

Submission to Ministerial Council on Energy

Re: National Electricity Rules Consultation Paper



**UNITED ENERGY
Distribution**

**Submitted by: United Energy Distribution
422 Warrigal Road
Moorabbin Vic 3189**

Phone: (03) 9265 7650

Fax: (03) 9265 7887

Contact: Verity Watson / Geoff Towns

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Highlights

Trade Practices Act issues

- The inclusion of clause 7.2.8(d)(1) suggests the Ministerial Council on Energy (MCE) believes that potential anti-competitive provisions in the Market Settlement and Transfer Solution (MSATS) Procedures need to be included as mandatory obligations in the National Electricity Rules (NER) rather than in the MSATS Procedures themselves.
- Has the Standing Committee of Officials (SCO) reviewed the MSATS Procedures generally to ensure that all provisions of those Procedures which may give rise to Trade Practices Act (TPA) concerns have been identified and included in the NER?
- Has the SCO given thought to whether compliance with procedures that sit underneath the formal MSATS Procedures may give rise to conduct which may breach the TPA and, if so, how protection from breach is to be provided?
- What steps has the SCO taken to address these issues in relation to all NEMMCO Procedures and guidelines. Advice from counsel is needed to comfort participants that TPA risks do not increase from compliance with NEMMCO procedures under the NER.

Derogations – clause 9.9(a)(2)

- Pritchard and Hutley SC raised particular concerns regarding the Victorian metering derogations.
- Regulatory certainty in relation to these metering arrangements is a significant immediate issue.
- United Energy Distribution (UED) requests the SCO specifically address and comment upon this matter and that advice be sought from Mr Hutley SC that clause 9.9A.2 does not give rise to TPA concerns.

Extension of powers for the AER

- There are a number of instances where the simple substitution of “AER” for “NECA” has the effect of altering the substantive rights and obligations in the current NEC.
- The drafting substitution fails to recognise that the Australian Economic Regulator (AER) has a broader function than that enjoyed by National Electricity Code Authority (NECA).
- Where the NER confers functions and powers on the AER which derive from a function of NECA, the AER’s exercise of those powers must be confined to the monitoring and enforcement function and not be available for the economic regulation function.

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Reviewable decisions

- The NER replaces former reviewable decisions of NEMMCO and NECA with judicial review.
- It is not sufficient to argue that because the National Electricity Tribunal (NET) is abolished so must reviewable decisions be abolished.
- The powers the NET had in relation to reviewable decisions should be conferred on a court.

NER objectives should be consistent with the National Electricity Laws (NEL)

- With the introduction of the new national electricity market objective centred upon the objective of efficiency, the objectives and principles in chapter 6 of the National Electricity Code (NEC) or NER are in need of urgent review.
- In the current process, UED believes that conflict between the new objective and the chapter 6 objectives needs to be identified and resolved. UED has identified two such issues.

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1. Introduction

In the Information Paper on the National Electricity Law (NEL) and NER issued for the MCE by the SCO, the MCE proposes major changes to the objectives of the national electricity market and the inclusion of a national electricity market objective in the NEL:

“The national electricity market objective under the new NEL replaces the list of “Market objectives” and “Code objectives” under the current Code. This change reflects the policy position agreed to by Commonwealth, State and Territory governments that reform should be made to promote the “long term interests of consumers”.

A single objective that comprehends a number of specific components or elements has the advantage of conveying the message that the long term interests of consumers will be served through a **composite** of efficient investment in, and efficient use of, infrastructure and capabilities having regard to price, quality, reliability, safety and security of electricity services. Such a composite definition encapsulates all of the components of the more detailed version currently in clause 1.3 of the current Code.

The alternative approach of listing a series of sub-objectives (such as those from clause 1.3 of the current Code) was considered but not adopted. The current Market Objectives are a product of committee considerations in the early 1990s at a time when the national electricity market and its various institutions did not exist. The national electricity market and its institutions have developed and evolved to a degree that detailed prescription of sub-objectives is not only unnecessary but also potentially counter-productive.

Accordingly, the generalised single national electricity market objective in the new NEL provides a more legally robust and economically testable statement of the national electricity market objective for the purpose of Rule making than the specific objectives listed in the original formulation of the current Code.”¹

In the Consultation Paper on the NER, the MCE notes its objective is to make minor changes to the NER:

“It is important to note that the changes proposed in the National Electricity Rules are not aimed at changing the regulatory obligations that are currently placed on participants in the national electricity market. Rather, the changes accommodate the new institutional arrangements implemented through the new NEL..... and give effect to the conversion of the NEC into rules made under the new NEL.”²

Whilst recognising the scope of the current changes to create the NER, UED observes that the criticism by the MCE that the original market objectives of the NEC were a product of committee considerations in the early 1990s at a time when the national electricity market and its various institutions did not exist can equally be applied to the specific objectives in chapter 6 of the NEC.

¹ National Electricity Law and National Electricity Rules, Information Paper, Ministerial Council of Energy, Standing Committee of Officials, December 2004, p. 10

² National Electricity Rules, Consultation Paper, Ministerial Council of Energy, Standing Committee of Officials, December 2004, p. 5.

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Further, the adoption of the composite national electricity market objective in clause 6 of the NEL has substantial implications for the specific chapter 6 objectives in the NEL. First, the same “out of date” criticisms can be made of the NEL chapter 6 objectives and pricing principles. And, further, an overriding national electricity market objective in the NEL means that the objectives in the NEL could be inconsistent or duplicate this national electricity market objective.

In this submission UED comments on issues arising from the scope of the changes as outlined by the SCO in section 1.3 of the Consultation Paper, ie the changes resulting from a change to “mandatory” statutory rules and the incorporation of the Australian Energy Markets Commission (AEMC) or AER to replace NECA or the Australian Competition and Consumers Association (ACCC). Attachment A contains a table of UED’s comments on specific clauses of the NEL.

However, given the need to:

- recognise the issues arising from the current reforms, including the creation of an overriding national electricity market objective;
- develop a best practice regulatory approach for the NEL; and
- observe the implications of the Productivity Commission’s Inquiries into the National Gas Access Regime and the National Access Regime,

a wider assessment of the chapter 6 objectives than proposed by the Consultation Paper should be conducted by the AEMC in the immediate future. In this context the problems with the chapter 6 objectives include:

- a multiplicity of objectives, some of which conflict;
- the mix of objectives and pricing principles;
- the potential lack of a consistency with the overarching national electricity market objective based on the key objective of efficiency; and
- the potential duplication of objectives.

UED has provided further detail and recommendations relating to the chapter 6 objectives and pricing principles in Attachment B of this submission.

2. Trade Practices Act (TPA) Issues

Clause 7.2.8(d1) requires *registered participants* to use the MSATS Business to Business (B2B) hub. At page 5 of the Consultation Paper, the SCO says “as rules made under law, these rules will be binding on any persons to whom they are expressed to apply”. This clause is expressed so that only *registered participants* must use the MSATS B2B hub.

Why is it that *Metering Providers* are not expressly required to use the B2B e-Hub but clauses 7.2.8(d) and 7.4.2(bb) provide that *Metering Providers* must comply with the MSATS Procedures?

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Is it intended that only *registered participants* benefit from the protection from breach of the TPA which the SCO apparently believes flows from the inclusion of this clause (see page 13 of the SCO Consultation Paper)?

The inclusion of this clause suggests the SCO accepts that this requirement may contravene the TPA and, in order to provide protection from an action for breach, the mandatory obligation must be included in the NER rather than simply being within the MSATS Procedures themselves.

UED understands from the proposed NEMMCO metrology harmonisation project that there are some 14 procedures and guidelines which are considered to relate to Chapter 7. We also understand that the MSATS Procedures may incorporate a number of underlying documents, for example the Consumer Administration and Transfer Solution (CATS) Procedures, and in the near future the B2B Procedures, and potentially some of the remaining 14 procedures and guidelines.

Relying on the precedent established by clause 7.2.8(d1), has the SCO reviewed the MSATS Procedures generally to ensure that all provisions of those Procedures which may give rise to TPA concerns have been identified and included in the NER? Has the SCO given thought to whether compliance with procedures that sit underneath the formal MSATS Procedures may give rise to conduct which may breach the TPA and, if so, how protection from breach is to be provided?

What steps has the SCO taken to address these issues in relation to all NEMMCO Procedures and guidelines.

If the MCE considers that if the NER requires compliance with Procedures conduct in accordance with the terms of the Procedures does not increase the current risk of a breach under the TPA, UED suggests there should be a clear obligation to comply and the Procedures clearly identified and listed. If the view is that anti-competitive provisions in Procedures need to be included as mandatory obligations within the NER, what steps has the SCO taken to identify these provisions, not only in the MSATS Procedures but also the other procedures and guidelines?

UED notes Pritchard and Hutley SC were not asked to advise on TPA risk arising from compliance with NEMMCO procedures.

UED also notes that the advice deals with the TPA risk to NEMMCO in setting technical standards (at paragraphs 158 and 159) but does not deal with the risk to participants from compliance with such standards.

