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Dear Sir/Madam

**SUBMISSION ON NATIONAL FRAMEWORK FOR ELECTRICITY  
AND GAS DISTRIBUTION AND RETAIL REGULATION ISSUES  
PAPER**

In August 2004, the Standing Committee of Officials supporting the Ministerial Council on Energy, invited comment on its paper, *National Framework for Electricity and Gas Distribution and Retail Regulation*. This paper was a compendious review of the relevant regulatory arrangements across all jurisdictions. The Paper raised a number of issues and invited comments on these and any other matters arising.

The Tasmanian Energy Regulator has certain responsibilities for both electricity and gas retailing and distribution and is an interested party. It is not my intention to comment on all issues raised in the Paper but to draw attention to some matters of particular concern for the development of efficient and effective regulation of the services the subject of the paper.

**The Framework**

The initial observation is that the Paper does not provide a 'framework' for a national regulatory scheme for the regulation of either retail or distribution services in the gas or electricity supply industries. To the extent that there is any framework, one must have reference to MCE Communiqué of 11 December 2003 (and some subsequent statements and position papers), which provide certain policy preferences and intentions.

The Paper does pose a number of open-ended questions in respect of the possible content of a national regulatory scheme. While the AEMC and the AER have been established in the broad, there is still no detail on their actual functions. In the absence of understanding these functions, it is, in many instances, only possible to make quite broad observations on what has been put forward for comment.

Clarity on the role of the AER is required before the issues of detail can be dealt with sensibly. Otherwise, the roles of the AEMC and AER may be determined by decisions about the detail of the framework, rather than being derived from the policy framework.

## **Objectives and Priorities**

One should assess any regulatory changes or interventions against the (assumed) underlying objective and driver of the scheme of regulatory reform. This will, in turn, inform the priorities in terms of the industry sectors and the time frame of any regulatory reform. I take it that the underlying objective in this matter is enhancing the efficiency of the NEM and its ability to deliver improved outcomes for end-users in terms of price and quality of product and service, at least as compared with the no (further) intervention alternative.

With the development of the NEM, there has been continuing industry restructuring and cross (state) border participation by entities. This has raised the issue of the cost of compliance in what is intended to be one market, but which tends to be a series of regional markets in the retail and distribution sectors. These costs are incurred as actual expenditures to ensure compliance, and system development to conform with differing regulatory arrangements to achieve what are seen as essentially similar policy objectives. The additional, non-quantifiable cost is the inhibition of competition through barriers to entry in these still separate markets.

It is a ready observation that distribution services comprise some 40% of end-users' costs, and retailing comprises about 12% of such costs. In the ordinary course, one would look to gains in distribution as offering potentially the highest dividends. Nevertheless, while there may be significant efficiency gains to be made in distribution, it is not readily apparent that these gains (if they are, in fact, available and realizable) are to be derived from breaking down barriers to entry. Distribution is inherently a 'natural monopoly' within its established network reach and competition will largely be for management (investment) in that entity. Distributors do not generally tend to expand their network to compete with other networks, although they may seek access to other networks.

There may well be potential allocative efficiency gains at the national level from a consistent distribution regulatory scheme, but the fact of the matter is that the regulatory arrangements at the moment suggest that it will take at least a decade to realize such gains. The first distribution revenue determination under a national regulatory scheme (assuming the published timetable) will be Tasmania in 2007. In any case, the government response to the Productivity Commission report on access arrangements is likely to have a significant influence on the arrangements and priority of reform of regulation of distribution networks.

There are some distribution matters that could, and probably should, be addressed sooner rather than later, eg access arrangements for embedded generators, but there should be some prioritisation of these issues as against the potential gains.

That brings me to the retail sector. While this sector accounts for about 12 - 15% of final costs, it is potentially a driver of significant efficiencies, both upstream and downstream (downstream in the sense that pricing and service offering may drive efficiencies at the customer level, eg demand side management). It has been the retail sector, as best as I

understand it, that has been most vocal in expressing concern about ‘cross border’ barriers to market participation.

