Consultation Paper whereby the AEMC, via a MCE-initiated review, would replace the current provision in the Rules that allows jurisdictional regulators to determine which services are excluded. EnergyAustralia has

consistently argued for a “separation of powers” model whereby the regulator should not be in the position of determining the activities it regulates.

The timing for any such review by the AEMC carries with it some urgency, as the services to be regulated by the AER need to be established well in advance of the first distribution price review to be conducted under the new national framework. With less than three and one-half years remaining on the current IPART determination applying to NSW electricity distributors, and recognising the lead time associated with conducting a review process, time is of the essence in defining what the AER will regulate.

Designation of regulated distribution networks

“The AEMC will designate Regulated Distribution Networks, in accordance with provisions in the NEL/NGL, as falling within the definition of core regulated distribution service. The AEMC designates by means of a Rule.”

EnergyAustralia considers that the designation of regulated networks is more an issue for gas than electricity; EnergyAustralia accepts that electricity networks will generally be covered. But EnergyAustralia is concerned to ensure that this concept is harmonised with the coverage decisions and the decisions on the form of regulation as discussed in the MCE response to the Gas Access Regime. If the NCC is to be responsible for deciding on coverage and whether a lighter handed form of regulation is appropriate, the role of the AEMC in “designating” a network is not clear.

EnergyAustralia is concerned to ensure there is consistency in the approach, and that recommendations arising from different processes do not work at cross purposes.

It is also not clear whether full responsibility for energy regulation will be passed to the national Regulator; notably, whether excluded services will be assigned to the AER or remain with the jurisdictional regulators. EnergyAustralia prefers a “one stop shop” for regulation; the AER should administer regulation for both designated and excluded services. It does not appear sensible that a jurisdictional regulator would retain (or be able to retain) skilled staff solely for regulating such matters as connection services and public lighting.

4.2. PRICE CAP REGULATION FOR DISTRIBUTION SERVICES

The Consultation Paper proposed the following principles for price cap regulation of distribution services:

- (i) there should be a limited number of specific, focused objectives set out for distribution price regulation. These objectives should be internally consistent and should be set out in the NEL/NGL;
- (ii) services falling under the basic definition of a regulated service should be regulated on the basis of a form of CPI-X price cap. This principle should be set out in the NEL/NGL;

(iii) the NEL/NGL should not contain any further prescription in relation to the form of distribution price regulation, or the form of price control adopted within any given form of regulation;

(iv) the Rules should specify one or more forms of price regulation (eg, building blocks, tender process). Where the Rules allow for more than one form of regulation, the Rules should also set out the circumstances in which the AER is to adopt each of the forms specified;

(v) the Rules should provide substantive guidance in relation to the application of the form(s) of regulation specified;

(vi) the AER would apply the form(s) of regulation detailed in the Rules; and

(vii) the form of regulation should be allowed to evolve over time, to reflect changing circumstances, through the consultation and decision making process for Rule changes, administered by the AEMC.

There appears to be some internal inconsistency within these principles. Notably, (ii) comments that the NEL/NGL should require that we use a CPI-X price cap, but the other principles are somewhat inconsistent with this. Point (iv) talks about forms of price regulation and then discusses approaches to revenue requirement determination. Page 23 of the Consultation Paper draws a distinction between “form of regulation” and “form of price control”.

4.2.1. Objectives of distribution price regulation

The Consultation paper proposes the following objectives for distribution price regulation:

(i) service providers should have the reasonable opportunity to recover efficient costs;

(ii) the form of regulation should provide incentives for efficiency; and

(iii) regulation should promote the same objective as that set out in the NEL/NGL for the market as a whole.

EnergyAustralia supports these objectives in general.

However, EnergyAustralia cautions that, by introducing additional objectives, the Rules risk moving away from an overarching NEM objective, further extending the current immeasurable multiple objectives and principles.

4.2.2. Form of regulation and substantive guidance on implementation

The recommended approach is that services falling under the basic definition of a regulated service should be regulated on the basis of a CPI-X price cap. The Consultation Paper recommends that:

“... the overall form of regulation, and substantive guidance on how that form of regulation is to be implemented, should be specified in the Rules.

The recommended approach is that the Rules set out that the AER is to adopt either the building block form of regulation or, in the case of greenfield projects, a form of regulation based on tender outcomes.

...The Rules should provide guidance on the manner in which the form of regulation should be implemented. This should be at a sufficiently substantive level to be meaningful."

As outlined throughout this submission, EnergyAustralia considers that more attention needs to be placed on establishing appropriate incentives in the regulatory framework to support investment in long lived assets and, in doing so, to deliver the MCE's policy objectives. Guidance on the incentives, in turn, should be specified in the Rules.

Total Factor Productivity as a regulatory tool

The Consultation Paper suggests that Total Factor Productivity (TFP) could form the basis of regulatory price control, and recommends that the MCE direct the AEMC to undertake a review of TFP. EnergyAustralia considers that the energy market as a whole is uncertain as to the usefulness of TFP as a primary regulatory tool. In this regard, EnergyAustralia considers that it would be beneficial for the AEMC to undertake a review of TFP with an aim to determining its usefulness in the Australian regulatory context.

However, relatively little discussion has taken place on important, related issues such as determining or re-determining starting prices (or "P₀" adjustment) and the means by which "off-ramp" or re-opener provisions may be invoked under a TFP arrangement. This is particularly important in an environment of increasing investment in network businesses, where there is a significant risk that future prices may not adequately signal the costs of the additional investment. Until such time as these issues are investigated, TFP is not supported for determining the regulated revenue requirement.

The success of any move to a TFP-type arrangement will also be limited by the extent that the starting prices are "efficient". By locking-in current prices that are not at efficient levels, it will only institutionalise any over or under recovered amounts and cross subsidies. Not only could this have a significant impact on the usage of the network and on effectively managing demand, but it would also institutionalise any current pricing inequities between various customer classes.

The information intensive nature of TFP is likely to require a much longer period for DNSP's to develop and refine the required data sources and systems and for industry, customers and the regulators to have confidence in the robustness of the likely outcomes. This would require parallel tracking of outcomes for at least one regulatory period.

Consistent with the current requirement in the Rules, EnergyAustralia considers that any move towards using TFP as the method of regulatory control (i.e. in replacement of the building block approach, or for more than informing the regulator on the appropriate value of X) needs to address the two year notification period required for changes to the form of regulation.

Extent of Discretion and Guidance in the Rules

The paper suggests that the Rules should provide substantive direction to the AER on the various elements of costs:

- (i) asset values should reflect past regulatory determinations, rolled forward on the basis of additions (that have been assessed as prudent), depreciation, disposals and inflation;
- (ii) in assessing additions to the capital base for prudence, the regulator may consider the extent to which the distributor has taken into account appropriate alternatives to network augmentation (eg, for electricity this may include DSM measures);
- (iii) the business's assessed costs should reflect the cost of complying with government obligations as outlined in the Jurisdictional Direction;
- (iv) the business's assessed costs should reflect obligations arising as a result of other elements of the regulatory framework, eg, metering; service standard requirements;
- (v) for electricity distribution businesses, any payments made to embedded generators to reflect reductions in TUOS costs and avoided network augmentation should be able to be recovered via distribution charges; and
- (vi) the regulator should use market based rates of return.

The regulatory framework as set out in the Rules should provide guidance both to businesses in preparing their pricing proposals and to the AER in assessing whether the proposals meet regulatory requirements. In formulating its views in this area, EnergyAustralia is conscious that the AER will be conducting reviews for approximately 40 network service providers. This extensive workload will require a change in the way economic regulation is administered. Policy makers no doubt recognise that the framework needs to be more efficient by streamlining regulatory process without diminishing effective incentives.

EnergyAustralia's view is that the extent of regulatory discretion afforded to the AER should be substantially more limited than is presently the case. In transmission, the National Electricity Code afforded the ACCC too much discretion, which we believe the ACCC did not exercise reasonably. This is evidenced by decisions of the ACCC in the final TransGrid and EnergyAustralia determinations to exclude part of the value of assets associated with the Sydney MetroGrid project, on the basis of an unrealistic and untested assumption that demand management or embedded generation would have permitted two years deferral of the project.

Discretion is most likely to be exercised judiciously if there are clear objectives, firm Rules on the cost components and incentive mechanisms and clear avenues for judicial and merits review of regulatory decisions.

Against this background, it is legitimate to consider the extent of regulatory discretion afforded to the AER under the Rules, and the manner in which this discretion is likely to be exercised. In particular, EnergyAustralia notes section 6.2 of the Rules (relating to transmission revenue) states that:

"The Rules do not limit the methodologies that may be applied by the AER in exercising its regulatory powers under them, except that those methodologies must be

consistent with the requirements of the National Electricity Law and with the objectives, principles, and broad forms and mechanisms described in clauses 6.2.2 to 6.2.4 inclusive."

In EnergyAustralia's view, this rule provides the AER with too much discretion in the methodologies that it may employ in exercising its regulatory powers and we would not be supportive of similar discretion being given to the AER for distribution regulation.

In transmission, the ACCC has attempted to outline its approach to regulating TNSP's by developing a document called the Statement of Regulatory Principles (SRP). While EnergyAustralia applauds the ACCC for attempting to clarify aspects of the regulatory framework, we are deeply concerned that the ACCC was afforded too much discretion in establishing, and modifying, its approach to regulation. The concern over the ability for an economic regulator to have seemingly unfettered discretion to change key aspects of the regulatory framework is evident in the SRP, where the ACCC explains that the document does not bind the regulator:

"The SRP does not form part of the [then] code and is not an instrument made pursuant to the code. Accordingly, the application of the SRP to a particular TNSP will depend on the individual circumstances of the case. The ACCC will depart from the SRP where required or justified by the code provisions."

"The approach set out in the SRP will continue to evolve in response to factors such as code amendments, changes in the industry, and improvements in regulatory models and best practice worldwide."

The SRP therefore provides little comfort to TNSP's that the regulator will continue to adopt these policies in future regulatory periods. In the absence of appropriate levels of certainty and predictability, the regulatory regime is unlikely to encourage investment for the long-term benefit of customers. In EnergyAustralia's view, appropriate arrangements in the Rules rather than at the discretion of the AER regarding regulatory conduct and governance are prerequisites to the achievement of the national electricity market objective.