UED seeks the MCE's response to these questions to ensure the approach adopted is not driven through in haste without proper consideration of these substantive issues relating to NEMMCO procedures. Further, UED considers that further advice from counsel should be sought to give comfort to participants that TPA risks do not increase from compliance with NEMMCO procedures under the NER.

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3. Derogations (clause 9.9A.2)

Pritchard and Hutley SC advise that any TPA issues regarding technical metering requirements in Chapter 7 could be avoided altogether by placing the requirements on a statutory basis.

The advice is considerably less certain regarding the Victorian metering derogations. At paragraph 164 of their advice, counsel refer to section 47(6) (third line forcing) and say “close attention would need to be paid to any treatment of this monopoly...in the proposed rules made under the NEL to ensure there is no scope, whatsoever, for any conclusion, other than that the monopoly, in every aspect, is statutorily imposed and regulated”.

The responsibility of the distributors for small customer metering in the future is one of the key recommendations from the Joint Jurisdictional Regulators Review conducted under clause 7.13(g) and the ongoing provision of metering is also a fundamental matter for the current electricity distribution price review being conducted by the Essential Services Commission in Victoria. It is the intention that any charges under these arrangements will be prescribed service charges with some regulator oversight. All metering arrangements are subject to regulator independent audits by NEMMCO.

Regulatory certainty in relation to these metering arrangements is therefore a significant immediate issue.

However, UED does not have access to Mr Hutley to ensure it fully understands and can respond to his concerns and it is difficult for UED to ensure that the drafting of clause 9.9A.2 addresses Mr Hutley’s issues. Simply, UED has not instructed counsel and therefore cannot explore an issue raised that directly, and significantly, affects its interests.

In these circumstances UED requests the SCO specifically address and comment upon this matter and that advice be sought from Mr Hutley SC that clause 9.9A.2 does not give rise to TPA concerns.

4. Extension of powers for AER from those of NECA

UED again notes that the scope of changes to the NEL as outlined in the Consultation Paper that the substantive rights and obligations of participants in the market under the current NEL and the NEC will remain under the new NEL and the NEL.

There are a number of instances where the simple substitution of “AER” for “NECA” has the effect of altering the substantive rights and obligations in the current NEC.

This happens because the drafting substitution fails to recognise that the AER has a broader function than that enjoyed by NECA. The AER has both a NEL monitoring and enforcement function and an economic regulation function whereas NECA only has the former function. Where the NEL confers functions and powers on the AER which derive from a function of NECA, the AER’s exercise of those powers must be confined to the monitoring and enforcement function and not be available for the economic regulation function.

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Two examples are:

- the right to develop reporting requirements in clause 8.7.2 must be drafted so that the rights of the AER relate only to monitoring for enforcement purposes and cannot be used by the AER to gather information for the purposes of economic regulation. NECA did not have such an economic regulatory function and so the powers in clause 8.7.2 could not be used for such a purpose; it must be made clear that the AER's powers under this clause are limited as were those of NECA.
- the prospect of Advocacy Panel funding for reviews of AER economic regulatory decisions under clause 8.10.3(d)(2)(ii). Again, NECA did not have an economic regulatory function and so Advocacy Panel funding was not available for end-user advocacy in relation to economic regulatory decisions; it must be made clear that the powers under this clause are limited to the exercise of the AER's powers derived from NECA.

UED seeks SCO confirmation that, in accordance with SCO commitments, the rights and obligations under the NEC in relation to economic regulatory decisions have not been altered by virtue the transfer of functions and powers from NECA to the AER.

5. Reviewable decisions

UED notes that the Consultation Paper says “the substantive rights and obligations of participants in the market under the current NEL and the NEC will remain under the new NEL and the NER” (at page 5).

The NER replaces former reviewable decisions of NEMMCO and NECA with judicial review.

To replace “reviewable decisions” with judicial review rights is a material change of substance to the rights and obligations of participants in the market under the current NEL and the NEC.

Reviewable decisions of NEMMCO and NECA were subject to the power of the National Electricity Tribunal to affirm the decision, to vary the decision or to set aside the decision and make a decision in substitution or remit the matter for reconsideration in accordance with any directions or recommendations of the Tribunal.

UED notes it is not sufficient to argue that because the NET is abolished so must reviewable decisions be abolished. A court could be conferred with the powers the NET once had in relation to reviewable decisions.

6. National Electricity Rules Chapter 6 objectives should be consistent with National Electricity Laws

As noted above and in Attachment B, with the introduction of the new national electricity market objective centred upon the objective of efficiency, UED considers the objectives and principles in chapter 6 of the NEC or NER are in need of urgent review.

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In the current process, UED believes that conflict between the new objective and the chapter 6 objectives needs to be identified and resolved. UED has identified two such issues.

Clause 6.10.2 (k) refers to balancing of the interests of users, distributors and the “public interest”. UED considers the reference to the “public interest” conflicts with the new NEL national electricity market objective of “[promoting] efficient investment in, and use of, electricity services for the long term interests of consumers”.

In the Review of the National Gas Access Regime, the Productivity Commission has also criticised the use of the term “public interest.”

“There are a variety of other possible objectives of competition policy, apart from economic efficiency. A joint study by the World Bank and OECD (1999) on competition law and policy noted a spectrum of views on the objectives of competition policy, ranging from *economic efficiency* at one end of the spectrum to *public interest* at the other end. Public interest is a relatively broad concept embodying social factors that are inherently difficult to quantify and ‘loaded with value judgements’ (World Bank and OECD 1999, p. 1). The World Bank and OECD study concluded:

This overview of the different objectives of competition policy indicates that in most jurisdictions the basic objectives are to maintain and encourage competition in order to promote efficient use of resources while protecting the freedom of economic action of various market participants. (World Bank and OECD 1999, p. 8)”³

Consequently the reference to “and the public interest” should be replaced with “to promote efficient investment in, and use of, electricity services for the long term interests of consumers”..

Similarly, clause 6.1.1(c)(4) notes that a core objective of chapter 6 is “equity”. However, the new national electricity market objective does not deal with equity and this concept should not be included in the NER as it also lacks a firm definition.

In the same review, the Productivity Commission opposed the use of the term “equity” in industry access codes:

“Under section 2.24(e) [of the Gas Code], a regulator has to take into account ‘the public interest, including the public interest in having competition in markets’ in assessing proposed access arrangements. By considering the public interest, other factors, in addition to the economic costs and benefits directly affecting service providers and consumers, can potentially become important.

According to the Australian Competition and Consumer Commission and National Competition Council (ACCC and NCC 2002, p. 22), these other factors could include ‘environmental considerations, regional development and equity’. Other factors might be in conflict with competition policy and the principle of economic efficiency employed in the

³ Productivity Commission., Inquiry Report, Review of the Gas Access Regime, No.31, June 2004, Australian Government, p.177.

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objects clause. Also, non-economic objectives might not have measurable outcomes, which would adversely affect regulatory accountability.”⁴

UED recommends that clause 6.1.1(c)(4) be deleted.

7. The Whole Picture

Many industry participants have requested that the other pieces of regulation which fit within the overall picture be made available, however to date these have not been issued. This does not constitute regulatory best practice and an openness and transparency that embarking on such a mammoth change to the industry warrants.

UED request that the regulations under the NEL and the transitional provisions be released for industry consultation prior to the NEL being introduced to the South Australian Parliament.

By way of example, without some review of these provisions it is difficult to assess what will happen with guidelines, procedures etc that are “under” the NER. UED notes:

- does NECA’s exemption guideline automatically become an AER guideline?
- will the AER have a Guideline for the Negotiation of Discounted Transmission Charges?
- do the transitional provisions provide a list of the documents considered broadly part of the NER, as opposed to just those referenced in the NER? Should an arrangement similar to the gas retail rules in Victoria be referenced where there is a list of all documents considered part of the interface protocol to the rules. This interface protocol clearly documents the relevant documents and latest version on one page so it is clear what are the underlying documents.

