

Submission to the Ministerial Council on Energy Standing Committee of Officials

Re National Framework for Energy Distribution and Retail Regulation:

Proposed Framework Schedule for transfer of Distribution and Retail Functions



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1 Introduction and background

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 (AEMC) and enforced by the Australian Energy Regulator (AER).

At the same time, the SCO invited submissions on a 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 that highlights 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);
- whether any existing economic regulation functions would be redundant under a national framework; and
- the appropriate timing of any transfers.

The SCO called for submissions on that document in the MCE’s *Energy Market Reform Bulletin No. 50*, which stated:

“The Commonwealth, States and Territories are considering amending the Australian Energy Market Agreement to provide binding commitments to transfer specified distribution and retail functions to the national framework.”

Following its meeting of 4 November 2005, the MCE issued a communiqué stating:

“Ministers made substantial progress on amendments to the Australian Energy Market Agreement (AEMA) dated 30 June 2004 to further advance critical energy market reforms. In particular, Ministers agreed, subject to the necessary Cabinet approvals, to:

- ‘certification’ as the national model for energy access; and
- a clear framework for the transfer of specified retail and distribution functions to national regulatory arrangements, with enabling legislation by the end of 2006 and the transfer of economic regulation of distribution networks to the national regime by 1 January 2007.”

The 4 November 2005 communiqué also noted that the MCE agreed to establish an Expert Panel to advise on a model to achieve a common approach to revenue and network pricing across the energy market.

Notwithstanding the outcomes of the MCE’s meeting of 4 November 2005, the SCO has invited submissions on the *Proposed Framework Schedule for Transfer of Distribution and Retail Functions* by 11 November 2005.

2 Purpose and structure of this paper

The purpose of this paper is to set out the submission of Multinet Gas (Multinet) and United Energy Distribution (UED)¹ in response to the *Proposed Framework Schedule for Transfer of Distribution and Retail Functions*.

This submission does not set out the companies' more detailed comments in response to the Consultants' Paper. Those comments will be provided in a separate submission to be lodged in accordance with the timetable set by the SCO in *Energy Market Reform Bulletin No. 50*.

This submission is structured as follows:

- Section 3 discusses the principles that Multinet and UED believe should guide the development of a national regulatory framework for distribution.
- Section 4 sets out Multinet's and UED's comments on the practical operation of the proposed legal architecture that will give effect to the national framework.
- Section 5 notes the implications of the AEMC's Review of Chapter 6 Rules relating to electricity transmission revenue determination and pricing;
- Section 6 proposes some guiding principles governing transition arrangements and the timing for transferring functions to the national framework; and
- Section 7 provides a table summarising Multinet's and UED's comments on the proposed framework schedule for the transfer of distribution and retail functions.

3 Principles guiding the development of a national regulatory framework for distribution

In October 2004, the Energy Networks Association (ENA) lodged a submission on the development of a national framework for distribution regulation. That submission established a set of criteria against which the distribution network sector proposed to assess the appropriateness and success of a national distribution regulatory framework. These criteria, with which Multinet and UED concur, are that an effective distribution framework is one which:

- is based on a clear separation between rule making and rule enforcement;
- produces the least overall compliance burden necessary to achieve the objectives of the framework;
- is adaptable to change through transparent and equitable processes;
- is accountable to all parties through fair processes and merit review mechanisms on key regulatory decisions;

¹ Multinet Gas is an urban distributor servicing some 626,000 gas connections in Melbourne's Eastern suburbs. United Energy Distribution is an electricity distributor servicing 610,000 connections in Melbourne's South-eastern suburbs.

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- is directed to addressing clear market failure, and where competition is feasible, relies to the maximum extent possible on the outcomes of competitive markets; and
 - facilitates investment certainty in the non-competitive sectors of gas and electricity markets.