EnergyAustralia's view is that the following aspects of the regulatory framework should be specified in the Rules for network businesses:

- guiding objectives and principles for revenue regulation;
- the form of regulation (i.e. CPI-X, TFP or some other variant);
- guidance on setting the price or revenue caps (i.e. "building blocks" and X factors);
- the form of control (price cap, revenue cap or some type of hybrid control);
- asset valuation, depreciation and roll-forward methodologies;
- the approach to calculating the return on capital (i.e. WACC);
- the regulatory treatment of capital expenditure;
- the incentive mechanisms to achieve operating and capital expenditure efficiencies;

- the treatment of taxation (i.e. a pre-tax or post-tax framework);
- the incentives for the development of non-network solutions to manage demand growth; and
- the approach to service standards.

While it is appropriate for the AER to have discretion in developing statements and guidelines, the discretion should be limited as its context and informed by details specified in the Rules. The discretion afforded to the AER should not enable the development of guidelines to go beyond the scope of the operative effect of the Rule.

Consistent with EnergyAustralia's support for a "propose / respond" model similar to that enshrined in the National Gas Code, and as discussed in section 4.5 below, specifying the key elements of the regulatory framework within the Rules would not only provide much needed investment certainty, but would also assist the regulator by narrowing the range of potential variability among proposals.

EnergyAustralia draws the SCO's attention to the requirements in the National Gas Code on the content of an Access Arrangement, where these requirements have engendered a great deal of comparability among business' proposals.

[Removal of the regulatory test for distribution businesses](#)

To facilitate long term investment in network infrastructure, investment certainty is required. For a regulated network, this certainty needs to be reflected in the regulatory framework, whereby the network owner has confidence that if it invests efficiently, its investments will be recognised by the regulator and attract a fair return.

The regulatory test provides one mechanism whereby the regulators' expectations for the efficiency of an investment have been communicated. While the purpose of the regulatory test is limited to a tool to rank and assess identified options to a network constraint on an *ex ante* basis - not to provide the Regulator with comfort that the out-turn costs of a project are efficient – the regulatory test nonetheless provides a degree of certainty that if a project meets the regulatory test requirements, its chances of being recognised and earning a regulatory return are enhanced.³

The Consultation Paper suggests, however, that the regulatory test for distribution should be removed (page 23) in favour of other (seemingly less onerous) alternatives, as stated below:

"It should be noted that (ii) above replaces the current requirement in the NEC for electricity distribution businesses to apply the regulatory test. The formal application of the regulatory test for distribution is an onerous requirement, given the relative size of the majority of distribution investments.

Allowing the AER to take into account the extent to which the distributor has considered alternatives to network augmentation as part of the AER's assessment of

³ EA believes that the Rules should be amended so that it is clear that the regulatory test (if retained) is only one of a number of criteria which a regulator can advise businesses will be taken into account when assessing the economic efficiency of completed projects.

the prudence of the investment, represents a more appropriate means of ensuring that non-network alternatives are considered where relevant."

EnergyAustralia supports such a recommendation, but is concerned that the impact of potentially reduced regulatory certainty from the removal of the regulatory test may outweigh any administrative gains from its removal. The relevant requirement in the Rules (clause 5.6.2(g)) states that:

"Each Distribution Network Service Provider must carry out an economic cost effectiveness analysis of possible options to identify options that satisfy the regulatory test, while meeting the technical requirements of schedule 5.1, and where the Network Service Provider is required by clause 5.6.2(f) to consult on the option this analysis and allocation must form part of the consultation on that option."

It is arguable as to whether the wording of the Rules would require a distributor to carry out an economic cost effectiveness analysis for all projects. To this extent, EnergyAustralia agrees with the premise in the Consultation Paper that the formal application of the regulatory test for distribution would be an extremely onerous and impractical requirement and that alternatives to the regulatory test should be considered.

"An option satisfies the regulatory test if:

(a) in the event the option is necessitated solely by the inability to meet the minimum network performance requirements set out in schedule 5.1 of the Code or in relevant legislation, regulations or any statutory instrument of a participating jurisdiction - the option minimises the present value of costs, compared with a number of alternative options in a majority of reasonable scenarios;

(b) in all other cases - the option maximises the expected net present value of the market benefit (or in other words the present value of the market benefit less the present value of costs) compared with a number of alternative options and timings, in a majority of reasonable scenarios."⁴

EnergyAustralia believes that it is possible, and desirable, to establish criteria in the Rules that would allow a distributor to meet the above requirements of the regulatory test through a more effective means, such as adherence to a rigorous internal investment processes. Similar processes are required to be undertaken by a distributor in order to demonstrate the regulatory compliance and efficiency of its investments to its Board, as required by any commercial organisation.

The Rules should also specify that the AER be obliged to rely on the incentives in place to deliver efficiencies (through the CPI-X framework) and accept the business's assessment if it has been conducted in accordance with the internal investment governance process. Such a requirement needs to be in place to provide a similar level of regulatory certainty as the regulatory test that investments undertaken will be recognised by the regulator and receive a fair return.

⁴ ACCC – Review of the Regulatory Test for Network Augmentations, August 2004. Page 7.

If the regulatory test is to be retained for distribution projects, EnergyAustralia believes that the dollar thresholds in the Rules for the definition of for “new small distribution network asset” (\$1m) and “new large distribution network asset (\$10m) do not reflect the current marketplace and are considerably too low.

4.2.3. Transitional arrangements

There are a number of current regulatory decisions or arrangements in place for EnergyAustralia, the impact of which extends beyond the current regulatory period. EnergyAustralia has developed investment plans on the basis that those regulatory decisions will be given full effect.

EnergyAustralia believes the recommendation in the Consultation Paper in the context of Fixed Principles in Gas Access Arrangements (pg 24) is equally applicable to electricity distribution:

“It is proposed that these fixed principles are to be taken into account by the AER in regulating the relevant distributors until they expire or until the distributor itself proposes a change to the fixed principle to adopt the national regime. The distributors may have made investments on the basis of these principles that should not be put at risk.”

EnergyAustralia agrees wholeheartedly with this recommendation, and believes it equally applies to aspects of decisions made by jurisdictional regulators that span across regulatory periods.

In the Consultation Paper, the SCO proposes that the AER should “take into account decisions made by previous regulators”. EnergyAustralia believes that this position does not provide adequate certainty. EnergyAustralia proposes that the AER should be obliged to recognise, rather than merely to take into account, current regulatory decisions and arrangements when making its first determination. This should not only enhance certainty in investment decisions, but also minimise the scope for value loss.

EnergyAustralia accepts that the first set of regulatory decisions in different jurisdictions made by the AER may continue to contain some differences but, as these unwind, the following period will allow for greater consistency.

A number of specific arrangements affecting EnergyAustralia are listed below in more detail:

Demand management

EnergyAustralia’s distribution business is subject to a D-factor as part of its price cap regulation. The D-factor was introduced as part of IPART’s NSW Electricity Distribution Pricing Determination for the 2004-09 regulatory period, established to encourage higher levels of network demand management (DM). The D-factor operates such that there will be a two-year lag between network DM implementation costs and foregone revenues and their pass through into prices. This creates an uncertainty for the recovery of DM costs for projects that are initiated in the current regulatory period but carry over into the next regulatory period (2009-14).

Transmission over (under) recovery balance

As a NSW DNSP, EnergyAustralia is required to maintain a "Transmission Overs and Unders Account". The account tracks the accrued difference between the actual transmission-related payments it pays and the actual revenue it receives through transmission cost recovery tariffs. The DNSP recovers or returns any balance in the account by adjusting transmission cost recovery tariffs in the following year. IPART made no provision for a carryover mechanism to provide regulatory certainty about the treatment of the balance at the end of the 2004-09 regulatory period, citing it could not bind future regulators to a particular course of action.

Transmission / distribution boundaries

The definition of transmission assets under the Code means that elements of EnergyAustralia's network that are recognised as distribution assets may change to transmission assets throughout the period. This is due to augmentations that are planned for the transmission network that will change the configuration and operation of the network, thereby changing the role of some assets to that of a transmission function.

Recognising the difficulty surrounding changes in asset definition, EnergyAustralia sought and achieved agreement with both transmission and distribution regulators that assets changing definition during the 2004-09 regulatory period will maintain their current classification until the end of the period. At that time a reassessment, and perhaps reclassification, would take place. EnergyAustralia wants to ensure consistency in the treatment of reclassified assets (eg. a newly built distribution asset that changes definition to a transmission asset will still undergo regulatory review by the distribution regulator as any other distribution asset for the 2004-09 period.).

EnergyAustralia's strong preference is that the transmission and distribution regulatory regimes would be sufficiently consistent for its business to be regulated as a single entity and subject to a single form of price control.

For pricing, it is acknowledged that a distinction is required between transmission and distribution assets. The transmission assets are included in a pricing model and a proportion of their costs are recovered from participants connected to adjacent networks. However, this could conveniently be managed with an internal division of costs, associated with the classes of assets involved.

Distribution over recovery balance

The revenue collected in excess of EnergyAustralia's AARR during 1999-04 was required to be resolved as part of the 2004-09 NSW Electricity Distribution Price Review. This 'over recovery' was offset against EnergyAustralia's building block revenue requirement for all years of the Determination period, including the final year 2008-09. As a result, prices in 2008-09 will be less than required to enable the recovery of efficient costs. Given that 2008-09 price levels will necessarily form the starting point for new prices in the 2009-14 regulatory period⁵, the AER should be obliged to recognise this pricing anomaly and to make a corresponding adjustment,

⁵ EnergyAustralia noted its concerns with the adopted treatment of the over-recovered revenue and had developed a number of other practical alternatives that would have achieved the same result (in NPV terms) without impacting on inter-period prices.

over and above any side constraints, when making its first determination for EnergyAustralia's distribution business.

EnergyAustralia believes that the continuation of existing arrangements preserves the integrity of the basis on which investments have been made and does not represent a significant impediment to the adoption of a national regime. Consistent with the recommendation in the Consultation Paper relating to fixed principles in gas, those arrangements should be recognised by the AER until they expire or until a distributor itself proposes a change adopt the national regime. Consistent with EnergyAustralia's support for a "propose/respond" model, if the business's proposal meets certain specified criteria, the AER should be obliged to accept it.