⁴ Productivity Commission, *ibid*, p.191

Attachment A - UED table of comments – National Electricity Rules

Provision	Description	Comments
2.5.1(b)	Access undertaking	<p>At the Consultation session on 10 December 2004 UED expressed its concern about the suggestion that the access provisions of the NER are “square bracketed” and will be amended once a policy decision on access had been made by the MCE. UED welcomes the commitment made at the Consultation session, repeated at the pre-finalisation hearing on the NEL on 7 January 2005, that there will be consultation on these changes.</p> <p>Whilst UED understands the MCE is anxious to progress the making of the NER, the access framework is clearly a critical issue for networks. Whilst not yet the focus for MCE deliberations, UED is similarly anxious to ensure any changes made to the NER in haste do not restrict the prospects for the evolution of a best practice national energy access framework.</p>
2.5.1(e) and (e1)	Exemption guidelines	<p>Exemptions from registration in the NEM should be a matter of policy and guided by the MCE through the AEMC. It is inappropriate to have an economic regulator establish exemptions from registrations to facilitate the efficient operation of the NEM; the economic regulator should only be able to guide whether an access undertaking is required or not.</p> <p>In addition, where there is to be an exemption for a party from the requirements of the NER it may be necessary in the case of networks to establish that that exemption is feasible from a technical point of view. An example is the connection issues surrounding embedded networks. Whilst NECA had that capacity, and so will the AEMC, the AER will not.</p> <p>If the option in the draft NER is preferred (with the AER responsible for exemption) , for these reasons, at the least, the guidelines to be established under clause 2.5.1(e) of the NER should be established by the AEMC.</p>

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Provision	Description	Comments
5.9.4A	AER notification of disconnection of any registered participant	Whilst this clause appears to be in line with the NEL and may potentially be considered a requirement arising from the replacement of the NET, there is no process outlined for what notification a party would receive prior to court direction, what consultation, time to rectify a breach etc. This is inappropriate and extensive power for one party given the extraordinary consequences of the relevant court order being made.
6.2	<i>General principles governing regulation of transmission revenue</i> - Section deleted which stated that the Code did not prescribe methodologies to be applied by the ACCC in exercising its regulatory functions except to the extent that methodologies had to be consistent with the objectives, principles, broad forms and mechanisms and disclosure requirements of the sections 6.2.2 to 6.2.6 of the Code.	<p>The NEL prescribes the principles and constraints to be used by the AER for a transmission decision in s.15 but not the methodologies. Clause 6.2 does not need to be deleted to maintain consistency with s.15 of the NEL.</p> <p>Clause 6.2 does not limit or prescribe the methodologies to be applied by the AER, except to the extent that those methodologies must be consistent with the objectives. As a point of principle, the NEL/NER should not prescribe methodologies and this clause should remain.</p>
6.2.2(k)	<i>Objectives of transmission revenue regulation</i> – reasonable and well-defined regulatory discretion which balances the interests of service providers, users and the public interest.	<p>Recent regulatory decisions seeking to balance the interests of service providers, users and the ‘public interest’ have tended to identify the public interest as lower short-term prices for users. This is unlikely to support the need for long-term investment in energy networks and is thus inconsistent with the new national electricity market objective.</p> <p>Consequently the reference to “and the public interest” should be replaced with “to promote efficient investment in, and use of, electricity services for the long term interests of consumers”.</p>
6.2.3(b)	<i>Principles of transmission regulation</i> – ‘form of economic regulation <i>is to be</i> revenue capping’ changed to <i>must</i>	This change appears to limit the ability to change methodology in (c). UED suggests that to rectify the drafting inconsistency, clause (b) be made subject to clause (c).

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Provision	Description	Comments
6.2.3(d)(4)(iv)(A)	<p><i>Factors to have regard to in transmission pricing – asset valuation – Removal of references to Council of Australian Governments (CoAG) decisions favouring deprival value as preferred methodology, and substitution with new principle that deprival value should be preferred methodology.</i></p>	<p>All regulators of electricity and gas distribution and transmission in Australia have adopted a depreciated optimal replacement cost (DORC) asset valuation rather than a deprival value.</p> <p>The NER as drafted with the requirement that regulators have regard to the <i>principle</i> (rather than simply a CoAG agreement) that deprival value should be preferred may enliven the argument that regulators must give weight to that principle as a fundamental matter. This may make it more difficult for regulators to adopt DORC than when the matter to have regard to was not a principle but a CoAG agreement.</p> <p>If such an interpretation were adopted the requirement to adopt deprival value is a change to existing NEC rights and obligations. Such a risk should not be taken from a drafting amendment. UED recommends that the clause be retained and a full economic review should be undertaken regarding the different approaches and the application of “a principle” of deprival value.</p>
6.10.3(e)(5)(iii)(A)	<p><i>Factors to have regard to in distribution pricing – asset valuation – Removal of references to CoAG decisions favouring deprival value as preferred methodology, and substitution with new principle that deprival value should be preferred methodology..</i></p>	<p>Refer above comment regarding 6.2.3(d)(4)(iv)(A).</p>
7.2.1A(a)	<p>Process for appointment of metrology coordinator has been removed on the basis that each jurisdiction has appointed the relevant regulator as the metrology coordinator.</p>	<p>The Joint Regulators Review proposes that NEMMCO take on the role of Metrology co-ordinator and also update the NEC Chapter 7 to facilitate the creation of a single metrology procedure. NEMMCO is initiating projects to undertake this work and this NER process should not alter code clauses when these review processes have commenced. The deletion of this clause is beyond the SCO changes. Further, depending on timing of events, this clause may be useful for Tasmania if they have FRC before a single national metrology procedure is approved.</p>

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Provision	Description	Comments
7.2.8(d1)	Insertion of clause making NEMMCO provision and operation of the B2B e-Hub and its use by registered participants compulsory.	<p>This clause requires <i>registered participants</i> to use the MSATS B2B hub. At page 5 of the December 2004 SCO Consultation Paper on the NER, the SCO says “as rules made under law, these rules will be binding on any persons to whom they are expressed to apply”. This clause is expressed so that only <i>registered participants</i> must use the MSATS B2B hub. Why is it that Metering Providers are not expressly required to use the B2B e-Hub but clauses 7.2.8(d) and 7.4.2(bb) provide that <i>Metering Providers</i> must comply with the MSATS Procedures?</p> <p>Given clauses 7.2.8(d) and 7.4.2(bb), why is the SCO only considering if Metering Providers be <i>relevant participants</i> for these purposes (see page 7 of the Consultation Paper) and so subject to enforcement action for NER breach?</p> <p>Is it intended that only <i>registered participants</i> benefit from the protection from breach of the TPA which the SCO believes flows from the inclusion of this clause (see page 13 of the SCO Consultation Paper)?</p> <p>The inclusion of this clause suggests the SCO accepts that this requirement may contravene the TPA and, in order to provide protection from an action for breach, the mandatory obligation must be included in the NER rather than simply being within the MSATS Procedures themselves.</p> <p>Relying on the precedent established by this clause 7.2.8(d1), has the SCO reviewed the MSATS Procedures generally to ensure that all provisions of those Procedures which may give rise to TPA concerns have been identified and included in the NER?</p> <p>Has the SCO given thought to whether compliance with procedures that sit underneath the formal MSATS Procedures may give rise to conduct which may breach the TPA and, if so, how protection from breach is to be provided?</p> <p>What steps has the SCO taken to address these issues in relation to all NEMMCO Procedures.</p>

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Provision	Description	Comments
		<p>If the MCE considers that if the NER requires compliance with Procedures conduct in accordance with the terms of the Procedures does not increase the current risk of a breach under the TPA , UED suggests there should be a clear obligation to comply and the Procedures clearly identified and listed. If the view is that anti-competitive provisions in Procedures need to be included as mandatory obligations within the NER, what steps has the SCO taken to identify these provisions, not only in the MSATS Procedures but also the other procedures and guidelines?</p> <p>UED notes Pritchard and Hutley SC were not asked to advise on TPA risk arising from compliance with NEMMCO procedures.</p> <p>UED also notes that the advice deals with the TPA risk to NEMMCO in setting technical standards (at paragraphs 158 and 159) but does not deal with the risk to participants from compliance with such standards.</p> <p>UED seeks the MCE's response to these questions to ensure the approach adopted is not driven through in haste without proper consideration of these substantive issues relating to NEMMCO procedures. Further, UED considers that further advice from counsel should be sought to give comfort to participants that TPA risks do not increase from compliance with NEMMCO procedures under the NER.</p>
7.3.1(d)	LNSP must issue NMI	UED recommend that the obligation continue to be expressed as "shall" in view of the fact that not all types of unmetered supply are contestable because the rules for the collection of devices that form a NMI have not yet been agreed.

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Provision	Description	Comments
7.13(g)(4)	Deletion of “expired” Code requirements that the jurisdictional regulators must jointly conduct a review of metering installations types 5 and 6.	<p>The review may have been completed, however, clause 7.13(g)(4) includes a requirement for that review to specify a date for a further review to be conducted. Deletion of this clause appears to remove from the record that a further review was intended and also appears to be beyond the stated scope of minimum change. What support can be found for a further review taking place if this clause is deleted?</p> <p>UED suggests the clause remain and allow the NEMMCO metrology harmonisation project to make the necessary Chapter 7 changes which will include the further review date and the objectives of the review. An alternative drafting suggestion would be to adopt the recommendations in the Joint Jurisdictional Review of Metrology Procedures: Final Report, recommendation 10.1, 10.2 and 10.3.</p>
8.1.3(f)	Administrative provision that described the “monitoring and reporting powers of NECA” are now described as the “requirements that may be imposed by the AER”.	This appears to reflect a substantive change in the kind of information and reporting powers vested in the regulator and not just a transfer of current powers. UED refers to its comments on clauses 8.2.7(a) and (b).
8.2.1(a)	Removal of reference to NECA as being subject to dispute resolution.	<p>UED requires SCO to confirm that decisions of NECA that were subject to dispute resolution will continue to be subject to dispute resolution where those decisions have been transferred to the AEMC or the AER.</p> <p>Whilst the NER appears to have the contrary effect, UED notes that the SCO Consultation Paper says “the substantive rights and obligations or participants in the market under the current NEL and the NEC will remain under the new NEL and the NER” (at page 5).</p> <p>To remove any rights to dispute a decision once made by NECA and now made by the AER or AEMC would be contrary to this clear statement from SCO.</p>

