

Submission to the MCE Standing Committee of Officials

Re: National Framework for Energy Distribution and Retail Regulation: Response to paper prepared by NERA and Gilbert + Tobin



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National Framework for Energy Distribution and Retail Regulation

1 Introduction

In October 2005, the Ministerial Council on Energy (MCE) Standing Committee of Officials (SCO) published a paper (the “Consultants’ Paper”) prepared by NERA Economic Consulting and Gilbert + Tobin, setting out a proposal for a nationally legislated framework for distribution and retail regulation rules made and administered by the Australian Energy Market Commission and enforced by the Australian Energy Regulator.

This submission is United Energy Distribution (UED) and Multinet’s response to the Consultants’ Paper.

The submission is structured as follows:

- Section 2 provides background and context to this submission by:
 - recapping on UED and Multinet’s earlier submission; and
 - noting the further developments that have taken place since the publication of the Consultants’ Paper.
- Section 3 sets out UED and Multinet’s comments on Part A (legal architecture and institutional framework) of the Consultants’ Paper.
- Section 4 sets out comments on Part B (scope of distribution price regulation).
- Section 5 sets out comments on Part C (customer protection).
- Section 6 sets out UED and Multinet’s comments on Part D (other distribution and non-price retail regulation issues).
- Section 7 sets out concluding comments.

2 Background and context of this submission

2.1 Proposed schedule for transfer of functions to a national regime

UED and Multinet have previously made a submission to the document titled *Proposed Framework Schedule for Transfer of Distribution and Retail Functions*. That document is a high-level listing of functions, drawn from the Consultants’ Paper, and highlighted the decisions that need to be made including:

- which functions should be transferred to the new governance arrangements;
- whether the functions should be nationally-uniform or jurisdiction-specific;
- whether any functions should remain with jurisdictional regulators (apart from general safety, environmental and similar functions not part of standard economic regulation);

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- whether any existing economic regulation functions would be redundant under a national framework; and
- the appropriate timing of any transfers.

UED and Multinet's earlier submission remains relevant to the issues addressed in the Consultants' Paper. In particular, the earlier submission commented on:

- the principles that should guide the development of a national regulatory framework for distribution;
- the practical operation of the proposed legal architecture that will give effect to the national framework;
- the implications of the Australian Energy Markets Commission's (AEMC) Review of Chapter 6 Rules relating to electricity transmission revenue determination and pricing;
- the principles that should govern the transition arrangements and the timing for transferring functions to the national framework; and
- the proposed framework schedule for the transfer of distribution and retail functions.

Where appropriate this submission reiterates some of the comments made in UED and Multinet's earlier submission.

2.2 Further recent developments

A number of developments have taken place since the publication of the Consultants' Paper.

- The MCE is scheduled to finalise its response to the Productivity Commission *Review of the Gas Access Regime* through December 2005.
- As part of that process, the MCE has recently appointed an Expert Panel to examine a range of energy access pricing issues, with the explicit task of seeking a consistent regulatory framework which could be applied to energy distribution and transmission businesses.¹
- The AEMC has released Issues Papers on transmission revenue regulation and pricing.

Under its terms of reference, the Expert Panel will provide recommendations to the MCE on a range of policy issues relating to energy distribution pricing and regulation, as well as advising the MCE on a model to achieve a common approach to revenue and network pricing regulation across the energy market. The work of the Expert Panel therefore supersedes that previously commissioned by the Standing Committee of Officials (SCO),

¹ Ministerial Council on Energy, *Energy Market Reform Bulletin No. 56: Expert Panel Review of Revenue and Network Pricing across the Energy Market*, 7 December 2005.

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and set out in Part B of the Consultants' Report. On this basis, it would be inappropriate for the SCO to progress work on revenue and price regulation issues until the Expert Panel has completed its review and reported to the MCE.