4.3. REGULATORY REQUIREMENTS IN RELATION TO TARIFF SETTING

The Consultation Paper suggests that the following principles be reflected in the NEL/NGL:

- (i) regulatory requirements relating to tariff setting should be limited and should relate to clear, economic criteria;*
- (ii) the principles for tariff setting should be set out in the Rules;*
- (iii) the same principles should apply on a national basis and should be consistent between the electricity and gas sectors; and*
- (iv) regulated distribution businesses should be allowed discretion in determining their tariff policy consistent with these principles.*

EnergyAustralia has strongly and consistently supported the principle that the business should determine its tariff policy. EnergyAustralia has also supported the inclusion of clear pricing principles in the Rules. In particular, EnergyAustralia supports the pricing principles recommended by the Productivity Commission in its *Review of the National Access Regime* and *Review of the Gas Access Regime*.

4.3.1. Tariff setting principles

The Consultation Paper proposes the following tariff setting principles should be included in the Rules:

- (i) tariffs for individual customers should lie between the incremental cost (lower bound) and stand-alone cost (upper bound) of serving them;*
- (ii) the allocation of fixed or common costs should be transparent;*
- (iii) there should be constraints on the extent to which tariffs can be changed year-on-year;*
- (iv) distributors should be permitted to give discounts on published tariffs where this reduces costs for all customers, compared to a situation in which discounts were not allowed. Distributors should be allowed to recover the revenue foregone as a result of such discounts from other customers; and*

(v) tariffs should take into account any explicit jurisdictional policy requirements as set out in the Jurisdictional Direction.

EnergyAustralia has a number of concerns with aspects of these proposed principles.

Tariffs to lie between incremental cost and stand-alone costs

EnergyAustralia agrees with this principle and currently carries out this form of analysis. It will be important, however, to define each term carefully to ensure that the long term, capital intensive nature of network businesses is considered (i.e. “incremental” cost should be specified as long term, and “stand-alone” specified as those facing a new entrant).

Allocation of fixed or common costs should be transparent

EnergyAustralia considers that the network needs to be afforded the ability to allocate costs on a reasonable basis as it sees fit across its customer base in a manner that takes into consideration the network’s particular circumstances. At the same time, the administrative complexities that would be associated with providing detailed cost allocation information to each of our 1.5 million customers must be recognised.

While EnergyAustralia is pleased to make the fixed and variable components of tariffs transparent to customers, we believe that the administrative burden and associated costs that would accompany providing detailed cost allocation information to customers would not be consistent with the national market objective.

EnergyAustralia agrees with the premise in the Consultation Paper that the network businesses should be allowed discretion in determining their tariff policy. EnergyAustralia considers that the Regulator should not involve itself in the detailed calculation of specific tariffs, and their allocation of fixed and variable costs. Due to the influence of history and side constraints (discussed in the following section), there are many instances in which the incidence of fixed and variable costs is not aligned to fixed and variable tariffs.

Pricing constraints

EnergyAustralia does not support the assertion in the Consultation Paper that side constraints should form a core aspect of the regulatory framework. In order to achieve the NEM objective, the regulatory framework must strive to provide a network business with a reasonable opportunity to recover the efficient costs of running its business. The imposition of side constraints on average prices, if it results in the business not being able to earn sufficient revenues to meet its efficient costs, would over-ride other aspects of the regulatory framework and become the default “form of regulation”.

The temptation to reduce average prices so that customers, on average, do not face the efficient costs of the network, must be avoided to ensure that the businesses are not left “holding that bag”. Continued use of side constraints to reduce prices below efficient levels can only have a dampening effect on investment for a commercial business. This is particularly relevant in NSW in a current environment of significantly enhanced expenditure programs to ensure a safe and reliable electricity network. To meet the NEM objective, the regulatory framework must enable the business to recover the efficient costs of running the business, including meeting any legislative obligations, irrespective of the price impact.

EnergyAustralia notes that side constraints on individual tariffs or tariff components also restrict the ability of the distribution business to charge cost reflective prices, and therefore limit the ability to send economic signals to customers. The ability to send economic signals to customers through pricing is a powerful tool in managing demand to ensure that customers are faced with the costs that they impose on the network when making their usage decisions. Side constraints on individual tariffs limit the time over which efficient prices can be achieved, thereby extending the both period over which inefficient usage may occur on the network and the period over which cross subsidies can be unwound.

As an extreme example of the overuse of side constraints, consider the present arrangements in operation in NSW:

- Distribution network *tariff components* are subject to the WAPC;
- Any increase in the *fixed distribution tariff component* for domestic customers is separately constrained;
- (Distribution + Transmission) charges are subject to a *price limit per tariff class*;
- (Distribution + Transmission + Retail) charges for domestic customers are subject to a *maximum price movement per bill*;
- Any increase in the *fixed retail tariff component* for regulated customers is constrained.

These confusing limits on price movement are inconsistent – the retail side constraint has on several occasions limited the network price movement.

The Regulator's concern should be limited to ensuring that the proposed tariffs align with the objective and mechanism of the regulatory control, and therefore allow the incentives inherent in that form of regulatory control to operate.

[Discounts on published tariffs](#)

EnergyAustralia agrees with the approach taken in the Consultation Paper.

[Tariffs to take account of Jurisdictional Directions](#)

EnergyAustralia agrees with the approach taken in the Consultation Paper, insofar as it does not result in the business not being able to recover its efficient costs (in NPV terms) over the regulatory period. The AER's role should be to set prices sufficient to enable the business to recover its efficient costs, and in performing this role it will support the achievement of the NEM objective. Should a jurisdiction require prices below efficient levels, the business should be compensated through a transparent CSO arrangement, whereby the business is left "whole" (in NPV neutral terms).

4.4. SERVICE PERFORMANCE TARGETS

The Consultation Paper recommends the following principles for service standards:

(i) service performance targets for distribution services should be explicitly incorporated within the national regulatory regime, so that they are transparent;

(ii) performance targets for distribution services should be specified at both:

A. the average service level; and

B. as minimum performance targets (or 'guaranteed service levels') for any particular customer, below which either some form of financial compensation becomes payable or reporting occurs.

(iii) minimum service performance targets should:

A. reflect attributes of service performance that customers care about;

B. be specified in a meaningful manner; and

C. be measurable.

(iv) service performance targets should be determined separately for the gas and electricity sectors (with the exception of measures relating to customer service, where a higher degree of consistency may be achievable);

(v) average and minimum service performance targets should be determined by each jurisdiction or, where the jurisdiction has not specified any targets, by the AER;

(vi) average and minimum performance targets may vary between jurisdictions and may differ between distributors within each jurisdiction; and

(vii) the cost to the distribution business of complying with the specified performance targets (average targets and minimum service targets) should be taken into account by the AER in regulating distribution prices. This includes the cost of expected compensation payments for failure to meet 'minimum performance targets'.

As a matter of principle, EnergyAustralia firmly believes that an economic regulator should not set minimum standards of service or network performance. The setting of standards of service (be it customer service or network performance and reliability) is a policy matter that should be separated from the setting of economic regulatory controls. To adequately set minimum standards the standard setter must be informed of the specific customers' service expectations.

EnergyAustralia believes that the only bodies in a position to meet this hurdle are the elected representatives of the customers, the customers themselves (or their representatives) and the network business who has dealings with its customers on a daily basis. The network business is the only body with the detailed knowledge of the technical implications and costs associated with delivering the service outcomes.

We should stress, however, that it is entirely appropriate for jurisdictions to set service standards and that a national regime should not seek to impose uniform service standards.

Conversely, economic regulators do not have the mandate to set policy as evidenced by the separation of powers between the economic regulators and the rule makers. Moreover economic regulators simply do not have the contact with customers necessary to make an

informed decision nor do they possess the requisite technical skills and expertise to mandate the engineering performance of complex infrastructure networks.

However, service standards are an integral component of the price and service mix, and therefore transparency in the service levels being offered and delivered is key to ensuring that customers are adequately informed of the level of service they receive, and as a discipline on the networks to ensure that they deliver service outcomes commensurate with the price that they charge.

In examining service standard performance there are three main issues to be considered;

1. Established minimum service targets and/or guaranteed service levels backed by payments to customers that are set by the respective governments;
2. Regulatory recognition of the full costs of meeting minimum service targets; and
3. Economic incentives to deliver efficient service level improvements beyond any minimum standard.

4.4.1. Establishment of Minimum Standards

Consistent with its views on duplication of regulatory process and removing dual layers of regulation, EnergyAustralia is firmly of the view that, where a jurisdictional government has imposed service standards on the network (as is the case in NSW through the business's licence conditions), the regulator should be prohibited from imposing duplicative service standard regulation. AER-imposed service standards would only result in an additional layer of regulation, with the commensurate costs, administrative burden, and scope for inconsistency.

Furthermore, EnergyAustralia would advocate that to ensure adequate separation of regulatory authority, the economic regulator should not allow itself to be drawn into setting its own minimum standards where the jurisdictional government has not established clear service target policies. Rather, the economic regulator would be wise to follow the policy as has been used historically in NSW of adopting historic and current service outcomes as the expected service targets. This avoids the economic regulator establishing policies for which it does not have a mandate and would set a clear baseline to which the respective network is held accountable through the regulatory processes.

Such an approach has similar characteristics to, but not as sophisticated as, the approach contained in the WA Electricity Access Code, in which the business is required to provide its service standards as a part of its price and service offering.

4.4.2. Regulatory Recognition of Costs

EnergyAustralia is firmly of the view that the regulator must take full account of the costs of compliance with jurisdictional service standard requirements, as recognised in the recommendations of the Consultation Paper:

“(vii) the cost to the distribution business of complying with the specified performance targets (average targets and minimum service targets) should be taken into account by the AER in regulating distribution prices. This includes the cost of expected compensation payments for failure to meet ‘minimum performance targets.’”

Without full recognition of such costs the regulator would be directly and deliberately undermining the policies implemented by the jurisdictional governments, and therefore is clearly untenable.

