

ESCO7D01451
ESCSA03/0026(1)



17 August 2007

Manager, MCE Secretariat
Department of Industry, Tourism and Resources
GPO Box 9839
CANBERRA ACT 2601

Level 8
50 Pirie Street Adelaide
South Australia 5000

GPO Box 2605 Adelaide
South Australia 5001

Telephone (08) 8463 4444
Facsimile (08) 8463 4449
Freecall 1800 633 592

www.escosa.sa.gov.au
escosa@escosa.sa.gov.au

Dear Sirs

MINISTERIAL COUNCIL ON ENERGY: RETAIL POLICY WORKING GROUP, NATIONAL FRAMEWORK FOR DISTRIBUTION AND RETAIL REGULATION – COMPOSITE PAPER

Thank you for the opportunity to provide comment on the Composite Paper, prepared by Allens Arthur Robinson on behalf of the Retail Policy Working Group.

The Essential Services Commission of SA (the Commission) has provided a number of comments on the various proposals contained in the paper, as set out in the pro-forma response attached. The Commission generally supports the proposals put forward, unless otherwise annotated or where disagreement is implicit by reference to a comment in relation to another section.

In addition, however, the Commission provides separate comment on four of the proposals set out in the Composite Paper.

The first is the use of the terms "sale" and "supply", more particularly the latter, throughout the Composite Paper. The second is the proposal to adopt a hybrid model for the contractual arrangements between distributors, retailers and customers in energy markets. The third is the proposal to remove connection services from those contractual relationships and to rely solely on provisions within the National Electricity and Gas Rules. The fourth relates to specific transitional issues which will affect the South Australian jurisdiction in relation to the application of the proposals.

In each case, the Commission is not looking to reject the proposals, but rather believes that the full implications of the proposals need further consideration.

In making its comments, the Commission is drawing on its practical regulatory experience in South Australia over the past six years, with a view to assisting in the development of the new national frameworks for energy retail and distribution regulation. At the same time, however, the Commission is mindful of its paramount statutory obligation to have regard to the long-term interests of South Australian consumers with respect to the price, quality and reliability of energy supplies. It is in that context that the Commission has identified the transitional issues for consideration in the development of the national frameworks.

Sale vs. Supply

The Commission uses certain terms in this submission in specific senses when describing functions undertaken by retailers and distributors. That terminology is important in understanding the Commission's concerns over the proposed "hybrid" model for the contractual arrangements between customer, retailer and distributor.

When referring to the "sale" of energy, the Commission is referring to the provision of units of energy (e.g., kWh of electricity, GJ of gas) which are consumed, akin to the provision of goods.

When referring to the "supply" of energy, the Commission is referring to the provision of: (a) in relation to the electricity market, components and systems which cause the phenomenon of electricity (ie, potential difference in voltage between two locations) at a connection point at specified standards so as to enable consumption of electricity at that place; and (b) in relation to the gas market, components and systems which permit gas to be available at a connection point at specified standards so as to enable consumption of gas at that place.

Importantly, under a triangular contractual model, retailers "sell" electricity or gas in the sense described above, while distributors "supply" the energy.

On the other hand, under either a linear model or the "hybrid" model as proposed by AAR, retailers will both "sell" and "supply" energy to the end-use customer, while the distributors' role is to "supply" energy, in an upstream capacity only, to the retailer which then on-sells a "bundled" product to a customer.

The Commission considers that these distinctions are crucial to a proper understanding of the issues relating to the choice of contracting model, as fundamental matters relating to liability arise from them. In addition, while the terms retailer and distributor have clear connotations as to role or function, the actual roles and functions performed by those entities under the two contractual models are very different.

Therefore, without being very clear as to the particular roles and functions arising under each of the models, the use of the terms "retailer" or "distributor" has the potential to cause confusion. This matter needs further consideration and is more than simply a matter of semantics, particularly given the significant liability issues attaching to each activity.