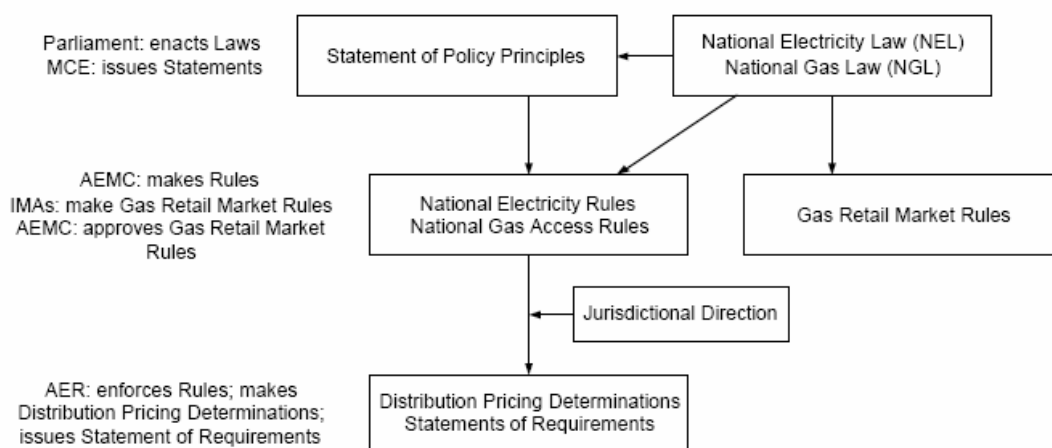
The companies support the full implementation of the recommendations made by the Productivity Commission's Inquiry into the National Gas Access regime. The companies also strongly support the use of the pricing principles articulated in the Inquiry recommendations as the basis of a nationally uniform approach to distribution and transmission regulation. UED and Multinet will be making appropriate submissions to the Expert Panel on these issues.

It is equally important that the AEMC review is co-ordinated with the work of the Expert Panel. The timetable for the AEMC review will require that review to come to a final position on matters of detail relating to the design of the regulatory regime to apply to electricity transmission providers. On this basis, there appears to be some risk that the AEMC review, which is limited to electricity transmission, may nonetheless set precedents which apply more broadly to the regulation of energy networks. Such an outcome would neglect the important work of the Productivity Commission and ignore the differences between transmission and distribution networks.

3 Part A: Legal architecture and institutional framework

Section 3 of the Consultants' Paper provides an overview of the legal architecture associated with the recommended national approach. The legal architecture is shown schematically in Figure 1 below.

Figure 1: Legal Architecture of Recommended Approach



Source: *Public Consultation on a National Framework for Energy Distribution and Retail Regulation*, prepared by NERA Economic Consulting and Gilbert + Tobin for the SCO, May 2005, page 7.

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UED and Multinet support the intention to separate of the functions of:

- policy-making (the province of the MCE);
- rule-making (the province of the AEMC); and
- enforcement (the province of the Australian Energy Regulator (AER), and subject to limited Jurisdictional direction in a small number of specified matters).

In UED and Multinet's earlier submission, the companies noted that in practice the distinction between policy-making, rule-making and enforcement is likely to be somewhat blurred. Therefore, the companies argue that it will be necessary for policy-makers and the regulatory bodies to exercise vigilance in maintaining the integrity of the delineation of functions outlined in the proposed legal architecture. It will also be necessary for all parties to exercise common sense and pragmatism in applying the legal architecture to deliver its broader objectives. These comments remain valid.

UED and Multinet would like to comment on the following three issues in relation to the legal architecture and institutional structure:

- Jurisdictional directions;
- transfer of responsibilities and development of national rules; and
- licensing arrangements.

3.1 Jurisdictional directions and jurisdictions' roles in setting service standards

The Consultants' Paper proposes that the Government of each jurisdiction can require that:

- (a) in making regulatory determinations the AER must have regard for tariff equalisation matters, specified values for certain identified assets, community service obligations, environmental obligations and taxes or levies; and
- (b) retailers and distributors must comply with distribution tariff equalisation, community service obligations, environmental obligations and taxes or levies.

UED and Multinet recognise that there is a need for jurisdictions to be able to direct the AER to have regard to the matters listed in paragraph (a) above. The companies strongly concur with the statement made on page 8 of the Consultants' Paper regarding the need to limit the scope of matters that can be addressed through Jurisdictional Directions; the scope of such Directions must be strictly limited to the matters set out in paragraph (a).

It is noteworthy that page 8 of the Consultants' Paper states:

"The recommendation for Jurisdictional Directions is unlike the current National Electricity Code derogations and jurisdictional derogations in that the Jurisdictional Directions would not comprise an exemption from or an alteration to the Rules. Rather,

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the Jurisdictional Directions would require the AER when applying the Rules to take account of the specific additional matters set out in the Jurisdictional Direction.”