When setting the capital expenditure and operating expenditure allowances, the regulator must have consideration of the service outcomes that can reasonably be achieved with such allowances. If the regulator does not afford sufficient capital and operating expenditure allowances to enable the DNSP to meet the minimum standards set by the jurisdiction, then the AER must accept that any penalty payments made by the DNSP as a result of being under funded must be allowed for as an explicit cost/revenue allowance in the regulatory decisions.

There is an important corollary for EnergyAustralia as a result of the penalties for which it is liable under the NSW jurisdictional scheme. The economic regulator should recognise the reasonable expected value of penalties for failing to meet service standards in responding to the regulated entity's proposed price path. This recognition could be implemented through some combination of the assumptions underpinning the proposed price path and the creation of positive incentives (i.e. bonuses) of equivalent value to the negative incentives (i.e. penalties) imposed under the jurisdictional scheme.

4.4.3. Service Incentive Regime

EnergyAustralia supports the discussion in the Consultation Paper regarding opportunities for providing enhanced services to customers, where the cost of doing so is less than the value they place on those enhancements. The economic regulator may therefore wish to implement a (one-sided) bonus-type incentive regime for out-performance and improvements in service standards.

EnergyAustralia believes that such an approach is most effective where the jurisdictional government has set the minimum acceptable service standards. The incentive to avoid service degradation is arguably more evident where the jurisdictional government has set minimum standards and therefore a symmetrical incentive regime may be a more appropriate balancing of interests.

In the event that the economic regulator does implement a form of service standard regulation, this must be coordinated with the jurisdictional requirements in order to avoid unnecessary duplication. For example, the NSW requirements operate as a penalty regime for not meeting minimum Guaranteed Customer Service Standards (GCSS). A service standards regime implemented by the economic regulator should align with the jurisdictional requirements such that, where the distribution business meets the jurisdictional requirement, there can be no duplicative penalty in the economic regulatory framework.

Finally, the NSW obligations contain extensive reporting requirements. EnergyAustralia is firmly of the view that it is inappropriate for the economic regulator to place an additional (and unproductive) administrative burden on the business by duplicating the reporting requirements for service performance. Should the economic regulator believe it is necessary to remain informed on network performance matters, it should be required to satisfy itself with the reporting conducted for jurisdictional purposes rather than imposing an additional layer of regulatory reporting.

4.5. PROCESS FOR REGULATION FOR PRICE CAPPED SERVICES

The Consultation Paper includes a set of key principles that should be included in the NEL/NGL:

- (i) the process should involve public consultation, in order to provide transparency;*
- (ii) the AER should be required to provide reason and supporting information for decisions (i.e., the AER's decision should be replicable); and*
- (iii) there should be a clear dispute process.*

EnergyAustralia supports these principles and their inclusion in the NEL/NGL.

Electricity regulation under the NEL/NER is conducted under a “submit/determine” model, in which the business files a detailed submission on costs, volumes, revenues and prices, and the Regulator issues a Determination. While they may choose to do so, the Regulator is under no clear requirement to have any particular regard to the business’s submission. There is also no scope for merits review of the Regulator’s Determination. EnergyAustralia has long objected that this model inappropriately places the business’s submission in the same league as that from any other interested party.

EnergyAustralia has strongly and consistently advocated a genuine propose/respond model as per the National Gas Code. However, the model being suggested in the Consultation Paper is far removed from the gas model, but its wording may give the impression that it is, in fact, similar:

- (a) The AER:*

 - (i) sets out the framework and approach for the price review; and*
 - (ii) clearly sets out what information is to be provided by the regulated business and in what form.*

- (b) distributors submit proposed price arrangements, consistent with the framework and required information set out by the AER;*
- (c) the AER consults;*
- (d) the AER issues its Draft Decision; and*
- (e) the AER issues its Final Decision (in a form that can be implemented).*

The Consultation Paper acknowledges that this process most closely follows that in electricity, but also that this model has elements of the gas “propose/respond” model. However, there is no indication in the Consultation Paper as to whether the regulator should have to accept the business’s proposal if it meets the requirements contained in the Rules. The lack of such an obligation on the regulator to accept a compliant proposal is a critical omission which renders the model largely ineffective, and in no way a “propose / respond” model.

EnergyAustralia is of the view that the proposed model offers no additional acknowledgement of the business’ proposal than the current “submit/determine” model. Moreover, it is a serious

detraction from the “propose/respond” model currently in place in gas and as such the recommended approach in the Consultation Paper should not be endorsed by policy makers.

EnergyAustralia acknowledges the extent of the workload on the AER in regulating some 40 energy distribution and transmission network businesses. In this respect, we note arguments by some that a genuine “propose/respond” model would introduce such a wide degree of variability in network price and service offerings that the AER would be unable to realise sufficient economies of scale. The arguments then assert that this variability would undermine the gains to be achieved through the streamlining of regulatory processes from a number of state based regulators to a single national regulator.

However, as is currently the experience under the National Gas Code, a genuine “propose/respond” model need not introduce a wide range of variability among proposals. EnergyAustralia draws the SCO’s attention to the requirements in the National Gas Code on the content of an Access Arrangement. These requirements have engendered a great deal of comparability among business’ Access Arrangements. As noted earlier in this submission, consistency can be achieved by elevating key aspects of the regulatory framework into the Rules.

A further refinement of this process can be seen in the Western Australia Electricity Access Code. Section 5.1 of this Code specifies a rigorous scope of matters that must be addressed in the proposed Access Arrangement:

5.1 An access arrangement must:

(a) specify one or more reference services under section 5.2; and

(b) include a standard access contract under sections 5.3 to 5.5 for each reference service; and

{Note: An access arrangement may contain a single standard access contract in which the majority of terms and conditions apply to all reference services and the other terms and conditions apply only to specified reference services.}

(c) include service standard benchmarks under section 5.6 for each reference service; and

(d) include price control under Chapter 6; and

(e) include pricing methods under Chapter 7; and

(f) include a current price list under Chapter 8 a description of the pricing years for the access arrangement; and

(g) include an applications and queuing policy under sections 5.7 to 5.11; and

(h) include a capital contributions policy under sections 5.12 to 5.17; and

(i) include a transfer and relocation policy under sections 5.18 to 5.24; and

(j) if required under section 5.25, include efficiency and innovation benchmarks under section 5.26; and

(k) include provisions dealing with supplementary matters under sections 5.27 and 5.28; and

(l) include provisions dealing with:

(i) the submission of proposed revisions under sections 5.29 to 5.33; and

(ii) trigger events under sections 5.34 to 5.36.

{Note: At the same time as an access arrangement is submitted, access arrangement information must be submitted under section 4.1 and technical rules must be submitted under section 12.10. Neither the access arrangement information nor the technical rules are part of the access arrangement.}

Moreover, Section 4.29 places restrictions on the process that the Economic Regulation Authority:

- *must not approve a proposed access arrangement which omits something listed in section 5.1; and*
- *may in its discretion approve a proposed access arrangement containing something not listed in section 5.1; and*
- *must not refuse to approve a proposed access arrangement on the ground that it omits something not listed in section 5.1.*

The Western Australia Electricity Access Code also includes model documents, such as a model standard access contract, a model application and queuing policy and a model capital contributions policy. Where the business adopts the model standard access contract, the model application and queuing policy, or the model capital contributions policy substantially as published in the Code, the Regulator is obliged to accept it (sections 5.5, 5.11, 5.17).

EnergyAustralia considers that this construct provides important information to the regulated businesses on the structure of the regulatory framework while still allowing the regulator to realise economies of scale in regulatory processes within a genuine “propose/respond” framework.

Moreover, it represents a good example in which the framework for the review is set out in advance. The regulator is then in a position to specify its approach to the analysis, and its information requirements, in direct response to that framework. This will allow the regulator to target its information requests to the framework requirements, and reduce the scope for “shotgun” information requests.

Process delays

The Consultation Paper acknowledges that, where the process is accompanied by fixed time frames to conduct the review, there may need to be provisions to allow for delays in that timetable. The Consultation Paper suggests that:

“A corollary of having a fixed timetable is that the Rules also need to make allowance for the timetable to be stopped, for non-provision of information, by the regulated

business that is reasonably requested by the AER. In addition, where there is a delay in making a final determination on the price cap, as a result in a delay by the business in providing information, then either:

(a) current prices should be rolled over at the expiry of the existing regulatory period subject to a pre-determined (penalty) factor; or

(b) where there are no current prices, any financial gain resulting to the business should be taken into account in setting the price cap. These arrangements ensure that the distributor does not have an incentive to withhold information in order to profit from the resulting delay in the timing of the regulatory determination."

Sadly, the Consultation Paper has couched these comments in terms of delays caused mischievously by the regulated business. It is disappointing that the Consultation Paper does not appear to acknowledge the scope for process delays to be caused by the Regulator, as has in fact occurred. A case in point is the recent transmission revenue cap review conducted by the ACCC for the EnergyAustralia and TransGrid transmission networks, where the ACCC's processes led to a one year delay in the issuance of the final determination. The delay impacted on all stakeholders involved in the review and necessitated the NSW Government to seek a derogation from the (then) Code to ensure the pricing and administrative consequences of the ACCC's delay could be managed.

Process delays can arise from poor management of the processes from the regulators or from complex matters being considered by an authority that causes the standard decision times to run over. For example, many of the decision timetables in the Trade Practices Act have the ability for the ACCC to extend the time to make decisions due to complex matters being considered. To think that there will never be a time when the regulator needs to delay the process so it can consider a new or complex matter is naive and does not recognise the administrative tools that are common practice in legislative instruments.

While it would be nonsensical to impose a financial penalty on the regulator (to ultimately be paid by customers) should the regulator be the cause of a process delay (as the paper suggests is appropriate for a business-initiated delay), a more sensible approach would be to ensure the financial effect of the ultimate decision - had it been made in accordance with the original timeframe - is maintained in NPV neutral terms. This should eliminate any potential concerns regarding gaming on the part of the businesses, and should provide comfort that the business will not suffer due to a regulator-caused process delay.

It must be impressed that delays in processes are not simply a matter of gaming (as the Consultation Paper seems to suggest) but also a consequence of the complexity of the issues that economic regulators and regulated business are faced with during the conduct of a complex, lengthy regulatory review.