Contractual arrangements: distributor/retailer/customer

The Composite Paper proposes that a "hybrid" (more in the nature of linear), as opposed to triangular, model be adopted for the contractual relationship between customers/retailers/distributors, subject to the proviso that a deemed "distribution contract" between distributors and customers will be imposed under the National Electricity Rules and National Gas Rules.

In South Australia, both forms of contractual relationship exist: in the electricity sector, the triangular contractual relationship has applied since the liberalisation of the electricity market in 1999; while in the gas sector a purely linear contractual relationship applies (that is, without any form of contract, deemed or otherwise, between the gas distributor and customers).

What is fundamental to both models is that the parties to the contracts have mutual rights and obligations, breaches of which may be remedied under the law of contract. In the absence of contractual rights, for example, if fulfillment of the obligation to supply energy of a certain quality were a legislative requirement only, then a customer would have no personal remedy (absent negligence on the part of the supplier) for any injury or loss suffered as a result of a breach.

Nature of the retailer's relationship with the customer

It would therefore appear necessary, under the proposed arrangements, for the contract between retailers and customers to be a "sale and supply" contract, with all attendant liabilities dealt with in that contract. This would require retailers to bear liability to customers not only for matters pertaining to the "sale" function, but also for those matters pertaining to the "supply" function, in particular, the quality, safety and reliability of supply.

While it may be the case that retailers would subsequently contract with distributors in relation to liability arising from supply issues under the retail "sale and supply contract", it would remain true that from a customer's perspective the retailer is the proper person to pursue in the event of injury or loss arising from a failure to supply.

In order to ensure that the rights of customers do not become the subject of disputes between retailers and distributors, there may be a need to require retailers to assume all liability except that specified in the distributor deemed contract.

While that outcome is not preferred, on the basis that the triangular model better deals with these issues, on the arguments made in the Composite Paper, it seems necessary.

Precisely for the reasons set out above, this arrangement has in fact been put in place in South Australia in relation to the "sale and supply" of gas to customers under the existing linear model. For example, clause 15 of the South Australian Energy Retail Code contains provisions in relation to the quality, safety and reliability of gas

supply, which must be complied with by retailers in their dealings with customers and must also be reflected in retail contracts.

Nature of the Distributor's relationship with the customer

Finally, the Commission notes that the proposed "deemed" contract between the distributor and the customer would be neither a "supply" contract, nor a contract for the provision of distribution services. This is because it is proposed that the distributor would supply and provide distribution services to a retailer in respect of each connection point, rather than to the customer.

Accordingly, as the Commission understands the proposals set out in the paper, it would be an agreement in relation to a discrete set of technical matters which arise in connection with the relevant retailer's agreement to "sale and supply" of energy to that customer.

For example, it would need to provide that the distributor warrants to the customer that in the event the distributor fails to provide the retailer with supply at the connection point of the appropriate reliability (e.g., there are more than X outages in a given regulatory year) then the distributor will pay a service level payment to the customer at that connection point.

The precise services the distributor would provide to the customer and the precise services the distributor would provide to the retailer under the proposed model need to be better articulated, as does the consideration to be given by the customer to the distributor in respect of those services, as there will be no financial consideration. It may be that the customer's agreement to maintain the safety of the customer's own electrical installation, to provide access to meters, to advise of the installation of new appliances (e.g., airconditioners), etc. could be consideration for such a contract, but there is no discussion of these matters.

These issues need to be further explored and explained, with all issues of contract and liability properly dealt with, prior to adoption of the proposal.

Connection services as matter dealt with in the Rules and commencement of deemed distribution contract on connection

The Commission notes the proposal in the Composite Paper that: first, connection of a supply address to the distribution network should be a matter dealt with solely under the relevant Rules; and, secondly, that the event of connection will be the trigger for the commencement of the deemed distribution contract.

As set out in the Composite Paper, it appears that connection services are to be removed from the scope of both the "sale and supply" contract which a customer would have with a retailer and the "deemed distribution contract" which would be in place with the distributor.