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Provision	Description	Comments
8.2.1(h), 8.7.2(b), 8.9(n), other "reviewable decisions of NECA"	Listing of decisions previously subject to merits review (those that were classed "reviewable decisions") are not subject to dispute resolution, only judicial review.	<p>This decision appears inconsistent with the policy statement released in August 2004 (MCE SCO <i>Legislative and Regulatory Framework Information Paper</i>) that while reviewable decisions have been removed "the Disputes Resolution Process in the National Electricity Code will be available to parties who wish to dispute any decision of NEMMCO".</p> <p>Further, to replace "reviewable decisions" with judicial review rights is a material change of substance. UED again notes that the SCO Consultation Paper says "the substantive rights and obligations or participants in the market under the current NEL and the NEC will remain under the new NEL and the NER" (at page 5).</p> <p>Reviewable decisions of NEMMCO and NECA were subject to the power in the National Electricity Tribunal to affirm the decision, to vary the decision or to set aside the decision and make a decision in substitution or remit the matter for reconsideration in accordance with any directions or recommendations of the Tribunal.</p> <p>UED notes it is not sufficient to argue that because the NET is abolished so must reviewable decisions be abolished. A court could be conferred with the powers the NET once had in relation to reviewable decisions.</p>
8.2.11	Referral of questions of law in the context of a dispute resolution procedure is dealt with in section 70(1) of the NEL	Clause 8.2.11 allowed referral to a court on a question of law arising during the resolution of a dispute whereas section 70 refers only to appeal from a decision or determination. Section 70 does not allow the same rights as existed under clause 8.2.11.

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Provision	Description	Comments
8.7.1	Deletion of NECA monitoring principles.	<p>These principles are not reproduced in the new NEL. Deletion of these principles means that the reporting requirements and monitoring processes to be developed by the AER under clause 8.7.2 no longer need to comply with principles such as:</p> <ul style="list-style-type: none"> - consistency over time; - no unnecessary discrimination between Code Participants; - cost effectiveness for both NECA and all Code Participants; and - publication of information except where covered by confidentiality provisions. <p>UED again notes that the SCO Consultation Paper says “the substantive rights and obligations of participants in the market under the current NEL and the NEC will remain under the new NEL and the NER” (at page 5). These constraints upon the AER’s monitoring function must be reinstated.</p>
8.7.2(a) 8.7.2(b)	<p>AER to establish reporting requirements for registered participants and NEMMCO in matters relevant to the rules.</p> <p>Clause does not require the AER to use the Code consultation procedures in developing these rules.</p>	<p>It is not appropriate for the AER to have a broad power to develop information gathering rules relating to its own powers which impose obligations on registered participants. It is more appropriate for the AEMC, through the Rules consultation procedures (including consultation with the AER), to develop reporting requirements for registered participants for enforcement purposes.</p> <p>If, however, the right to develop reporting requirements is to remain with the AER this clause must be drafted so that the rights relates only to monitoring for enforcement purposes and cannot be used by the AER to gather information for the purposes of economic regulation. UED again notes that the SCO Consultation Paper says “the substantive rights and obligations of participants in the market under the current NEL and the NEC will remain under the new NEL and the NER” (at page 5). NECA did not have such a function and so the powers in clause 8.7.2 could not be used for such a purpose; it must be made clear that the AER’s powers under this clause are limited as were those of NECA.</p>

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Provision	Description	Comments
8.7.2(d)	The AER no longer needs to notify all registered participants if it imposes more onerous reporting requirements on certain participants. Old provision allowed NECA not to notify only if it breached confidentiality to do so. New provision allows the AER not to notify if it "considers it appropriate to do so".	Change in requirements in transfer of requirements from NECA to AER such that less onerous requirements apply to the AER if it wishes to change reporting requirements for some Registered Participants. The previous requirements should apply equally to the AER.
8.8.1(d) and (e)	Deletion of requirement for the old NECA to carry out a review on NEMMCO's use of powers granted under 4.2.6 (system security).	Change in requirements on the AER compared with those on NECA. The SCO amendments table argues that review could be initiated by ministers through review powers in NEL however UED believes the amendment is beyond scope.
8.10.3(d)(2)(ii)	Extension of the subject matter on which the Advocacy Panel can seek funds from issues directly related to NECA and/or NEMMCO to issues related to the AEMC, NEMMCO and the AER.	This has the effect of opening up revenue decisions (which were previously outside the scope of advocacy panel funding) to grants from the Advocacy Panel. This is a change of substance and should be rejected. NECA did not have an economic regulatory function and so Advocacy Panel funding was not available for end-user advocacy in relation to economic regulatory decisions; it must be made clear that the powers under this clause are limited to the exercise of the AER's powers derived from NECA.
9.9A	Metering derogation in Victoria	<p>At paragraph 164 of their advice of 5 August 2004, Pritchard and Hutley SC say "close attention would need to be paid to any treatment of this monopoly...in the proposed rules made under the NEL to ensure there is no scope, whatsoever, for any conclusion, other than that the monopoly, in every aspect, is statutorily imposed and regulated".</p> <p>UED requests the SCO specifically address and comment upon this matter.</p> <p>UED requests that Mr Hutley SC advise that clause 9.9A does not give rise to TPA concerns for Victorian Local Network Service Providers.</p>

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Provision	Description	Comments
Provision	Description	Comments
B2B e-Hub		<p>B2B includes within its scope requests which are essentially aimed at functions performed by <i>Metering Providers</i>. The category of <i>Registered Participants</i> is too limiting.</p> <p>Given clauses 7.2.8(d) and 7.4.2(bb) provide that <i>Metering Providers</i> must comply with the MSATS Procedure (and transact communications through the B2B e-Hub), this definition should include <i>Metering Providers</i>.</p>
New large/small distribution network asset		<p>This definition creates an ongoing role for the jurisdictional regulator to assess; why doesn't this function go to the AER as it will be ultimately providing the avenue for cost recovery? The establishment of the AER as national distribution regulator has been assumed by the SCO in the proposed amendment to clause 6.10.1(g) and there is no reason for a different approach here.</p>

Attachment B – Assessment of Objectives and the Principles of the Draft National Electricity Rules, Chapter Six.

1. Introduction

The criticism by the MCE that the original market objectives of the NEL were a product of committee considerations in the early 1990s at a time when the national electricity market and its various institutions did not exist can also be applied to the NER.

The changing of the NEL market objective would have substantial implications for the objectives in the NER given that the same out of date criticisms can be made of the NER objectives and pricing principles. An overriding objective in the NEL means that the objectives in the NER could be inconsistent or duplicate this objective.

Given the principle laid down by the Productivity Commission in the reviews of the National Access Regime and the Gas Access Regime (NGC) a wider assessment is possible of the National Electricity Rules than proposed by the MCE Paper. In this context the problems with the NER objectives in clauses 6.1 and 6.1.1 include:

- a multiplicity of objectives some of which conflict;
- the mix of Code objectives and pricing principles;
- the lack of a consistency with the overarching national electricity market objective based on the key objective of efficiency as proposed for the NEL; and
- the duplication of objectives.

The Productivity Commission has also provided a new context in which to consider best practice regulation for the NER, which would include:

- the need to establish a best practice economic regulation model (and given the recent review of the NGC this is considered to be the best practice regulatory model); and
- in comparison the NER has not been reviewed since its establishment and review is overdue especially given the new NEL overriding objective and the CoAG objective of the harmonisation of the energy codes.

A best practice model includes:

- appropriate and consistent objectives and pricing principles,
- submission of pricing proposals by regulated businesses which are considered by regulators for compliance with the objectives and principles; and
- adequate appeal rights.

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Given the need to review the NER, UED proposes that a substantial clean-up of the objectives and pricing principles be undertaken before the NER is introduced or soon thereafter.

To assist the MCE in this task UED's attachment applies these best practice principles to an evaluation of the objectives and the pricing principle of the NER.

Given the objectives and pricing principles of the NER are almost identical for transmission and distribution companies the submission is based on the following:

- the distribution objectives, pricing principles and the form of regulation are assessed in detail; and
- where these involve the same objectives or pricing principles or form of regulation as in transmission the same comments and recommendations can be applied to transmission regulatory requirements.

2. Assessment of the Summary Objectives for Network Pricing

The Draft NER has a series of summary objectives in clause 6.1 of the NER and clause 6.1.1 sets out the key principles and key objectives.

The key principles of clause 6.1.1(b) include:

- 1) Promotion of competition wherever possible in transmission and distribution services;
- 2) Facilitation of a stable and transparent commercial environment which does not discriminate between users and service provider;
- 3) Regulate service providers which replicates competitive markets;

The core objectives of clause 6.1.1(c) include:

- 1) Efficiency in the use, operation and maintenance of, and investment in transmission and distribution services and in the location of generation and demand;
- 2) Upstream and downstream competition;
- 3) & 4) Price stability and equity;

2.1 Evaluation of the Summary Objectives

The assessment is based on the following principles:

- do the multiplicity of objectives conflict with each other;
- do they provide the regulator with clear and effective guidance;

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- are they consistent with the new overarching objective based on efficiency as proposed for the NEL ;
- do they meet best practice regulatory principles;
- are they consistent with recommendations on the reform of the NGC; and
- is there any duplication of the objectives?