4.6. INFORMATION DISCLOSURE

The Consultation Paper proposes the following principles for information disclosure should be reflected in the NEL/NGL:

(a) the Rules should require that network businesses collect, compile and provide to the AER information that the AER reasonably requires for the purposes of its regulatory functions; and

(b) the Rules should:

(i) provide that the AER should develop standard, national Statements of Requirements for Ringfencing, which should be consistent between electricity and gas businesses;

(ii) the Statement of Requirements should cover ringfencing between regulated and non-regulated activities, and between different regulated activities; and

(iii) set out the circumstances in which the Statement of Requirements for Ringfencing apply.

(c) the Rules should:

(i) provide that the AER can develop standard national Statements of Requirements for Regulatory Accounts, consistent across electricity and gas businesses; and

(ii) set out the circumstances in which the Statement of Requirements for Regulatory Accounts apply.

EnergyAustralia broadly agrees with the above principles.

As a matter of principle, however, EnergyAustralia believes that the Regulator should only require information necessary to meet the following objectives:

- to support the assessment of the business' proposed Access Arrangement;
- to monitor compliance with that Access Arrangement; and
- general information to collaborate or support the veracity of other information provided.

In the context of conducting a pricing review, EnergyAustralia has consistently advocated a considered approach to advance planning. In this process the regulator would:

- identify the critical risk areas in the review;
- develop the analytical tools to address those risks, and
- request information from the business required to support that analysis.

EnergyAustralia supports the process by which the Regulator is required to set out its framework and approach in advance of the review. However, EnergyAustralia has concerns about the propensity for regulators to issue "ad hoc" information requirements that are poorly targeted for the analysis to be undertaken as part of the review process.

The scope for unplanned information requests may reduce the perceived need for planning discipline in the conduct of the review and encourage the Regulator to conduct its analysis in

an unstructured, scatological approach. EnergyAustralia is firmly of the view that a well planned, structured approach to the analysis is critical to enabling the Regulator to cope with the workload, and also to ensure consistency of treatment across regulated businesses. Recognising the AER's potential mandate to regulate approximately 40 regulated network businesses, the AER will have no option other than to specify and standardise its information requirements as much as possible.

Consistent with this view, EnergyAustralia objects to the notion that "the Rules should permit (but not require) the AER to issue Statements of Requirements in relation to other reporting requirements, where such reporting is reasonably required for the purposes of the AER's regulatory functions". In EnergyAustralia's view, this "open-ended" scope for the Regulator to demand information simply paves the way for intrusive micro-management of the business on the part of the Regulator.

EnergyAustralia also believes that information must be relevant to the purpose required. In this regard, EnergyAustralia believes that the Regulator should be required to disclose the *purpose* of the information in order that the business can ensure the information provided meets the Regulator's requirements in the appropriate level of detail. Linking the information requirements to the review process, as discussed above, would accomplish this objective.

Also, where the principles allow the Regulator to demand information that it believes it "reasonably requires", there must be scope for merits review of the Regulator's demands for this information. This will be particularly important where the Regulator can impose penalties for failure to provide the information requested.

EnergyAustralia notes that the Consultation Paper (Part B, section 7 – Information Disclosure) only refers to information disclosed by a business to the AER. The Consultation Paper is silent on the circumstances surrounding when a regulator is empowered to publicly disclose the information it obtains from a network business. Further guidance needs to be provided in the Rules relating to when the AER is able to publish information. The Rules should include an obligation on the regulator to demonstrate how the public disclosure of the information would lead to the attainment of the AER's obligations under the Rules, and that the business is not commercially disadvantaged by its public release.

Ringfencing

The Consultation Paper recommends that the AER should issue a Ringfencing Statement of Requirements to cover:

- (a) clear requirements relating to the allocation of common costs between regulated and non-regulated businesses, and between different regulated businesses;*
- (b) requirements relating to the required operational separation of businesses; and*
- (c) prohibitions on preferential self-dealing.*

These requirements are more akin to the requirements in gas than in electricity, although they are fundamentally consistent. However, there may be different reporting requirements, and the Consultation Paper indicates that some transitional arrangements may be required to allow the businesses time to develop reporting systems.

EnergyAustralia does not object to the proposed ringfencing principles; they are similar to the requirements EnergyAustralia observes today. However, where new reporting systems are required, the costs of implementing those reporting systems must be clearly recoverable through tariffs.

EnergyAustralia is concerned that one of the stated goals of the standardised reporting requirements is to allow the AER to conduct benchmarking. EnergyAustralia's experience with benchmarking in the past has been unfavourable, caused primarily by benchmarkers not adequately specifying the appropriate outputs and not making sufficient allowance for differences in the networks.

4.7. CONNECTION AND CAPITAL CONTRIBUTIONS REQUIREMENTS

The Consultation Paper outlines that:

"[t]he approach to determining connection charges and capital contribution charges should be clearly set out, in order to provide transparency for both regulated businesses and customers. The requirements in relation to connection charges and capital contributions should be applied on a national basis, and should be consistent between the energy and gas sectors."

We note, however, that the Consultation Paper focuses on the calculation of connection and capital contribution charges and is silent on a distributor's rights to connect customers within its designated territory. The exclusivity of the distribution service territory reflects the fundamental economies of scale inherent in natural monopoly industries. These economies of scale provide significant price benefits to customers and to the economy as a whole. In the context of customer connections, contestability arrangements to undertake the connection work, as are currently in place in NSW, are an effective means to deliver the services at lowest cost.

Since 1995, NSW has had a contestability framework in place under which, where a charge is to be levied for the connection to the network, the customer has the right to choose the contractor (known as the Accredited Service Provider or ASP) performing that work. This is consistent with ensuring that the connection works are done at the lowest cost. The DNSP administers safety training and authorises service providers to work on or near the network in order to conduct these works. While there is room for debate as to the appropriate design of the form of contestability, the principle of its use to deliver efficient outcomes should be recognised and adopted in the proposed national Statement of Requirements.

In regard to the proposed basis for charging for connections, the Consultation Paper purports to reflect connection and capital contribution procedures that are currently in place:

- Customers within proximity to the existing system are allowed to connect at no charge;
- Small customers are not required to contribute to upstream system augmentation;
- Major customers and embedded generators are required to contribute to augmentations attributable to their connection, subject to a tracking and refund mechanism.

The Consultation Paper does not reflect the connection and capital contribution procedures that are currently in place in NSW, under which connection services are contestable.

To change the customer connection and contribution policy to allow customers within proximity of the system to connect at no charge would have a profound impact on the contestable works industry that has grown out of the NSW policy.

The IPART-administered NSW capital contributions and customer connection policy also provides that customers should not be required to contribute to upstream augmentation except for two situations: rural areas; and large customers. There is also a capital contribution tracking and refund mechanism designed to limit “free rider” problems.

Overall, EnergyAustralia broadly supports the existing NSW capital contributions arrangements for customers wishing to connect to the network, which provide an important location and load specific price signal. We suggest that these arrangements should form the basis for a national framework.

[Signaling the costs imposed on the network](#)

EnergyAustralia believes that large customers have a disproportionate impact on the network. It is clearly appropriate for such customers to make an additional contribution towards the upstream infrastructure development that is imposed on the network.

EnergyAustralia suggests that any national framework for capital contributions should not preclude the ability for a network to introduce a pricing signal in the upfront purchase decision to reflect the upstream costs imposed on the network.

A similar principle applies to the supply of all customers where, in EnergyAustralia’s view, an upfront charge is an efficient method of signalling the cost of infrastructure.

[Tax loss arising from capital contributions](#)

EnergyAustralia is concerned that the capital contributions regime in NSW, excludes contributed assets and contributed funds for the purchase of assets from the regulated asset base, even though a significant taxation liability is accrued. As other options to address this anomaly have been exhausted (including obtaining a tax ruling from the Australian Taxation Office), a regulatory solution is now needed to ensure capital contributions do not destroy value and potentially distort business decision making.

One area that EnergyAustralia believes needs to be addressed is the value loss associated with the current capital contribution arrangements. Under the current arrangements, a capital contribution or contributed asset is required to be entered into the regulatory asset base at zero cost, and therefore earns neither a return on nor return of capital. However, the receipt of the contribution is reported as revenue for tax purposes, and tax paid on that revenue. However, that value is only recovered for tax purposes as the asset is depreciated for tax purposes. Therefore, each time the business accepts a capital contribution or contributed asset, it destroys business value equal to the amount of the NPV loss associated with the timing of the tax inclusion and depreciation. This loss in value is substantial, being in the order of 15%.

EnergyAustralia has previously recommended that the business be allowed to increase its regulatory asset base by the value of the NPV loss arising from the taxation of the capital contribution. A more complete analysis of this issue is included in EnergyAustralia’s submission to the IPART 2004 Electricity Price Review.

4.8. DISTRIBUTION NETWORK EXPANSION RULES

This section of the Consultation Paper does not appear to have been subject to the same rigorous attention as the other sections.

This section has different implications for electricity and gas:

- For gas, this section may address issues as to whether the expansion becomes part of the covered network;
- For electricity, these provisions are meant to replace the Regulatory Test for distribution businesses.

As discussed in section 4.2.2, EnergyAustralia is cautiously optimistic regarding proposals to remove the obligation to perform the Regulatory Test for system expansion. However, as discussed, in that section, it is not clear what Rules would be applied to effect this removal.

This is an area where more detail on the proposed changes to the regulatory framework is required before meaningful commentary can be offered.

5. CONSUMER PROTECTION

Generally, the Consultation Paper proposes to impose consumer protection obligations directly on the businesses through legislation, rather than as a function of its license.

EnergyAustralia applauds the Consultation Paper's principle that the consumer protection provisions in this process should not duplicate other, existing requirements. This will ensure that there is not a patchwork of potentially conflicting obligations applying to the same requirement. However it must be recognised that the proposed rationalisation of consumer protection requirements will require extensive changes to the jurisdictional licence provisions and diverse other instruments, such as the installation inspection regime in place in NSW under the Office of Fair Trading.

5.1. DISTRIBUTOR OBLIGATION TO PROVIDE CONNECTION SERVICES

[Contractual relationship between distributor, retailer and end-customer](#)

EnergyAustralia supports the proposed move to a consistent national contractual relationship between distributors, retailers and end-customers.