UED and Multinet strongly agree with this statement.

The companies also support the proposal that Jurisdictions should determine the average and minimum service performance targets applicable to regulated network businesses. In this context, the companies strongly concur with the following statement, which appears on page 32 of the Consultants’ Report:

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

Indeed, under the new national framework, it will be essential to ensure that the AER is *formally required* to recognise the costs incurred by each network business in complying with the service standards set by the relevant Jurisdiction.

The issue of setting national service standards is complex. To account for this problem jurisdictional government must be given the opportunity and responsibility to set minimum service standards as they are responsible for state economic development (where service standards are important for a modern industrial economy) and for their residents’ standard of living. They set service standards on behalf of their citizens, although in some circumstances an enhanced standard can be agreed between a customer and the distributor on a user pays basis.

In summary, UED and Multinet believe that jurisdictional directions should operate within the following framework:

- jurisdictional directions should be limited to issues that are local rather than national;
- jurisdictional directions should only be imposed through legislation or regulation;
- the AER must recognise jurisdictional directions and any costs arising in price reviews; and
- within period jurisdictional directions that have adverse financial consequences for a distributor should be subject to a pass-through.

3.2 Transfer of responsibilities and development of national rules

UED and Multinet support the legal architecture set out in the Consultants’ Paper, providing that:

- there are properly developed arrangements for transitioning from existing jurisdictional rules to the National Rules;
- there is a clear allocation of responsibility for enforcement of rules transitionally and long term;

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- there is a well-defined process for developing and approving the new national distribution rules that includes industry involvement in the development and approval of rules; and
- there is an effective process for on-going management and execution of functions that are not transferred to the national regime.

It is also essential that the AEMC is adequately resourced, both through funding and appropriate staff, to manage the considerable workload that this process would entail.

UED and Multinet consider that it would not be possible to develop a full set of national rules to apply to the distribution sector before 1 January 2007. Attempting such an undertaking would risk insufficient consultation on key regulatory provisions, possibly meaning that issues of jurisdictional difference that may adversely affect businesses and customers may not be able to be considered and addressed appropriately in the new framework.

UED and Multinet consider that it is far more desirable to take the time required to ensure that the national rules are appropriate, take account of all interests, and are workable, than to rush through a framework that may not meet the needs of the community. There may be some areas, however, such as detailed rules relating to pricing and access, where there has already been considerable debate; in such cases, it may be possible to develop rules before the transfer of functions.

The companies reiterate the points made in their earlier submission regarding the high-level principles that should apply to the transition to the new arrangements:

- The companies should not incur any financial or economic loss as a result of the transfer of regulatory functions to the new national regime.
- Pre-existing contractual rights and obligations should not be affected by the new national regime.
- Additional costs incurred by the companies in implementing and administering systems and processes under the national regime should be taken into account in future regulatory pricing determinations, to ensure that the companies are fully compensated for such costs.

3.3 Licensing

The Consultants' Paper argues that with limited exceptions the use of other forms of regulatory instruments (such as Codes, licences, mandatory Guidelines and Regulations) to apply regulatory obligations would be discontinued thus simplifying the regulatory environment.

The Consultants' Paper proposes that there will be no national distribution or retail licensing/authorisation regime. Instead, the Paper proposes that distribution licences (or business authorisations) remain a jurisdictional responsibility, and relate mainly to safety,

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environmental and technical regulation. Retail licences would no longer be required at all under the framework.²

It is important to note, however, that the role of licensing differs between retail and distribution businesses. In particular, for distribution businesses licences typically:

- allocate responsibility to the asset owner for compliance with network safety and environmental standards; and
- confer rights on the asset owner to conduct its network business within a designated franchise area.

In contrast, as retailers do not own networks the scope of the retail licence is slightly different. In relation to distribution licences, UED and Multinet have the following observations:

Allocation of responsibility

Legal responsibility for compliance currently clearly rests with the licence holder. It is important that under an arrangement where there is not a licence in place, the legal obligation for compliance with jurisdictional and national laws, rules and regulations clearly rests on the appropriate party. UED and Multinet consider that this party should be the asset owner, rather than the asset operators, because:

- asset operators are contracted to the licensee (the asset owner) to manage or operate the assets, or to undertake certain functions as agents of the asset owner;
- there may be many different asset operators contracted to provide services to the asset owner; and
- the asset operators may change from time to time as a result of contractual changes.