Objective clause 6.1.1(b)(1)

The promotion of competition wherever possible is certain to benefit consumers in the long term (the new NEL objective) and hence this objective clause 6.1.1(b)(1) provides no new information for regulators and the industry and should be deleted.

Recommendation 1

That objective clause 6.1.1(b)(1) of the NER on the objectives of network pricing be deleted.

Objective clause 6.1.1(b)(2)

Any discrimination between users would not be in the interests of consumers and is clearly covered by the overriding objective.

Recommendation 2

That objective clause 6.1.1(b)(2) of the NER on the objectives of network pricing be deleted.

Objective clause 6.1.1(b)(3)

The Productivity Commission in the Inquiry into the National Gas Access Regime expressed some serious concern about the use of a “competition” objective given the wide possible interpretations:

“Effective competition and related concepts (such as workable competition) imply a realistic concept of competition where some degree of market power might be present, in contrast to a theoretical ideal of ‘perfect’ competition which does not replicate real-world market behaviour.

Replicating the outcome of a competitive market (s.8.1(b) of the Gas Code) is an unachievable objective for setting reference tariffs. Seeking to apply the concept of workable competition does not provide a practical approach to this problem.”⁵

Recommendation 3

That objective clause 6.1.1(b)(3) of the NER on the objectives of network pricing be deleted.

⁵ Productivity Commission, Inquiry Report, Review of the Gas Access Regime, No. 31, June 2004, Australian Government, p. 261

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Objective clause 6.1.1(c)(1)

Efficiency is covered in the NEL overriding objective and this separate objective is unnecessary.

Recommendation 4

That objective clause 6.1.1(c)(1) of the NER on the objectives of network pricing be deleted.

Objective clause 6.1.1(c)(2)

The first part of this objective deals with upstream and downstream competition and as consumers will benefit from both upstream and downstream competition this is now covered in the overarching NEL objective and can be deleted from this objective.

The issue of competition has been discussed above and there is no reason for this separate objective.

Recommendation 5

That objective clause 6.1.1(c)(2) of the NER on the objectives of network pricing be deleted.

Objective clause 6.1.1(c)(3)

Price stability is clearly an objective of the long-term benefit of consumers in light of the safety, reliability, quality and security of the networks and is therefore not required as a separate objective.

Recommendation 6

That objective clause 6.1.1(c)(3) of the NER on the objectives of network pricing be deleted.

Objective clause 6.1.1(c)(4)

The overriding objective does not deal with equity and this concept should not be included in the NER as it also lacks a firm definition.

In the Review of the National Gas Access Regime the Productivity Commission opposed the use of the term “equity” in industry access codes:

“Under section 2.24(e), a regulator has to take into account ‘the public interest, including the public interest in having competition in markets’ in assessing proposed access arrangements. By considering the public interest, other factors, in addition to the economic costs and benefits directly affecting service providers and consumers, can potentially become important.

According to the Australian Competition and Consumer Commission and National Competition Council (ACCC and NCC 2002, p. 22), these other factors could include ‘environmental considerations, regional development and equity’. Other factors might be in conflict with competition policy and the principle of economic efficiency employed

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in the objects clause. Also, non-economic objectives might not have measurable outcomes, which would adversely affect regulatory accountability.”⁶

Recommendation 7

That objective clause 6.1.1(c)(4) of the NER on the objectives of network pricing be deleted.

The review of this section has shown that all the objectives can be deleted as they are covered by the overriding objective in the NEL and could therefore be amended by the MCE, as there would be no change to the intent of the objectives.

3. Assessment of the Objectives of the Distribution Regulatory Regime

Clause 6.10.1 deals with State regulatory arrangements when states operate under the NER. This section is no longer required in a national framework and should be deleted.

The Draft NER has a series of objectives in clause 6.10.2 that states that the objectives of the distribution revenue regulatory regime to be administered by the AER include that they must seek to achieve the following outcomes:

- a) An efficient and cost effective regulatory environment
- b) 1&2 An incentive based regulatory regime, which provides an equitable allocation of efficiency gains between service providers and users and a sustainable commercial revenue stream, which includes a fair and reasonable rate of return on efficient investment for service providers;
- b) 3&4 Ensure consistency in the regulation of distribution networks and distribution pricing and provide for recovery of Transmission Use of System (TUOS) charges for relevant distribution customers in a manner that preserves location and time signals of the customer’s TUOS usage price;
- c) Prevention of monopoly rents;
- d) e) f) An environment that fosters efficient investment (O and M) in distribution and in upstream and downstream areas;
- g) Reasonable recognition of pre-existing government policies of asset values, revenue paths and prices;
- h) Promotion of competition in upstream and downstream markets and in distribution services where economically feasible;
- i) Reasonable regulatory accountability through transparency and public disclosure of regulatory processes and outcomes;

⁶ Productivity Commission, *ibid*, p.191

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- j) k) Reasonable certainty and consistency over time in regulatory outcomes and the balancing of the interests of service providers, users and the public interest;

3.1 Assessment of the Objectives of the Distribution Regulatory Regime

The assessment is based on the following principles:

- do the multiplicity of objectives conflict with each other;
- do they provide the regulator with clear and effective guidance;
- are they consistent with the new overarching objective based on efficiency as proposed for the NEL ;
- do they meet best practice regulatory principles;
- are they consistent with recommendations on the reform of the NGC; and
- is there any duplication of the objectives?

Objective clause 6.10.2(a)

This objective is concerned with an efficient and cost-effective regulatory environment. The efficiency part of the objective is covered by the overriding objective and should be deleted.

The second objective should remain, as it is a requirement of best regulatory practice and is part of the Victorian Essential Services Commission Act.

Recommendation 8

That objective clause 6.10.2(a) of the NER on the objectives of the distribution regulatory regime be revised to read:

That the regulatory model for distribution must be cost effective.

Objective clause 6.10.2(b)(1 & 2)

Both these so-called objectives are pricing principles and are considered later in this submission.

Objective clause 6.10.2(b)(3)

The need to ensure consistency in the regulation of connection to distribution networks and in distribution pricing is really a pricing principle rather than an objective and is considered later in the submission.

Objective clause 6.10.2(b)(4)

This objective is to ensure consistency in the regulation of distribution networks and distribution pricing and provide for recovery of TUOS charges for relevant distribution

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customers in a manner that preserves location and time signals of the customer's TUOS usage price.

This is really a pricing principle rather than an objective and is considered later in this submission.

Objective clause 6.10.2(c)

The promotion of competition in related markets and the constraints on monopoly power are the means by which the benefits of network efficiency improvements are transmitted to other parts of the electricity supply chain, to other industries and to final consumers. In this way, the promotion of network efficiency leads to economy wide efficiency improvements. Therefore for this reason this objective is covered by the overarching objective and can be deleted.

The prevention of monopoly rents is clearly in the long term interests of consumers and is therefore covered by the NEL overriding objective.

Recommendation 9

That objective clause 6.10.2(c) of the NER on the objectives of the distribution regulatory regime be deleted.

Objective clause 6.10.2(d)

This deals with efficient investment in upstream and downstream areas and the first part of the objective is another efficiency objective, which is covered by the overriding objective in the NEL.

The second part of this objective deals with upstream and downstream competition and as this is now covered in the overarching objective above can be deleted from this objective.

Recommendation 10

That objective clause 6.10.2(d) of the NER on the objectives of the distribution regulatory regime be deleted.

Objective clause 6.10.2(e)

This deals with the efficiency of operational and maintenance practices and is another efficiency objective that is covered by the overriding objective in the NEL, which refers to all practices.

Recommendation 11

That objective clause 6.10.2(e) of the NER on the objectives of the distribution regulatory regime be deleted.

Objective clause 6.10.2(f)

This deals with the efficiency of the existing use of infrastructure and is another efficiency objective that is covered by the overriding objective in the NEL, which refers to all uses.

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Recommendation 12

That objective clause 6.10.2(f) of the NER on the objectives of the distribution regulatory regime be deleted.

Objective clause 6.10.2(g)

The issue of pre-existing government policies is considered below in section 4.4 on asset valuation and other matters.

Objective clause 6.10.2(h)

This refers to the promotion of competition in upstream and downstream markets and in the provision of distribution services.

The Productivity Commission in the Inquiry into the NGC expressed some serious concern about the use of a “competition” objective given the wide possible interpretations of the term.

The second part of this objective deals with upstream and downstream competition and as this is now covered in the overarching objective above can be deleted from this objective.

Recommendation 13

That objective clause 6.10.2(h) of the NER on the objectives of the distribution regulatory regime be deleted.

Objective clause 6.10.2(i), (j) and (k)

These are not objectives of the distribution regulatory regime but principles of best regulatory practice to guide the regulator. However under this test they fail the requirement of regulatory best practice and they should not be in then objectives section.