The Consultation Paper recommends a triangular relationship, whereby there is a direct contractual relationship between the distributor, retailer and end-use customer. While a triangular contracting arrangement may be appropriate, it needs to be implemented in a way that is clear and unambiguous and does not create confusion for the contracted parties.

In the end, it is not clear that there are any fundamental differences (in electricity, at least) between the relationships characterised as linear and triangular. Both models require a relationship between the distribution business and the customer for connection and service standard purposes, and a financial relationship in which the retailer is interspersed between the distribution business and the customer for billing purposes. EnergyAustralia believes the preferred "triangular relationship" is an efficient and effective approach in the allocation of rights and legal responsibilities directly between parties.

Recommendation (d) in the Consultation Paper (page 47) provides that:

(d) each of the NEL and the NGL should provide for a deemed contract between a distributor and end-customer.

EnergyAustralia agrees that it is important for the distribution business to have a contractual relationship with its end use customers to address the physical and technical matters associated with the operation of the network that cannot reasonably be managed by any other party. Considering the large number of customers affected by this relationship, a deemed contract is the only practical solution. Such an arrangement is in place in NSW at present. EnergyAustralia recognises there may be rare instances where individually negotiated connection agreements may be needed for larger customers with specialised needs.

However, the broader issue in this section is on the nature of the relationship between the distributor and retailer is discussed in more detail section 6.2.

Obligation on a distributor to provide connection services

The obligation to connect is only a relevant obligation where the connection would be uneconomic in its own right; where the connection is economic, the commercially-operating distributor will perform that connection in the absence of an obligation to do so.

There is some comfort in that the Consultation Paper recommends that the obligation to connect should only apply to the “basic distribution service”. EnergyAustralia agrees that there should be no obligation to connect services other than “basic distribution services” – the DNSP would (and should) only connect other services where the provision of that service was economically justified.

These obligations are flagged to apply “on designated distributors to provide standard connection services to end-customers within designated regions”. But there is no clear definition as to the criteria which might be applied to determine which distributors might be designated, and which regions within the distributor’s service territory might be designated.

This will be significant for distributors with large rural service territories. EnergyAustralia believes that the designation of regions should reflect the economic cost of providing service to rural and remote customers. An obligation to extend the network to allow rural and remote customers to connect will impose significant uneconomic costs on the distribution business and re-introduce cross subsidies from its other customers.

It should be noted that an obligation to connect is one of the components that forms part of the package of rights conferred and obligations imposed by the distribution licence.

The development of standard terms and conditions for the supply of standard connection services is also supported by EnergyAustralia. We are of the view that the AEMC should consult with stakeholder, industry and community representatives during the process of making Rules regarding standard terms and conditions for the supply of connections services. Furthermore, industry should be consulted when the AEMC are making Rules in relation to the definition of ‘Standard Connection Services’.

5.2. DISTRIBUTOR DISCONNECTIONS AND RECONNECTIONS OF SMALL END CUSTOMERS

This section of the Consultation Paper is relatively brief, perhaps reflecting that the various jurisdictions already have effective (and relatively consistent) rules for managing disconnections by the distributor.

The Consultation Paper puts the onus on the AEMC to develop rules for customer disconnection.

EnergyAustralia supports the regulation of disconnection and reconnection of small end-customers by distributors, however we believe the AEMC should have regard to retailer’s rights when making Rules relating to the circumstances a distributor can legally disconnect a small

end-customer. A distributor should not be permitted to disconnect a small end-customer without the retailer's permission unless there is an agreement with the customer, an emergency situation or a technical/safety issue requiring such action. Any associated liabilities for disconnection should be specified either in the Use of System agreement or Market Operation Rules (as discussed in Section 6.2).

It is our view that there is a need for the establishment of a standardised threshold level between jurisdictions regarding the rate at which a person is deemed to be a small end-customer (eg consumption of less than 1 TJ for gas and 40 MWh for electricity per annum). The establishment of such a universal level will achieve consistency between regulation in the electricity and gas sectors across jurisdictions. This view applies throughout this submission where reference is made to 'small end-customer'.

5.3. DISTRIBUTOR - SMALL END-CUSTOMER DISPUTE RESOLUTION

The Consultation Paper recommends that "small end-customers should have access to informal, fair and efficient dispute resolution arrangements", something akin to the current ombudsman schemes. The Consultation Paper also acknowledges that these schemes are likely to be jurisdictionally based.

The Consultation Paper also recommends that the AEMC should develop standards for these dispute resolution schemes.

EnergyAustralia considers that the state ombudsman schemes are working effectively for small customer dispute resolution. Moreover, the state ombudsman offices currently share views and coordinate in such a way that a level of national consistency is being developed. EnergyAustralia considers that this is not an area which requires urgent attention.

5.4. RETAILER OBLIGATION TO SUPPLY SMALL END CUSTOMERS

EnergyAustralia notes that the Consultation Paper proposes one class of Move-in Customer, and that the same contract arrangement will apply regardless of whether or not the prior occupants were on a standing or negotiated contract arrangement. We believe this should be clarified.

In regard to deemed contracts, EnergyAustralia believes further clarity is needed under the recommended policy criteria section as to how the administrative duties of the Jurisdictions and the AER will be separated. EnergyAustralia believes it is not appropriate to have the same deemed agreement managed by different regimes.

EnergyAustralia believes deemed agreements should be temporary arrangements applying to small-end customers only, which allow sufficient time for a small-end customer to move to a standing or negotiated agreement. Up to 6 months is a reasonable time period.

EnergyAustralia accepts that written notification of the existence of the deemed agreement and the customer's contract options should be provided to the premises.

If a customer has been contacted by a non-local retailer in a deemed agreement situation and has not elected to enter into a negotiated contract, the retailer should have the discretion to set the terms and conditions of supply after the 6 month period.

In the situation of a local retailer, who is obligated to supply the customer, we also believe that if a new move-in customer has not provided sufficient identification details in order to allow the establishment of a standing contract within 6 months of move-in, then the retailer should have the right to disconnect that customer. Such a right would only be exercised after providing written notice to the premises.

5.5. RETAILER: SMALL END CUSTOMER MARKET CONTRACTS

EnergyAustralia supports the recommendation that where full retail competition is effective, no (energy specific) regulation of Market Contracts should be needed. Generally, we believe consumer protection issues, including cooling off periods, could be appropriately dealt with through general legislative regimes which deal with fair dealings, misleading and unconscionable conduct. We believe this would more effectively facilitate competition in the future compared to energy specific regulation.

Model Terms for Market Contracts for small end-customers should be, in our opinion, limited to circumstances where general consumer protection laws are not adequate (i.e. disconnection), and in markets where competition is not effective in addressing specific consumer protection issues.

5.6. RETAILER: SMALL END CUSTOMER MARKETING

EnergyAustralia does not support development by the AEMC of specific Marketing Rules relating to energy contracts as proposed in the Consultation Paper. We believe such a proposal will impose additional unnecessary regulatory costs, duplicate existing provisions of the National Consumer Protection Regime (which is already a feature of the existing jurisdictionally based marketing codes) and, along with increasing the complexity of the regime, provide limited benefits in terms of consumer protection.

We believe the current national consumer protection legislation (i.e. Trade Practices Act, Corporations Law and Privacy Act) already provides a national basis for governing the behaviour of retailers in the market, and that further duplication in industry specific instruments is not required. In adapting this approach, current jurisdictional codes for marketing would be repealed.

Any deficiencies identified in the current consumer protection framework should be addressed through the relevant Ministerial Council of Consumer Affairs as necessary. Such an approach will help ensure that the conduct of energy retailers is treated consistently with other comparable industries.

5.7. RETAILER: SMALL END CUSTOMER DISPUTE RESOLUTION

EnergyAustralia agrees with the position in the Consultation Paper that jurisdictionally based ADR schemes are probably the most effective under the current industry structure. In the longer term, however, the need and/or benefits and effectiveness of a national ADR scheme should not be dismissed. We believe a reassessment of this principle should be conducted in the near future once the national framework has been in operation for some time.

EnergyAustralia considers that the current state ombudsman schemes are generally working effectively for small customer dispute resolution. The state ombudsman offices currently share views and attempt to coordinate in such a way as to promote national consistency. However, that is not to say that national consistency has been achieved. For example, it is vital in our opinion that all ombudsman schemes focus their retail dispute resolution activities on small end customers only. The NSW scheme, for example, currently accepts large customer retail complaints and disputes.

In the interests of greater transparency and accountability, EnergyAustralia also strongly supports the introduction of performance based standards for ombudsmen schemes.

6. OTHER DISTRIBUTION AND NON-PRICE RETAIL REGULATION

6.1. BUSINESS AUTHORISATION

The Consultation Paper outlines a policy recommendation that:

“As a general principle licensing/authorisation regimes should not be used as a device to impose legal obligations, the consequence of which are considered, from a policy perspective, to be serious. Where it is intended that non-compliance with the obligations is to give rise to a civil or criminal penalty the obligations should be contained in legislative instruments, not administrative instruments.”

EnergyAustralia agrees that it is not necessary for an additional DNSP business authorisation as part of the national framework. The imposition of obligations through the National Electricity Law and Rules and the consequences for breach of such obligations are appropriate and sufficient.

EnergyAustralia also agrees that generic requirements in relation to environmental and occupation safety that apply to all business should be imposed through the appropriate Federal and State Laws. EnergyAustralia would, however, recommend that consideration be given to the national framework providing for the issue of jurisdictional licences. In this way, energy specific licence obligations such as those relating to technical competence, electrical or gas safety and service standards could be issued by the relevant jurisdiction, but under the national framework.

The National Laws and Rules could, for example, provide for jurisdictions to issue licences to reflect jurisdictional requirements, and these could be confined to specific issues only. The licences could be enforced through the national framework. This would remove the need for each jurisdiction to have separate legislation relating to administration and enforcement of energy licensing. This proposal is consistent with the recommendations in the Consultation Paper for Jurisdictional Directions which seek to make provision for specific policies of individual jurisdictions to be incorporated within the overall national framework.