There are significant economies of scale to be realized in retailing, and the general consensus is that the minimum efficient scale is quite large in terms of the NEM. Further, there may be scale and scope efficiencies to be gained by developing gas and electricity markets in a manner that facilitates convergence of them. Thus, it would seem to be a priority to develop a national scheme supporting retailing of electricity and gas. In this regard, note should be taken of the ‘light-handed’ regulatory approach to the development of a greenfields natural gas industry in Tasmania, including the lack of price regulation at either the retail or distribution levels.

## **Comments**

### **Boundary issues:**

A national [NEM] scheme necessarily implies a national code (or rules). The AEMC should be responsible for developing/amending the code but should focus its attention upon the strategic rather than the operational level.

The AER should be responsible for the operational principles, as it will be at this level that the AER will need to apply some level of discretion to meet individual needs as the circumstances of distributors or retailers vary. To the extent that the AEMC (or MCE) consider that the operational approach may be in conflict with the broad policy principles and objectives, the AEMC and MCE have authority to address such matters through policy statements or Code changes.

### **AER and Other Regulators**

The principles applied in drawing the boundary between the economic and ‘technical’ regulation is of crucial importance. While the paper makes some generalised observations in this regard, there is not a clear statements of principles, nor an acknowledgement that economic regulators determine a price and service package. Delivering on this package requires capital, maintenance and operating expenditures clearly matched to the performance outcomes specified. This is consistent with, and necessarily implied in, any pricing approach which embodies an incentive regime.

It should be recognised that the NEC does deal with technical issues for generation, transmission and distribution (particularly in terms of its interface with transmission). If the AER is to address distribution pricing, then it would be inconsistent to distinguish somehow ‘technical’ issues at the distribution level when they have been explicitly recognized as being within the national regulatory scheme for transmission and generation. There is no doubt that there are significant technical and operational differences between the distribution systems, but that is also the case for generation and transmission.

The distinction to be drawn on ‘other’ technical regulation (eg safety and environmental) is most likely to be founded in the different externalities being addressed, and this form of ‘technical’ regulation is therefore quite readily distinguishable.

### **National Jurisdiction and State Policy**

The purpose of licensing in the electricity and gas industries is generally to confer a (revocable) right to undertake certain prescribed operations in accordance with prescribed

standards. Consistent with this, licensing can be used as an entry qualification to ensure that the entity has the ability to meet the prescribed standards.

Licensing should be limited to matters relevant to the efficient operation of the electricity market. Other matters (eg greenhouse gas management) should be dealt with by specific regulation (not necessarily an energy sector regulator).

In Tasmania, the State government and the Regulator have maintained a clear distinction between electricity industry operations and other matters like community service obligations, industry development, regional development, greenhouse policies. This approach would seem to be consistent with good regulatory practice and facilitates a sharper focus on the underlying policy objectives of the jurisdiction in any particular instance.

The Regulator has recently undertaken a review of electricity licensing and has given considerable weight to the stated intention to move licensing to the AER. To this end, the proposed licences in Tasmania are principally confined to conferring the right to undertake certain specified operations within the electricity supply industry. The intention is to impose jurisdictionally specific obligations on the entities through other jurisdictionally specific regulatory instruments.

The proposed license arrangements as put forward in the Paper are consistent with the proposed licences as put forward by the Regulator.

It will be noted that in some jurisdictions the cost of regulation is recovered (in whole or in part) through licence fees. It would seem to be inappropriate to have two licensing authorities in respect of the one activity. If licensing moves to the AER, consideration will have to be given to the funding of the residual jurisdictional regulator activities, eg retail pricing, planning including jurisdictional network standards, detailed performance reporting to support jurisdictional planning and oversight. This will be a matter for jurisdictional consideration.

### **Codes and Rules**

A national scheme implies that there will be national codes (or rules) which address those matters the province of the national regulator. As noted, the NEC currently addresses many detailed technical issues which support national access arrangements as well as providing a necessary underpinning to price regulation for transmission network services. This approach reflects the fact that many aspects of the electricity supply industry produce public goods, eg power system security and stability and network standards.