Objective (i) uses the term “reasonable” and this does not provide any specific guidance for the regulator and the term should be removed.

Objective (j) also uses the term “reasonable” and refers to “the adaptive capabilities of participants” which also provide little guidance for regulators and this term should be removed.

Objective (k) refers to balancing interests between users and industry, which conflicts with the overriding objective in the NEL and should be deleted. In addition it also deals with the issue of the “public interest” which also conflicts with the NEL objective of the “long term benefit of consumers”.

The Productivity Commission has also criticised the use of the term “public interest.”

“There are a variety of other possible objectives of competition policy, apart from economic efficiency. A joint study by the World Bank and OECD (1999) on competition law and policy noted a spectrum of views on the objectives of competition policy, ranging from *economic efficiency* at one end of the spectrum to *public interest* at the other end. Public interest is a relatively broad concept embodying social factors that are

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inherently difficult to quantify and ‘loaded with value judgements’ (World Bank and OECD 1999, p. 1). The World Bank and OECD study concluded:

This overview of the different objectives of competition policy indicates that in most jurisdictions the basic objectives are to maintain and encourage competition in order to promote efficient use of resources while protecting the freedom of economic action of various market participants. (World Bank and OECD 1999, p. 8)⁷

Consequently the objectives reference to “public interest” is of limited interest in the NER for pricing principles.

Recommendation 14

That objectives (i, j and k) of the NER on the objectives of the distribution regulatory regime be deleted.

4. Assessment of the Principles of Distribution Services Prices

4.1 Introduction

In the Review of the National Access Regime the Productivity Commission argued that pricing principles in a best practice regulatory model were required to:

- provide better guidance on how the broad objectives of the regime should be applied in setting more detailed terms and conditions;
- provide a measure of certainty for regulated businesses and access seekers to help address concerns that a regulator’s own values will unduly influence decisions on terms and conditions;
- provide guidance on how the broad objectives of the regime should be applied in setting reference tariffs; and
- provide greater certainty for regulated businesses and access seekers, and reduce the scope for regulatory risk and error (arising from regulatory discretion).

The pricing principles in the draft NER in 6.10.3 include that the AER must administer in accordance with the principles that:

- distribution price regulation is best approached through the introduction of competition and where this cannot be achieved the form of regulation must be as described in clause 6.10.5 and must not be changed during a regulatory period;
- if the jurisdictional regulator proposes to amend the form of regulation in clause 6.10.5 they must give two years notice to the service provider and apply it at the next regulatory period and consult fully on the new form of regulation;
- the jurisdictional regulator must also have regard to the need to:

⁷ Productivity Commission. Ibid, p.177.

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- ❑ provide incentives and reasonable opportunities to increase efficiency
- ❑ create an environment in which *generation*, energy storage, demand side options and *network augmentation* options are given due and reasonable consideration;
- ❑ take account of and be consistent with the allocation of risk where this has been agreed between distribution service providers and Users;
- ❑ provide distribution service providers with a fair and reasonable risk-adjusted cash flow on efficient investment where:
 - assets subject to a take and pay contract are valued accordingly;
 - assets in service on 1 July 1999 are valued by the jurisdictional regulator providing it does not exceed deprival value
 - new assets after 1 July 1999 are valued by the jurisdictional regulator who must have regard to:
 - deprival value is the preferred approach to asset valuation;
 - such other matters to be consistent with clause 6.2.2; and
 - benchmark returns established by jurisdictional regulators are consistent with the asset valuation methodology and a commercial return on efficient investment;
- provide reasonable certainty and consistency over time of regulatory outcomes having regard to;
 - the need to balance the interests of service providers and users;
 - the capital intensive nature of the distribution sector;
 - the need to minimise the cost of regulatory actions and uncertainty;
 - previous regulatory decisions including:
 - the initial revenue cap and asset values set by jurisdictions in the context of the Competition Principles Agreement;
 - decisions made by relevant Ministers under jurisdictional legislation or jurisdictional regulators;

4.2 Assessment of the Distribution Pricing Principles.

The assessment is based on the following principles:

- do the multiplicity of principles conflict with each other;
- do they provide the regulator with clear and effective guidance;

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- are they consistent with the new overarching objective based on efficiency as proposed for the NEL;
- do they meet best practice regulatory principles;
- are they consistent with recommendations of reform of the NGC; and
- is there any duplication of the principles?

Pricing Principle (a) and (b)

These are poorly worded and can be simplified by combining and restructuring as set out below:

“Distribution pricing regulation is best approached through the introduction of competition and where this cannot be achieved the form of regulation to be applied is described in clause 6.10.5”

Recommendation 15

That pricing principle (a) and (b) of the NER on the principles for regulation of distribution service pricing be restructured as above.

Pricing Principle (c)

This principle states that the form of regulation must not be changed by the jurisdictional regulator during the regulatory period. In addition clause 6.10.3(d)(1) states that the regulator must give two years prior notice of a change before the commencement of the next regulatory period.

The form of regulation is a principle of best practice regulation that states the form must be consistent with the ability to exert monopoly control. In addition, it is a principle of code development supported by regulators that a code should not prescribe one method of regulation in case a better model comes along or if circumstances change.

However, the principles in other places appear to enshrine the Capital Asset Pricing Model as the required method of regulation. Thus this term should be revised to ensure that any new method could be introduced should circumstances change:

“Notwithstanding any other clause in the NER, the AER is responsible for determining whether sufficient competition exists or whether circumstances have changed to introduce more “light handed” regulation to distribution pricing, including Total Factor Productivity (TFP) or price monitoring or other pricing models should the regulated distribution company agree. The AER must not change the method of regulation within the regulatory period and give at least two years notice to the regulated utility.”

Recommendation 16

That pricing principle (c) of the NER on the principles for regulation of distribution services pricing be restructured as set out above.

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Pricing Principle (d)

In addition to the issue raised above clause (d)(2) states that in considering a change to the regulatory model the regulator must publish a description of the process to be followed and the timetable and allow adequate consultation with affected parties.

It is best practice regulation to consult fully over such a change and hence this clause should remain.

Recommendation 17

Retain pricing principle (d)(2) of the principles for distribution service pricing.

Pricing Principle (e)

Principle (e)(1), (2) and (3) state that the regulator must have regard to:

- providing incentives for efficiency
- creating an environment in which generation, energy storage, demand side options and network augmentations options are given due consideration; and
- take account of the allocation of risk where this has been agreed between Distribution Service Providers and Users.

The first area deals with efficiency incentives and this is considered in detail below in section 4.5 of this submission.

The major problem with this clause is the use of the term “ have regard to” which is subject to legal uncertainty and is therefore not best practice regulation. The authorities on the meaning of “to have regard to” establish that the expression “is capable of conveying different messages depending on its statutory context” (*Re: Dr Ken Michael AM; ex parte Epic Energy (WA) Nominees Pty Ltd & Anor* [2002] WASCA 231 at paragraph 55, see also *Sackville J in Singh v Minister for Immigration and Multicultural Affairs* [2001] FCA 389 at paragraph 54).

In comparison, *R v Hunt; Ex parte Sean Investments Pty Ltd* (1979) 180 CLR 322 stands for the proposition that a decision maker must give weight to the matter to which it must have regard as a fundamental element in a determination whereas *Rathborne v Abel* (1964) 38 ALJR 293 stands for the proposition that a direction to have regard to a particular matter would usually mean no more than a requirement to consider whether a matter should be given any, and if so what, weight (see Barwick CJ at 295).

The other two areas (2) and (3) should remain as they represent best practice regulatory principles of recognising past arrangements and contractual arrangements.

Principle (e)(5) requires the regulator to provide a fair and reasonable risk-adjusted rate of return on efficient costs and refers to a number of sub-clauses dealing with asset valuation which is considered below. This clause can be deleted as it deals with efficient investment which duplicates the overriding market objective and can be

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replaced by more up to date best practice pricing principles as set out in sections 4.3 and 5.5 of this submission.

Recommendation 18

Retain pricing principle (e)(2) and (3) of the principles for distribution service pricing and revise the clause to change “have regard to the need” to “must”

Delete principle (e)(5) of the principles for distribution service pricing.

Pricing Principle (6)

This principle requires the regulator to provide reasonable certainty and consistency over time of regulatory outcomes having regard to;

- the need to balance the interests of service providers and users;
- the capital intensive nature of the distribution sector;
- the need to minimise the cost of regulatory actions and uncertainty;
- previous regulatory decisions including:
 - the initial revenue cap and asset values set by jurisdictions in the context of the Competition Principles Agreement;
 - decisions made by relevant Ministers under jurisdictional legislation or jurisdictional regulators;

Principle (6)(i) refers to the balancing of the interests of users and service providers which conflicts with the overriding market objective in the NEL and should be deleted as it is inconsistent with the long term benefit of consumers.

Principle (6)(ii) refers to the capital intensive nature of the distribution sectors and this is stating the obvious and adds nothing to the regulatory pricing principles and should be deleted.

Principle (6)(iii) refers to the need to minimise the cost of regulatory actions and this is covered by objective (a) above and therefore is not required in the principles section.