EnergyAustralia believes that there is a need for a national control mechanism to regulate the entry, participation and exit of retailers from the market, along with a process that ensures retail participants meet fundamental elements such as commercial and business competencies necessary to successfully operate.

We are of the view that the proposed civil/criminal penalty regime proposed in the Consultation Paper for incidents of non-compliance with consumer protection rules will be effective, however we believe the AER should also have the power to revoke a retailer's participation rights to conduct business if necessary.

In regard to commercial competencies, we believe prospective retailers should be required to satisfy the AER that they have the prudential soundness, risk management and governance policies and procedures in place in order to meet the operational cost and exposures

characteristic in retailing energy. It is our view that such mechanisms, in addition to the prudential requirements of NEMMCO, VENCORP and REMCO, will further protect the integrity of the market and reduce the risk of the collapse or failure of a retailer.

In regard to the provision in the Consultation Paper relating to “private network / resellers” (such as shopping centres, caravan parks etc) which may be subject to a limited tailored set of regulatory arrangements (particularly in the areas of price regulation and consumer protection), EnergyAustralia believes the recommendation needs to be strengthened. We recommend that ‘may be subject to’ be replaced with ‘will be subject to’. We believe this is necessary in order to better protect consumers from potentially unreasonable high prices being charged by private network/resellers. It is our view that the NSW regulatory protection model should be considered as a suitable model for the regulation of private network/resellers moving forward.

6.2. DISTRIBUTOR INTERFACE WITH RETAILERS

The Consultation Paper recommends that:

- There be a requirement for distributors and retailers to enter into Use of System (UoS) Agreements;
- If a distributor and retailer have not entered into a negotiated UoS agreement, a Default UoS agreement (to be established by the AEMC) is deemed to apply;
- The Default UoS agreement should contain provisions dealing with:
 - The allocation of liability between retailer, distributor and end-customer;
 - connections or disconnections at request of any of the parties,
 - collection and on-payment of network charges by the retailer;
 - information sharing to facilitate connection, disconnection, churn, single bill, billing disputes,
 - handling of fault complaints; and
 - handling of complaints (including re billing).

EnergyAustralia agrees that it is important to have a transparent contractual relationship between distributors, retailers and end-customers so that all parties are aware of the rights and obligations of each of the parties.

EnergyAustralia believes that the foundation elements of any default agreement should be provided for in the Rules. In particular, it will be important for the AEMC, following consultation with industry participants, to clarify which parties bear the liability for supply interruptions and damage to customer equipment and the extent of that liability. Once these foundation elements have been clarified, it is anticipated that the negotiations between distributors and retailers are more likely to result in negotiated UoS agreements in a timely manner.

Ideally, the goal of this initiative would be to develop a common “any to any” UoS agreement which could govern the relationship between any retailer operating on any network. Without clarity on the foundation elements of a UoS agreement, however, the result is likely to be a minimal UoS agreement not unlike the NSW Market Operations Rule MOR2.

The significant difference between the models in use in Australia today appears to be the extent to which the UoS agreements address matters relating to liability for interruptions and damage to customer equipment. EnergyAustralia acknowledges that the current NSW framework does not adequately address this issue.

EnergyAustralia supports the development of a nationally consistent regulatory regime where possible in order to ensure a level playing field for all parties in their dealings. We note, however, that the current differences in approach between the various jurisdictions will mean that the development of a proposed Default UoS agreement(s) or any other similar process will be a substantial project moving forward that will require extensive consultation with industry.

6.3. INTERFACE BETWEEN NETWORK SERVICE PROVIDERS

Just as there is a need for a default Use of System agreement between distributors and Retailers, EnergyAustralia considers that there is a need for a default Connection Agreement between network service providers. We note that the Consultation Paper does not specifically address this issue. A Connection Agreement between network service providers would need to set out:

- the allocation of liability between network service providers;
- any indemnities that must be provided by either party;
- connections or disconnections at request of either party,
- terms concerning the collection and on-payment of network charges and billing disputes;
- information sharing to facilitate planning, connection and disconnection; and
- handling of complaints.

6.4. DISTRIBUTOR INTERFACE WITH EMBEDDED GENERATORS

The Consultation Paper indicates that the issues surrounding the distributor interface with embedded generators are being developed through a different work stream. However, the Consultation Paper still addresses items such as avoided TUoS.

EnergyAustralia is concerned that the issues surrounding embedded generation are complex. However, EnergyAustralia has a unique perspective on this issue as both a transmission and distribution business.

EnergyAustralia has consistently supported the recovery of a component of TUoS from existing generators, on the basis of providing equity between existing generators and new generation and demand management options, regardless of whether they are located in the transmission network or embedded within a distribution network. EnergyAustralia notes that this was the original intention when the pricing arrangements were first being established, although the decision was reversed prior to the finalisation of the arrangements. The fundamental approach for both customers and generators should be that each pays the Long Run Marginal Cost (LRMC) associated with their use of the network.

EnergyAustralia therefore supports the pricing approach for generators being embedded within the Rules in the same way as for load customers.

EnergyAustralia believes that the current payment arrangements for distributors to embedded generators which are proposed in the Consultation Paper to be grandfathered should also contain the provision to include retailer payments under the national framework. This will ensure the inclusion of existing grandfathered arrangements for some embedded generation that passes directly through to retailers.

6.5. BALANCING REGIME AND SETTLEMENTS, EFFECTING CUSTOMER TRANSFER

The Consultation Paper recommends that, where FRC is in place, there is a need for a markets settlement system. Such a system is already in place in electricity. The Consultation Paper recommends an Independent market operator for gas.

EnergyAustralia believes that the market settlement and transfer system in electricity is working effectively. Consistent business-to-business information protocols are developing nationally. EnergyAustralia does not see a need to make changes in this area and urges that the transaction costs of moving away from current systems to meet existing requirements be considered as they may prove to be prohibitive.

The Consultation Paper recommends that the “Rules for balancing systems, supply consumptions reconciliation and settlements and customer transfer should: (a) be made or approved by a party independent of the market participants”. It is unclear whether VenCorp, GMC or REMCo satisfy what the MCE envisage as being ‘independent market participants’ under the Rules. EnergyAustralia believes further clarification is required regarding what constitutes ‘independent’.

EnergyAustralia also questions the intent of the Consultation Paper under Section 5.2 (f) whereby the AEMC should only be required to carry out limited consultation of those parties who had made submissions to the Independent Market Administrators (IMA). We believe the consultation process on developing the Gas Retail Market Rules should extend to all industry representatives irrespective to having previously made an application under Section 5.2 (d) for changes. This would ensure a consistent, effective consultation process.

6.6. METERING

EnergyAustralia supports the recommended policy approach of developing nationally consistent metrology procedures under the Rules and NEL.

As the MCE would be aware, NEMMCO has already developed default metrology procedures that cover meter types 1 to 7. This draft procedure was prepared by the NEM Metrology Reference Group (MRG) which was chaired by NEMMCO and comprised representatives of NEM retailers, networks and metering businesses. This major project resulted in the unification of 6 jurisdictional metrology procedures (Types 5 to 7) and the NEMMCO Type 1 to 4

metrology procedure. To this end, a draft National Metrology Procedure already exists for meter types 1 to 7.

EnergyAustralia agrees that it would be undesirable for various jurisdictions to retain or develop metrology procedures that vary with the National Metrology Procedures. EnergyAustralia would strongly support legislative requirements for all jurisdictions to comply with the National Metrology Procedures. During the 2005 working of the MRG there was strong jurisdictional support for national metrology procedures.

The Consultation Paper states that: "*Metering rules should be set by a party independent of the participants*". EnergyAustralia believes this goal is quite impractical. With reference to the work of the MRG in harmonising the metrology procedures into one document, every member of the MRG is a market participant - retailer, network or metering service provider. As the MCE would be aware metering is quite complex and sensible metering rules require the rule makers to have a good understanding of metering and related issues. It is our opinion that it would be a fair compromise to broaden the membership of the rule making bodies to ensure that metering rules are fair to the public as well as the participants.

EnergyAustralia has a particular concern regarding contestability in the provision of remotely read metering for smaller customers, as a consequence of the ACCC's 2005 metering derogation decisions. The current arrangements add greatly to the business risk of DNSP's introducing Advanced Metering Infrastructure and can only delay its introduction and the availability of its substantial benefits for both customers and DNSP's. EnergyAustralia believes that this issue needs to be revisited in the development of an effective national regulatory framework.

6.7. LOAD SHEDDING AND CURTAILMENT

EnergyAustralia considers that the priorities for load shedding and curtailment should be specific to each jurisdiction and notes that the National Electricity Rules already provide an effective national approach to load shedding and curtailment. We would question the merits of any move to introduce a new process.

As the MCE would be aware, TransGrid is in the process of reviewing the electricity "Jurisdictional Load Shedding Guidelines for New South Wales" which is due by the Minister to submit to NEMMCO by 1 February 2006. The development of such guidelines by each jurisdiction effectively considers the priorities for load shedding and curtailment specific to each jurisdiction. In addition, any changes in load curtailment rules would also need to be consistent with agreed MCE gas supply emergency protocols.

EnergyAustralia notes that the Consultation Paper recommended that "loads that affect human safety should be shed / curtailed as a last resort (eg hospital without on-site auxiliary power plants etc) followed by loads where shedding/curtailment may cause substantial asset damage". EnergyAustralia is concerned that the wording of this section may be ambiguous. For clarity, EnergyAustralia recommends that the policy clearly indicate that loads where shedding/curtailment may cause substantial asset damage should be shed *before* loads that affect human safety.

6.8. RETAILER FAILURE ARRANGEMENTS

The issues surrounding retailer failure are both profound and complex. The following comments outline the main concerns from EnergyAustralia's perspective as a combined distribution and retail business.

While primarily a retail issue, the implications of a retailer's failure may have a profound impact on the network and from that perspective our concerns are to ensure that:

- customers remain supplied with electricity or gas;
- the distribution business does not suffer financial harm as a result of a retailer failure;
- the burden placed on the step-in retailer are not so heavy as to cause cascading retailer failure; and
- to ensure that the integrity of the wholesale market is maintained..