Conferral of rights and obligations

Licences do not only impose obligations on licence holders. Licences currently confer a number of rights on licence holders, including franchise areas and access to private property and easements. Licences are a simple tool for granting these rights, as a licence refers to a particular party as holding these rights, rather than legislation which usually refers to a class of person with rights. It is possible, however, that this issue could be addressed through regulations, which are more readily changed than legislative provisions and therefore can refer to particular parties.

² Ministerial Council on Energy Standing Committee of Officials, *Public Consultation on a national framework for energy distribution and retail regulation*, prepared by NERA and Gilbert + Tobin, May 2005 pp 65-6.

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Avoiding “gaps” in the regulatory framework

UED and Multinet support the view that barriers to entry and duplication of regulatory obligations should be reduced wherever possible. In this regard, to the extent that the licensing regimes create unnecessary barriers to entry, UED and Multinet support their abolition.

However, care needs to be taken to ensure that the proposed abolition of the licensing regime does not create gaps in the regulatory regime. At present, the effectiveness of the regulatory framework in the gas and electricity industries relies on the interdependencies between:

- (a) Legislation;
- (b) Codes, guidelines and regulations;
- (c) Licences; and
- (d) Use of system agreements or access arrangements.

A new framework could be developed which removed licences and instead imposed obligations, rights and responsibilities through one or more of the remaining framework elements. It is important, however, that the architects of the new framework ensure that the following ‘design principles’ are satisfied:

- ‘Gaps’ are not created in the new framework as a result of removing the licensing regime; and
- Roles, responsibilities, rights and obligations should remain unchanged, or if there is a change then this needs to be fully recognised in the revenue-setting processes.

In summary, UED and Multinet support the removal of the licensing regime, providing that the above design principles are met. It follows from these principles that simply removing the licensing regime, without also considering how the remaining elements of the framework should change, is likely to create undesirable gaps in the framework.

4 Part B: Scope of distribution price regulation

As noted in section 2, the work of the MCE’s Expert Panel to address the issue of network pricing and regulation should inform the SCO’s work in relation to distribution price regulation. In fact, UED and Multinet recommend that the SCO ceases its work in relation to distribution price regulation until the Expert Panel concludes its work.

As already noted, UED and Multinet will be lodging submissions to the Expert Panel. In the meantime however, we refer the SCO to UED and Multinet’s submission to the framework paper, which provided a high-level response to each of the issues raised in relation to distribution price regulation.

5 Part C: Customer protection

UED and Multinet generally support the Consultants' recommended approach to customer protection, which is to impose obligations directly on parties engaging in distribution and/or retailing activities rather than indirectly as a condition or regulation applying to holders of licenses or business authorisations. However, UED and Multinet refer the SCO to the companies' earlier comments in relation to the proposal to abolish the licensing regime.

Matters relating to retailers' obligations to supply small consumers do not directly affect UED and Multinet as distributors, and hence the companies do not have any comments in relation to those matters.

UED and Multinet do have specific comments in relation to the contractual arrangements and obligations to supply between distributors and end customers. These are set out below.

Relationship between customers, distributors and retailers

The Consultants' Paper states that a direct contractual relationship between distributor and end-customer is preferred. It argues that the principal benefit of requiring a direct contractual relationship between a distributor and an end-customer is that it can and should allocate rights and liabilities between those two parties in relation to losses that may arise from a failure in the distribution network.

The Consultants' Paper discusses the following issues on the basis that a triangular relationship is adopted:

- Distributor disconnections and reconnections of small end customers; and
- Distributor / small end-customer dispute resolution.

UED and Multinet note that these issues are inextricably linked with the issue of the relationship between distributors, retailers and customers. The Consultants' Paper wrongly assumes that a triangular relationship should be adopted. UED and Multinet believe that SCO should reconsider this position and adopt a predominantly straight line relationship as this minimises cost and effectively allocates risks and responsibilities.

UED and Multinet do not support the arbitrary assignment of a single approach to supply contracting between customers, distributors and retailers for electricity and gas. In the Victorian gas sector, the relationship between customers, retailers and distributors is predominantly "straight-line" and these arrangements have worked well in terms of effectiveness and cost efficiency.