Principle (6)(iv) refers to the need to take account of previous regulatory decisions which are likely no longer relevant. In addition this clause has been replaced by the proposals in section 4.4 below.

Recommendation 19

Delete principle (6) of the principles for distribution service pricing.

Other Pricing Principles

The objective removed above on the basis that it was a pricing principle was to ensure consistency in the regulation of distribution pricing and provide for recovery of TUOS charges for relevant distribution customers in a manner that preserves location and time signals of the customer’s TOUS usage price

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The first section of this clause referring to “consistency” has been considered further below in section 5.3 of this submission on best operational procedures.

The remainder of the objective dealing with recovery of TUOS charges and preservation of pricing signals should be retained.

Recommendation 20

This should be a new clause in the NER section for distribution service pricing.

4.3 New Best Practice Distribution Pricing Principles

A more modern set of pricing principles is required in the NER given the new market objective in the NEL which are best practice and consistent with the National Access Law.

To be more consistent with the National Gas Code and the proposed new access pricing principle in the Trade Practice Act the following should be placed in this section of the NER:

Recommendation 21

That regulated prices under the Building Blocks pricing model should be designed with regard to the overarching NEL objective and the following pricing principles:

(a) That regulated prices must:

- (i) be set so as to generate expected revenue for a service or services that is at least sufficient to meet the efficient costs of providing access to the service or services**
- (ii) include a return on investment commensurate with the regulatory and commercial risks involved**
- (iii) allow multi-part pricing and price discrimination when it aids efficiency**
- (iv) not allow a vertically integrated service provider to set terms and conditions that discriminate in favour of its associated businesses in upstream or downstream markets, except to the extent that the cost of providing access to non-associates is higher**
- (v) be set so as to provide incentives to reduce costs or otherwise improve productivity.**

4.4 Assessment of the Principles of Distribution Pricing –Asset Valuation and Jurisdictional Decisions

Asset Valuation

The asset valuation objectives are contained in various parts of this section 6.2.3 and direct the AER to “have regard to” which does not provide any regulatory certainty given the broad interpretations possible from this clause.

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This section also provides for:

- Assets established on 1 July 1999 are valued by the Jurisdictional Regulator providing it does not exceed the deprival value
- New assets or any subsequent revaluation of all assets is to be undertaken by the AER who must have regard to deprival values and be consistent with the principles in 6.2.2.
- Returns established by the AER are consistent with asset valuation methodologies and lead to a commercial economic return on efficient investment.
- The AER must have regard to the initial revenue setting and asset valuation decisions made by participating jurisdictions under the Competition Principles Agreement, decisions made by Ministers, jurisdictional regulators or the ACCC or the AER and any regulatory intentions previously expressed.

All regulators of electricity and gas distribution and transmission in Australia have adopted a DORC asset valuation rather than a Deprival value and the NER should reflect this change.

The NER allows the regulators to revalue the asset base at regular intervals, which is not the case with the National Gas Code. However, the ACCC have recently announced that they are planning to move away from the periodic revaluation of the capital base of transmission companies.

This change to ACCC practices is consistent with the operations of the NGC in asset valuation. The most important feature of the NGC and its clear advantage over the NER is that, once the initial regulatory asset base is set, that value is set forever, and there is no further reopening of that value (with the exception of identified redundant assets) at future price reviews. Updating the regulatory asset base to reflect new capital invested and the return of funds to investors (regulatory depreciation) provides greater certainty that investments made in the networks will be recovered, and thus provide further incentive for future investments.

UED supports the position that the initial asset valuation, providing it is based on the DORC valuation, should be fixed and updated as a historical cost as happens currently under the NGC. In addition, it also reflects existing practices in electricity as evidenced in the last price determination by the Victorian ESC for electricity distributors.

Recommendation 22

That the NER asset valuation section is revised to read:

The AER must:

- 1. Base asset valuations on the DORC methodology;**
- 2. Value assets created at any time under a *take or pay contract* in a manner consistent with the provisions of that contract;**
- 3. Adopt asset valuations made by a previous jurisdictional regulator where these are DORC based; and**

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4. Where relevant update asset valuations over time at actual cost and consider past expenditure as efficient.

Jurisdictional Decisions

There are a number of key issues that need to be considered in the development of a new national regulatory model. One of these is that if states retain non-economic regulation (eg. Safety, trade measurement, road management, etc.) then there needs to be a model where consultation occurs and the pass through of costs or cost recovery is allowed for utilities.

However, there are many differences between the states in regards to the regulation of distribution companies. In particular, in the regulation of Victorian electricity distribution businesses have appeal rights against pricing determinations under the Victorian Essential Services Commission Act. These rights do not exist for electricity distributors under the NER.

It would substantially disadvantage Victorian electricity distributors to lose merit appeal rights in any move to a national regulator. This is particularly important, as the Productivity Commission has proposed that adequate appeal rights are an essential component of a best practice regulatory model. In the development of the NER there should be a requirement to ensure that best practice regulation is maintained:

- Distributors moving to the AER should be able to retain all the benefits currently permitted by relevant state governments especially those on asset valuation and merit appeal rights which reflect best practice regulation; and
- A pass through model for jurisdiction imposed costs needs to be included in the NER to cover safety, environmental, service standards and any other legislation or statutory rules that impose costs on utilities.

Recommendation 23

That the NER should have a new clause that covers:

- **Distributors moving to the AER and the AEMC should be able to retain all benefits currently permitted by relevant state governments especially those on asset valuation and appeal rights;**
- **Distributors moving to the AER should be able to recover costs associated with government policies such as interval meter rollout; and**
- **There should be a pass through model for jurisdictional imposed costs placed in the NER as proposed in a previous UED submission to the MCE.**

4.5 Incentives and Efficiency Gains in the NER

The two energy codes are different in their approach to incentives and efficiency gains. The NGC allows an efficiency carryover model while the NER is silent on the

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matter⁸. Efficiency carryover schemes enable service providers to keep the benefits of beating the benchmark costs for a certain length of time beyond the current access period.

While the pricing principles set out above allow that they should “*be set so as to provide incentives to reduce costs or otherwise improve productivity*” the Productivity Commission in the National Gas Access Inquiry proposed a role for such carryover models:

“The Commission notes that in a competitive market at least some of the benefits of productivity improvements tend to be redistributed eventually to customers as lower prices. If a pipeline has market power, then such a distribution is less likely to occur and this might inhibit more efficient outcome in upstream and downstream markets. Thus there appears to be a case for regulators to distribute at least some of the efficiency gains of such schemes to users”⁹

Recommendation 24

That a requirement for efficiency carry over be introduced into the NER to provide a more incentive driven regulator model. That this new section be based on the section in the NGC.

5. Form and Mechanism of Distribution Economic Regulation

5.1 Introduction

The form and operations of the regulator in respect of distribution pricing are set out in Section 6.10.5 of the NER. This allows that:

- economic regulation must be $CPI - X$ and the regulator can take account of the performance with service standards provided it is consistent with clauses 6.10.2 and 6.10.3;
- the regulator must set a revenue cap, a weighted price cap or a combination of the two for a minimum period of three years;
- in setting prices the regulator must have regard to demand growth, energy consumption by sector, the length of the network and service standards imposed by the regulatory regime, price stability, reasonable judgements on efficiency gains, the weighted average cost of capital having regard to the risks and a fair rate of return on efficient investment, the right to recover costs from any taxes paid and payments to any embedded generators and energy storage, any correction factors from previous regulatory periods, any reduction or increase in

⁸ However, some regulators of electricity distributors allow a carryover model to operate. For example, the Victorian ESC allows such a model as the Victorian Government has derogated the operations of the NER so pricing in Victoria follows the Essential Services Commission Act.

⁹ Productivity Commission. Ibid, pp. 246-247

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energy losses, the ongoing commercial viability of the industry, and any other financial indicator.

- the regulator may revoke a determination if it was set on false or misleading material, or there was a material error and the parties agree;
- the regulator may make a new revenue determination if it has revoked a previous determination for the remainder of the regulatory period; and
- prior to the end of the regulatory period the regulator must publish a description of the process and timetable for re-setting the regulatory cap to apply in the next regulatory period.

5.2 Assessment of the Form and Mechanism of Distribution Economic Regulation

There are a number of problems with this section including the:

- use of the term “have regard to” which is subject to legal uncertainty and is therefore not best practice regulation;
- that the process related requirements are not separated from the other details;
- details only allow a CPI-X approach and this is inconsistent with other regulatory controls such as price monitoring;
- there is duplication in some of the clauses and some inconsistency with the NEL over-riding objective; and
- the whole section could be substantially simplified.

Principles (a), (b) and (c)

Clause (a) specifies one form of regulation – CPI-X – which has traditionally been seen as the Building Blocks pricing model. Clause (b) specifies the form of the regulatory cap and clause (c) refers to the minimum period of three years.

Recommendation 16 above dealt with this issue of only specifying one regulatory model and this clause (a) should remain in the NER. Clause (b) should also be retained given and clause (c) should remain with the term of the regulatory period increased to 5 years, which is the same as electricity transmission and gas regulatory periods.