As a result, in the event that a customer or a distributor caused some failure of the connection process (e.g., a customer was not connected, notwithstanding that all the requirements of the Rules had been satisfied) there would be no contractual right which could be enforced to either effect the connection or to provide recompense for losses arising from the failure to connect. Is this what is intended? If so, it does not appear satisfactory that consumers would have no recourse for loss.

In South Australia, failure to connect a supply address within a certain time frame results in a payment from the distributor to the customer – the contract starts on connection but it provides a contractual right to compensation and payments for acts not done prior to connection.

Transitional issues for the South Australia jurisdiction

The Commission sees two important transitional issues arising for the South Australian jurisdiction from the proposals in the Paper, which it would draw to the attention of the MCE in considering the best way in which to transition to the new national scheme.

First, as noted above, South Australia presently has a triangular form of contractual arrangement in the electricity supply industry and a purely linear form in the gas supply industry. In relation to the electricity supply industry, in 2005 the Commission made a price determination for the distributor, ETSA Utilities, which has effect for the five-year period 1 July 2005 to 30 June 2010. That price determination is predicated on the triangular contractual relationship. To move to a different contractual arrangement, with attendant changes in matters such as risk profile and business and customer operations and systems, during the life of the price determination would, therefore, be problematic.

The Commission would therefore expect the new arrangements would not apply until the commencement of the new regulatory period from 1 July 2010. This would, however, lead in turn to an issue for retailers operating in this State, as they would be required to continue under the South Australian triangular contractual model until that same date, notwithstanding that the new national scheme provisions might be in effect elsewhere in Australia.

In the event that the new arrangements were to apply immediately, however, it is likely that there would be issues (as identified above) for not only the operation of the current price determination, but also for the business operations of ETSA Utilities.

Similarly, were the proposals to have immediate effect, the regulated gas distribution business in South Australia, Envestra Limited, would be required for the first time to have a direct contractual relationship, with attendant liability, with customers connected to its gas distribution network.

As the Commission has only recently (October 2006) approved revisions to the Access Arrangement applicable to Envestra's network, the regulatory framework in

relation to that network has been set for the next five years. At the same time, certain provisions of the retail "sale and supply" contract would need to be removed. If, however, no change were to occur until the commencement of the next regulatory period in 2011, retailers would again face the risk of continuing to need South Australian specific contracts, systems and processes.

The second issue concerns the pricing arrangements for South Australian electricity customers (the issue does not affect the gas supply industry in South Australia).

Under the current triangular model, customers pay ETSA Utilities for distribution services provided. This means that reductions in tariffs must be passed through to customers by retailers (as retailers are merely the agents of ETSA Utilities in collecting distribution charges through single bills).

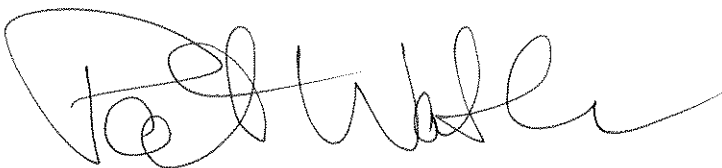
Under a linear model (and also the proposed hybrid model), customers do not purchase distribution services, retailers do. This permits retailers to levy "sale and supply" charges on customers, which incorporate distribution charges, but need not reflect the actual costs of the retailer for distribution services in relation to any given customer connection point.

As a result, under the linear and hybrid models, reductions in distribution tariffs will not necessarily lead to the same level of, or indeed any, reduction in tariffs paid by customers, as, for valid business reasons, a retailer may choose to re-distribute the impacts of the distribution tariff reduction throughout its entire customer base.

This would mean, for example, that had the linear model rather than the triangular model been in place in South Australia, then the reductions achieved through the Commission's distribution price determination in 2005 might not have flowed directly to South Australian customers (as it was, under the triangular model South Australian customers were able to benefit from those reductions).

Should you have any queries in relation to the issues raised in the submission, please contact Adam Wilson, Director Legal, Compliance and Consumer Protection, on telephone 08 463 4444 or via email at adam.wilson@escosa.sa.gov.au.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Patrick Walsh', written in a cursive style.

Dr. Patrick Walsh

CHAIRPERSON