The arrangements in the Victorian electricity distribution sector are also characterised by a general straight-line relationship, although there is a default contract between customers and the distributor. The Use of System Agreement defines the existing relationship and allocates roles, responsibilities and liabilities accordingly.

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Use of system agreements

In the gas sector the terms and conditions of access form part of the regulatory approval process every five years. For example, Multinet's access terms and conditions were submitted for regulatory approval as part of Multinet Access Arrangement review. There are minor differences between the approved default terms and conditions for each distributor in Victoria which reflect local differences. However, these terms and conditions have been changed into a Use of System Agreement and have been signed by retailers, who are also able to negotiate higher standards.

In electricity regulation in Victoria, UED also proposed a default Use of System Agreement to the local regulator which must be approved by the regulator. Similar to gas minor differences are allowed and higher terms can be negotiated by retailers.

The linking of the regulatory approval of the Use of System Agreement with the price review is important as a change in the risk allocations between the parties to the Agreement may require a change in the pricing area. Under the proposed approach in the Consultants' Paper is unclear how any changes in the costs and risks would be coordinated. The companies therefore question whether the Consultants' proposal in this area would meet the public benefit test.

UED and Multinet are also concerned that the Consultants' Paper recommends an approach to regulating the relationship between distributors and retailers, involving the development of a default use of system agreement by the AEMC. UED does not consider that such an approach represents best regulatory practice.

In contrast to the approach contemplated in the Consultants' Paper, the Victorian gas sector is an effective regime in which terms and conditions are proposed by the service provider, and then approved by the regulator if the proposal satisfies the criteria set out in the Gas Code. This arrangement correctly places primary responsibility on the service provider to propose access terms and conditions, and if necessary to modify these to meet the criteria set out in the Gas Code (a propose/respond model). These arrangements are much preferred to arrangements where the AEMC sets default Use of System Agreements independently of the revenue-setting process.

UED and Multinet consider that the model in gas where terms and conditions proposed by the service provider and considered as part of the review of the access arrangements has a number of benefits for a national model. In addition, as electricity regulation will also be an approved access arrangement under the new national approach to regulation the gas model could also be applied to electricity. Such an arrangement would be effective and efficient public policy because:

- it allows for different terms and conditions that reflect essential jurisdictional differences (eg the terms and conditions of access may be quite different where vertical integration is common and where there is no or little retail competition);

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- the linking of terms and conditions with the price review makes sense as a change in the allocation of rights and responsibilities between the parties may have implications for the WACC;
- the gas access regime is a national arrangement and if these arrangements are reflected in electricity regulation then the approach will be a national process for energy markets; and
- this will assist in the simplification of the national approach by eliminating licenses providing that essential jurisdictional matters are transferred to relevant jurisdictional legislation or regulation and other relevant matters are included in national regulation.

Finally, UED and Multinet note the comment on page 69 of the Consultants' Paper that "the effectiveness of consumer protection regimes will be compromised by suboptimal dealings between distributors and retailers." Contrary to the view expressed in the Consultants' Paper, UED and Multinet do not believe that Use of System Agreements play an important role in customer protection. It is vitally important that the MCE fully understands the role and scope of Use of System Agreements before making detailed policy decisions.

6 Part D: Other distribution and non-price retail regulation

This section addresses each of the issues addressed in Part D of the Consultants' Paper.

a) Business authorisation (Section 2)

As noted earlier in this submission, the Consultants' Paper argues that licensing/authorisation regimes create barriers to entry and regulatory costs that should only be imposed where it is clear that the benefits of the regime outweigh its costs. For the reasons set out in section 3 and 5 of this submission, UED and Multinet believe that the MCE should give this issue more careful consideration before abolishing or substantially diminishing the scope of the licensing regime.

b) Distribution interface with retailers (Section 3)

Please refer to the comments in section 5 of this paper in relation to Use of System agreements.

c) Distribution interface with embedded generators (Section 4)

UED and Multinet support the development of national rules for the connection and operation of embedded generators. However, further work is required to resolve issues such as:

- the role of embedded generation in the network with regard to network augmentation;
- the degree to which embedded generators should bear the costs of connection compared to load connections which generally do not bear specific costs;