To include such 'technical' regulation in the national regulatory scheme for distribution would be consistent with the approach for transmission and generation under the NEC. It would thereby provide a basis for determination of the price/service package that requires capital, maintenance and operating funding. There does need to be a recognition of the differences in individual networks, eg configuration, geographic and climatic factors, etc. There can, and ought, be common principles, but that does not, and should not, mean common service standards in all dimensions of network standards.

The regulators are moving towards a common set of service measures for reporting purposes, and publishing them in a common format. In distribution, where there is no direct competition as between entities, this is a necessary underpinning to developing 'benchmarking' for monopoly enterprises. There may also be certain matters which are not part of the price/service package in terms of technical industry operations, but which may

nevertheless be liable to inclusion on customer protection grounds, eg restrictions on times when disconnection may occur, notification of planned outages.

It is appropriate to have a higher level statement of regulatory principles for revenue or pricing in a code, but there needs to be some 'next level' statement of regulatory intent at the AER level, as in transmission. At present for distribution, the 'next level' of pricing principles for distribution is provided by jurisdictional regulators. There needs to be a capacity in any national regulatory scheme to address a variety of regional, technical, operational and performance requirements, and to support administratively their development, maintenance and review.

## **Retail**

As has been observed, the retail margin is a much smaller component of final price than are distribution service charges. Nevertheless, retailing can provide, through price and service delivery, a significant driver of efficiency both upstream and for end-use customers.

It is noticeable that the regulation of the retail sector has a different emphasis from that of networks and generation, especially in respect of the technical dimension of the electricity supply industry. In some respects, it may be arguable that distribution and retail may be amenable to separate regulation due to the different skill sets required, although pricing regulation (so long as it remains) requires similar skills across sectors and should be informed and integrated by an understanding of the chain of production and supply. To the extent that there are electricity/gas specific regulatory issues for retailing, these should be addressed in a national scheme, eg who carries the credit risk for distribution services, or dual fuel retailing and disconnection.

Most matters in the proposed 'consumer code' are industry specific enough to warrant regulation within the national scheme. Nevertheless, it is possible some aspects of 'retail' regulation could be passed to other agencies as they have no electricity/gas specific characteristics, eg marketing codes and other behavioural regulation.

## **Other matters**

- Dispute resolution
- Retailer of Last Resort
- Customer Transfer Schemes
- B2B information

If there is an underlying objective to facilitate the development of a national market, then one ought start from a presumption that these matters be included as part of the national scheme.

Nevertheless, there has been considerable investment and institution building in some of these areas and a cost benefit assessment will need to be made for any transition. It is also notable that in some instances (eg dispute resolution) the services should be delivered at a regional or jurisdictional level. There is a real risk that, due to the diversity of approaches developed in jurisdictional schemes, some aspects of a national scheme could remove existing customer protections. It will be important to take the higher standards as being the basis of any national scheme.

It would seem that the time is past for jurisdictionally specific RoLR schemes, as retail entities trade across regional boundaries. As the RoLR is intended to deal with extreme events, it must cater for a large scale failure across regional markets. It is unlikely that current jurisdictional based arrangements could adequately manage such a large scale retailer failure.

There should also be recognition that markets are developing at different rates across jurisdictions or have different underlying industry arrangements. Thus, a national RoLR scheme needs to be able to accommodate the exclusion of Tasmanian natural gas which operates in a quite different market context to gas in other regions.

## **Conclusion**

There are many other practical issues to be addressed in implementing any national regulatory scheme which includes distribution and retail in both gas and electricity. Not least of these will be the resourcing of 'residual' regulation at the jurisdictional level. Nevertheless, this is a matter for governments to consider in developing the over-arching policy.

To my mind there ought be a clearer recognition or statement of:

- the prioritisation of specific regulatory proposals linked to the reform objectives;
- a decision-making framework which more explicitly acknowledges the allocation of costs and benefits of the regulatory proposals; and
- the close integration of many aspects of 'technical' regulation with the determination of the price/service package. This involves close ongoing scrutiny and critical assessment of detailed performance and an acknowledgement of a wide diversity of the underlying technical and operational detail, especially of network operations.

Thank you for the opportunity to provide comment in this matter.

Yours faithfully

Andrew Reeves  
**REGULATOR**

15 November 2004