EnergyAustralia believes it is appropriate for customers to have pool price risk passed onto them in the event of failure of their retailer, as each customer must bear some responsibility for the quality of the retailer they choose as their supplier, and the step-in retailer must have the ability to recover the cost of purchasing energy on behalf of the customers of the failed retailer. If small customers were to be protected from high pool prices, as is currently the case in NSW in the form of regulated maximum retail prices, then arrangements will need to be put in place to protect the step-in retailer (SIR).

EnergyAustralia is firmly of the view that the transfer of the existing hedge contracts of the failed retailer to the step-in retailer is not feasible or useful, particularly if these hedge contracts did not prevent the existing retailer from failing. Furthermore, we do not believe that the spot prices should be administered until the step-in retailer secures hedges as the market should be allowed to clear without intervention.

In preference to the AEMC automatically appointing or designating one or more SIR's for each jurisdiction, EnergyAustralia is of the view that the AEMC should go to the market for quotes for the provision of this service (similar to the current processes of going to the market for reserve capacity and black start support). In the event that market participants were invited, or alternatively, required to tender for such services, then it should follow that the costs of doing so should be reimbursed – such costs to be covered by either or both of the market and customers.

As with other areas of the Consultation Paper EnergyAustralia would like sufficient industry consultation on the design/operation of any proposed national scheme regarding 'step-in' retailers.

6.9. JURISDICTIONAL DIRECTIONS

EnergyAustralia recognises that there may be some circumstances in which a jurisdictional direction is appropriate. To ensure that these directions do not undermine the attainment of a national framework, it is important to have a defined scope as to the circumstances to apply

when a jurisdictional direction can be issued. Further, the issue of such directions should be transparent, including their justification.

EnergyAustralia takes a pragmatic approach that it is extremely unlikely that jurisdictions would willingly “sign up” to a national framework if in the process some of their key policy initiatives (such as the Greenhouse Gas Abatement Scheme in NSW) were to be lost.

With respect to the recommendation (b) in the Consultation Paper referring to asset valuation, we believe that it is inappropriate for the jurisdictions that are able to issue a direction to be limited to Victoria and South Australia. There are equally valid reasons in other jurisdictions, including NSW, where a jurisdictional direction relating to asset valuation may also be warranted.

Current jurisdictional arrangements generally differ from one another in regard to CSOs and the environment, often substantially. This results in additional operational complexity and costs for national retailers that must be passed through to consumers.

EnergyAustralia does have some concerns that the jurisdictional direction could be imposed unchecked and could adversely affect the business’s property rights. EnergyAustralia broadly agrees with the policy principles espoused in the Consultation Paper, and in particular with the view that jurisdictional directions should be clear and explicit and that the areas affected should be limited. However, an additional requirement should be added to ensure that the business does not experience an economic loss as a result of an imposed jurisdictional direction.

ATTACHMENT 1 – OFGEM SLIDING SCALE

In the UK, the Office of Gas and Electricity Markets (Ofgem), as part of the 2004 Electricity Distribution Price Control Review, devised an innovative “sliding scale” incentive mechanism for capital expenditure. This attachment provides a summary of this mechanism.

Background

The CPI-X regime’s predecessor, the RPI-X regime in the UK, was established following the British electricity distribution companies’ restructuring and privatisation in 1990-91. The energy regulator (the Director-General of Electricity Supply / head of the Office of Electricity Regulation) was charged with encouraging the companies to cut costs as it was believed that high levels of inefficiency existed in the businesses. This was achieved through introducing relatively simple price caps at the start of each five-year regulatory period, which defined a maximum average revenue for each business. The price caps were linked to the Retail Price Index (RPI) and adjusted annually by an efficiency “offset”, referred to as “X”.

The RPI-X price caps encouraged the businesses to improve profits by cutting costs as they were able to keep the higher returns generated from these reductions for the remainder of the regulatory period. The businesses cut costs accordingly and history shows that they rapidly raised profits. However, in the UK many network assets have reached the end of their useful life and require replacement. In addition, businesses are required to take on new responsibilities such as connecting more distributed generation to their low voltage networks. It was apparent in the UK that the incentives to reduce costs are no longer sufficient and that the price caps needed to allow for increasing investment.

Sliding Scale Mechanism

The sliding scale mechanism is accompanied by reliability and service performance incentives and allows a distribution network owner (DNO) to choose between:

- a lower capex allowance but with a “higher-powered incentive” that allows the business to retain significant benefits if they can do even better than the low figure; or
- a higher allowance but with a “lower powered incentive” that gives relatively smaller reward for underspending the higher allowance.

Ofgem’s stated intention has been to “*provide clear and consistent incentives to DNO’s to help ensure they provide an appropriate quality of service to customers-including incentives for timely and efficient investment in the network*”. Through this mechanism, Ofgem seeks to:

- retain an efficiency incentive throughout the period;
- reduce emphasis on Ofgem’s or its consultant’s view of the appropriate capex;
- reduce the perceived risk that the price control causes under-investment;
- allow but not encourage overspending in excess of the allowance;

- reduce the possibility of “high” capex companies making very high returns from underspend;
- reward the low capex companies (provided they can deliver acceptable performance); and
- avoid strong incentives to underspend by cutting corners and not delivering outputs, thus storing up problems for subsequent periods.

Under this approach, Ofgem was aiming to be “incentive compatible” with the capital expenditure requirements of DNOs. This demonstrates a very astute awareness by Ofgem of the type of problems faced by both regulators and the businesses in attempting to balance regulatory and commercial objectives.

The sliding scale mechanism provides scope for the DNO to spend above the base case capital expenditure allowance proposed by Ofgem. This attraction of the sliding scale approach is that it offers DNOs the ability to choose the incentive scale that suits their circumstances. The benefit to the regulator is that it reveals information about the capital investment requirements of the DNO and puts a brake on short term gaming incentives to either over or under spend on capital. This approach avoids the need for ex post investigation of the actual projects as long as the DNOs have met reliability and service standards requirements.

In essence, the theory of the model is to offer businesses a “menu” of contracts to choose from. Each contract is based on the ratio of the business’s own capex forecast divided by the forecast of Ofgem’s consultant and contains a range of available incentives (financial bonuses or penalties) linked to the actual, out-turn expenditure. The business is provided with a financial incentive to select the contract that most closely matches (what turns out to be) its actual expenditure. The business has an incentive to forecast accurately and is worse off if it supplies (what turns out to be) inaccurate information.

Companies that choose the low cost allowance get a reward (a small amount of additional return above the base cost of capital) for spending no more than their allowance, while companies that choose the high cost allowance do not (they are neither rewarded nor penalised if they spend their allowance). The aim is that companies who know they need to spend a lower amount of capex will find it more beneficial to choose the lower allowance, whilst companies who know they need to spend relatively more will find it more beneficial to choose the higher allowance (this property is known as being “incentive compatible”).

Table 7.6 below⁶ provides the efficiency incentive rates and allowed expenditure levels are linear functions of the ratio of the DNO’s forecast to PB Power’s view. The additional income is then adjusted to ensure the matrix remains incentive compatible.

⁶ Reproduced from Ofgem’s November 2004 decision titled: *Electricity Distribution Price Control Review: Final Proposals*. Page 87.

Table 7.6 Sliding scale matrix

DNO:PB Power Ratio	100	105	110	115	120	125	130	135	140
Efficiency Incentive	40%	38%	35%	33%	30%	28%	25%	23%	20%
Additional income	2.5	2.1	1.6	1.1	0.6	-0.1	-0.8	-1.6	-2.4
as pre-tax rate of return	0.200%	0.168%	0.130%	0.090%	0.046%	-0.004%	-0.062%	-0.124%	-0.192%
Rewards & Penalties									
Allowed expenditure	105	106.25	107.5	108.75	110	111.25	112.5	113.75	115
Actual Exp									
70	16.5	15.7	14.8	13.7	12.6	11.3	9.9	8.3	6.6
80	12.5	11.9	11.3	10.5	9.6	8.5	7.4	6.0	4.6
90	8.5	8.2	7.8	7.2	6.6	5.8	4.9	3.8	2.6
100	4.5	4.4	4.3	4.0	3.6	3.0	2.4	1.5	0.6
105	2.5	2.6	2.5	2.3	2.1	1.7	1.1	0.4	-0.4
110	0.5	0.7	0.8	0.7	0.6	0.3	-0.1	-0.7	-1.4
115	-1.5	-1.2	-1.0	-0.9	-0.9	-1.1	-1.4	-1.8	-2.4
120	-3.5	-3.1	-2.7	-2.5	-2.4	-2.5	-2.6	-3.0	-3.4
125	-5.5	-4.9	-4.5	-4.2	-3.9	-3.8	-3.9	-4.1	-4.4
130	-7.5	-6.8	-6.2	-5.8	-5.4	-5.2	-5.1	-5.2	-5.4
135	-9.5	-8.7	-8.0	-7.4	-6.9	-6.6	-6.4	-6.3	-6.4
140	-11.5	-10.6	-9.7	-9.0	-8.4	-8.0	-7.6	-7.5	-7.4

where, for example: (top-left corner) $16.5 = (105 - 70) \times 40\% + 2.5$
(bottom-right) $-7.4 = (115 - 140) \times 20\% - 2.4$

Each company will be positioned in a particular column of this matrix as part of the price review. Actual capex will then determine the row.

While the business does have the incentive to increase profits by reducing costs, Ofgem's "sliding scale" tempers the incentive to over-forecast by reducing the available incentive the more actual results vary from forecast. The business, however, is always better off by selecting the contract that most closely matches its likely capital expenditure, with the "sliding scale" attempting to entice the business to reveal its "truthful" view of expected costs.

There are clearly some areas that need refinement. For instance, the Ofgem model - modified from the original theory - is based on the assumption that its consultant's forecast is "right" and that the business's forecast is "wrong". This is evidenced by the fact that the mechanism does not allow the business to recover the actual cost of its investments if it exceeds the consultant's forecasts by more than 15%, *even if* the business had, in fact, accurately forecast its required capital investment.⁷ This anomaly places more emphasis on the accuracy of consultant's reports rather than on the incentives underpinning the mechanism.

⁷ See "Using Incentives to Inform Regulatory Decisions" by Graham Shuttleworth, in the August 2005 Issue of NERA's Energy Regulation Insights.