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- the appropriate allocation of service performance risk where embedded generators accept payment for avoided network costs; and
- the appropriate treatment of the various classes of embedded generation. In particular, there may be merit in determining a hierarchy of classes (by size, type) of embedded generation for the purposes of charging and connection agreements.

d) Balancing regimes, settlements, customer transfers within the balancing and settlements system (Section 5)

The Consultants Paper argues that:

“Consumer protection rules in relation to the connection, disconnection or transfer of customers must not conflict with the regime(s) for balancing systems, supply/consumption reconciliation and settlements and customer transfers. If there is no national framework for the regime(s) for balancing systems, supply/consumption reconciliation and settlements and customer transfers any attempts to implement national energy regimes for consumer protection and distribution price regulation will risk being ineffective.”

UED and Multinet are not convinced that the case for national harmonization has been made. In particular, the case for harmonization appears problematic where different Jurisdictions have different market models (as is presently the case in gas). Any proposal for harmonization should be subject to a full and rigorous cost-benefit analysis.

e) Metering (Section 6)

The Consultants’ Paper argues that if there is no national framework for the regime(s) for metering, any attempts to implement national energy regimes for consumer protection and distribution price regulation will risk being ineffective. Whilst ‘a national framework’ may be desirable, UED and Multinet are not convinced that customer protection and distribution price regulation depend on it. Moreover, it is essential that any national framework takes account of Jurisdictional differences, for example Interval Meter Roll Out (IMRO) in Victoria but not other States, and pre-payment meters in SA and NSW but not in Victoria.

f) Load shedding and curtailment (Section 7)

It is important to recognise that under the present Load Shedding Rules, each Jurisdiction determines the hierarchy of classes of customers and the order in which these classes are to have their respective supplies of electricity or gas shed/curtailed. In Victoria, VENCORP chairs the Demand Reduction Committee, which contains representatives from a range of stakeholder organizations across industry and government. Given the sensitivity associated with determining load shedding priorities, it seems likely that the Jurisdictions would have a legitimate desire to continue to make such determinations.

On this basis, UED and Multinet support the approach set out in the Consultants’ Paper, noting that the Rules should continue to permit Jurisdictions to manage transparently the impact of any load shedding that is directed by NEMMCO.

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g) Retailer failure arrangements (Section 8)

UED and Multinet support the main elements of the retailer failure arrangements set out in the Consultants' Paper. It is essential to ensure that there are clear rules establishing the parties responsible for supply after retailer failure, as well as the rules of that supply, both over the short term with the transfer of any liabilities, and the longer term as the customer moves to alternative retail arrangements.

UED and Multinet believe that further consideration of whether it is appropriate to designate distribution businesses as step-in retailers, particularly given that many of these businesses do not have current retail responsibilities. Jurisdictions need to agree on cost recovery arrangements for DBs in the event of retailer failure.

h) Interaction with government policies (Section 9)

Refer to earlier comments in section 3.1 of this submission on jurisdictional directions.

7 Concluding comments

The commitment by energy Ministers to transfer distribution regulation to the national arrangements by 1 January 2007 sets an ambitious timeframe for governments, industry and the energy market bodies. UED and Multinet welcomes the continuation of industry consultation represented by the release for industry comment of the Consultants' Paper.

UED and Multinet considers that this timeframe is achievable, provided that ministers accept that some of the details of the national approach to distribution regulation must be developed following the formal transfer of functional responsibility to the national energy bodies. This will mean that the legislative framework that is developed over the coming year must provide adequate guidance to the AEMC in developing Rules under the framework, such that the expectations of ministers, industry and end-users are met in the development of the framework.

The ambitious timetable set by Ministers also requires rigorous planning and project management (delivery against the project plan) by SCO. UED and Multinet believe that much more detailed planning and project management will be required in future if the timetable is to be achieved. Inevitably, work will need to be prioritised to ensure that the project is successful in meeting its key goals.

UED and Multinet believe that industry working groups can provide a useful resource to SCO, providing that deliverables are properly defined and achieved in accordance with a carefully considered project plan. In addition to the industry working groups, UED and Multinet urge the SCO to continue to engage with industry through effective and timely consultation.

UED and Multinet acknowledge the significant tasks ahead in the coming months, and look forward to working constructively with SCO in their successful delivery. UED and Multinet would be delighted to provide expertise through working groups if called upon to do so by SCO.