Recommendation 25

That clauses 6.10.5(a) and (b) of the NER should be retained in the NER.

That clause (c) be amended to increase the regulatory term to a minimum of five years.

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Principle (d)

This clause refers when the regulator sets prices they must have regard to:

- demand growth,
- energy consumption by sector,
- the length of the network and service standards imposed by the regulatory regime,
- price stability,
- reasonable judgements on efficiency gains,
- the weighted average cost of capital having regard to the risks and a fair rate of return on efficient investment,
- the right to recover costs from any taxes paid and payments to any embedded generators and energy storage,
- any correction factors from previous regulatory periods, any reduction or increase in energy losses,
- the ongoing commercial viability of the industry, and
- any other financial indicator.

The major problem with this clause is the use of the term “have regard to” which is subject to legal uncertainty and is therefore not best practice regulation.

The issues of price stability has also been raised above. Price stability is clearly an objective of the long-term benefit of consumers in light of the safety, reliability, quality and security of the networks and is therefore not required as a separate principle.

The issue of the ongoing viability of the industry is dealt with in section 5.4 of this submission and should be retained. The issue of efficiency gains and cost recovery is dealt with in section 4.5 of this submission.

It is not likely to be necessary to specify that a regulator must consider demand growth, customers demand levels, energy losses and the length of the network and these should be deleted.

The clause on the Weighted Average Cost of Capital can be deleted as the recommendations in sections 4.3 and 5.5 of this submission above have dealt with this issue.

The clause (11) refers to the use of any other financial indicator, which provides no useful information for the regulator and should be deleted.

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Recommendation 26

That clauses 6.10.5(d)(1)(i), (ii), (iii) and (iv), (d)(3), (d)(5), (d)(6), (d)(7)(i), (d)(9) and (d)(11) should be deleted in the NER.

That clause (d) be amended to refer to “must” rather than “have regard to”.

Principles (e), (f) and (g)

Principle (e) refers to the issue that the regulator may revoke a determination if it was set on false or misleading material or there was a material error and the parties agree;

Clause (f) states that the regulator may make a new revenue determination if they have revoked a previous determination for the remained of the regulatory period; and Clause (g) sets out the necessary consultation arrangements to re-set prices in the next regulatory period.

These terms are consistent with the National Gas Code and should remain in the NER as they reflect best regulatory practice.

Recommendation 27

That principles (e) (f) and (g) of 10.2.5 are retained in the NER.

5.3 New Performance Requirements for the Regulator

The AER should follow best practice operational procedures. Such a best practice approach implies a more detailed approach to consultation by the AER instead of the clauses set out above. This best practice approach could include the following:

- the AER may produce an issues paper that stimulates debate on the issues;
- the service provider submits a proposed pricing approach and access terms;
- the AER produces a draft determination which is based on a detailed examination of the service provider’s submission and other submissions against the NER objectives;
- the AER makes available its relevant staff for consultation with the service provider and other interested parties; and
- the AER reviews further submissions from the service provider and the public before producing a final determination that meets the objectives and pricing principles of the NER.

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Recommendation 28

That the changes set out above are used to amend the NER on the consultation framework.

5.4 Other Issues in Operational Regulations - Ongoing Financial Viability

Clause (8) of the NER states that the AER must have regard to the on-going commercial viability of the transmission industry.

The ongoing financial viability of the distribution industry is a common feature of the Victorian legislation and should remain a pricing objective as it reinforces the intent of the other recommended pricing principles.

UED believes that adopting the objective from the ESC Act adds to the security of the industry in terms of the new national regulatory model and is not inconsistent with the efficiency objective of the NEL.

Recommendation 29

That ongoing financial viability of the industry is used as a guiding pricing principle in the NEL to reinforce the “efficiency” objective and that principle 6.10.5(d)(10) is retained in the NER.

5.5 Other Issues in Operational Regulations - Dealing with Uncertainty

In order to calculate target revenue, it is necessary to set an *ex ante* regulatory rate of return on capital. This expected rate of return is generally required to be commensurate with prevailing conditions in the market for funds and the risk involved in delivering relevant reference services.

The rate of return is usually based on an estimate of the Weighted Average Cost of Capital (WACC). This weights the rates of return required by a business's equity investors and debt providers by, respectively, the amount of equity and debt relative to the business's total capital.

There have been substantial concern expressed by academics, industry participants and others about the uncertainty of the empirical basis of the Capital Asset Pricing Model (CAPM) or WACC model that has been reflected in the Productivity Commission's reviews of the Gas Access Regime and the National Access Regime. This concern led the Productivity Commission in the Review of the Gas Access Regime to recommend a different regulatory model and to reform the use of the WACC in regulatory pricing decisions.

While the debt costs of a service provider are relatively straightforward to assess, the return required by equity investors is not. The return on equity is typically estimated using the CAPM. This method depends on the measurement of two contentious variables — a service provider's 'beta' (a measure of its risk relative to that of the total market for risky investments) and the market risk premium.

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In the NGC Inquiry the Productivity Commission concluded that:

“Implementing the WACC/CAPM approach is not a precise science, given the numerous debatable assumptions involved. There is even disagreement on the precise formulas to use, due to different views on how issues such as tax should be treated. Hence, a range of plausible values can be generated for the regulatory rate of return using the WACC/CAPM approach. This in turn implies that it does not automatically lead to a single indisputable number for a reference tariff.”¹⁰

And

“An important insight from the Tribunal’s decisions is that the regulator’s role is to assess whether an Access Arrangement falls within a reasonable range before amending it. This is a fundamentally different approach from that which has been adopted by regulators to date, where the regulator has felt empowered to substitute its view for that of the service provider, irrespective of whether or not the service provider’s position fell within a reasonable range. (sub. DR100, p. 11)”¹¹

Given that the CAPM is a theoretical model based on debatable assumptions, the Productivity Commission was concerned that the model has become a de facto requirement under the regulatory regime. The Productivity Commission considered that it needed to be made more explicit that there is no single correct method to calculate a rate of return and there can be a range of plausible values used in applying a method. Such a conclusion would also be made in respect of regulatory pricing decisions under the NEC that is also based on the CAPM or WACC model.

Recommendation 30

That a new objective is placed in the NER, which states that:

If a Rate of Return is used in determining a Reference Tariff then the method used to calculate the Rate of Return and the values used in applying that method shall in the first instance be proposed by the Service Provider.

In assessing the Service Provider’s proposal the AER must take account of the fact that there is no single correct method to determine a Rate of Return and there is often a range of plausible estimates that could be used in applying a Rate of Return method.

The role of the AER is therefore to assess whether the Service Provider’s:

- (a) proposed method has a plausible conceptual basis; and**
- (b) values used in applying the method lie within the range of plausible estimates.**

The AER must approve the proposed method if (a) is satisfied. The AER must approve the values used in applying a method if (b) is satisfied.

¹⁰ Productivity Commission, *ibid*, p 296.

¹¹ Productivity Commission, *ibid*, p 299.

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5.6 Other Issues in Operational Regulations Safe and Reliable Operation of the Network

A key objective in the NGC which was supported by the Productivity Commission in the Inquiry into the NGC is Section 2.24(c) that states that a regulator must take into account 'the operational and technical requirements necessary for the safe and reliable operation of the covered pipeline' when assessing a proposed access arrangement. Safety standards must be met irrespective of market conditions and access arrangements.

In addition, clause 6(3) of the Competition Policy Agreements (CPA) requires that, for an access regime to conform to the principles, it should apply to services where:

- (a)(iii) the safe use of the facility by the person seeking access can be ensured at an economically feasible cost and, if there is a safety requirement, appropriate regulatory arrangements exist ...

Safety issues are most likely to be of relevance at the time a third party user seeks access, rather than at the time a coverage decision is made. Further, one argument for an industry-specific access regime for electricity is that there is potential for many third party access seekers. This suggests that it is important to include this requirement in the NER as a factor to be considered in pricing decisions.

While the new NEL market objective deals with safety UED considers that it is such an important matter that should be considered by the regulator in every pricing decision that it should be separately listed in the principles section.

Recommendation 31

That the new objective is placed in the NER based on the above clause in the CPA.

6. Assessment of the Objectives of the Transmission Regulatory Regime

6.1 Introduction

The Draft NER has a series of specific objectives in 6.2.2 that state that the objectives of the transmission revenue regulatory regime to be administered by the AER must seek to achieve the outcomes which are almost identical to the requirements in distribution regulation

The same arguments as advanced in the distribution objectives can be used to revise the transmission objective to develop an effective and efficient energy code.

6.2 Assessment of the Principles of the Transmission Regulatory Regime

The pricing principles in the draft NER in 6.2.3 are almost identical to the distribution principles and hence the assessment of the distribution principles can be applied to the transmission principles.

6.3 Form and Mechanism of Economic Regulation

The form and operations of the AER in respect of transmission pricing are set out in Section 6.2.4 of the NER and are almost the same as the form and operation of distribution regulation. Hence the analysis of the distribution section can also be applied to this transmissions section.

Recommendation 32

That the changes to the NER recommended in distribution regulation also be applied where relevant to transmission objectives, pricing principles and the form of regulation.