These criteria are useful in guiding a consideration of the *Proposed Framework Schedule for Transfer of Distribution and Retail Functions*. However, in considering the matters raised in the *Proposed Framework Schedule*, it is necessary to supplement these criteria with a more specific criterion to enable an assessment of the merits of achieving a particular level of consistency within the national framework.

In this context, it is noted that page 3 of the Consultants' Paper states that the recommended approach for retail and distribution regulation comprises the following element (among others):

“Consistency, to the greatest extent appropriate, between the regulatory arrangements applying in the electricity and gas sectors...”

In the case of “consistency” it is important to distinguish between:

- consistent regulatory principles or framework;
- consistent Rules; and
- consistent outcomes in terms of revenue, pricing and investment.

It seems reasonable to expect consistency in the regulatory principles and framework. However, the Rules may need to address sector-specific issues or to accommodate particular jurisdictional issues. In relation to the objective of consistent outcomes, it should be widely accepted that this can only be achieved at the level of broad principles, such as encouraging the development of competition; establishing a framework for efficient pricing; and facilitating efficient investment.

It is also important to note that the question of consistency arises not only in relation to consistency across the gas and electricity sectors, but also in relation to consistency across jurisdictions within the same sector, as well as consistency between the transmission and distribution elements of each sector. It is therefore important to be clear which elements of a nationally consistent framework can be achieved in practice.

Multinet and UED are strongly of the view that any consideration of the “appropriateness” of the level of consistency to be achieved between the regulatory arrangements to be applied to gas and electricity networks must be based on an objective assessment of the costs and benefits associated with achieving consistency. “Consistency”, of itself, should not be an overarching goal; rather, the achievement of *net benefits* through the creation of a national regime should be the goal. It needs to be recognised, therefore, that the goal of national “consistency” within the electricity sector for instance, whilst laudable, may not be desirable in practice because of cost considerations.

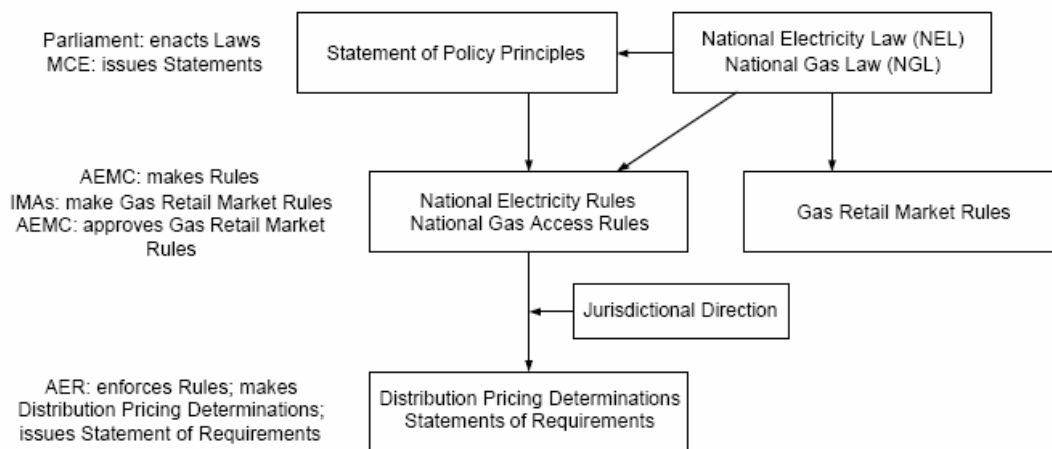
Finally, as noted in section 4 below, there is also a need for a degree of pragmatism and “common sense” to be applied in moving towards a more detailed specification of the national framework for regulation of gas and electricity networks. In particular, account should be taken of the current framework and the extent to which it is fit for purpose. These considerations will provide an immediate insight into whether the benefits from changing these arrangements are likely to outweigh the costs. Multinet are of the view that the current straightline relationship between distributors, retailers and customers is

operationally working well, any move to a triangular arrangement cuts across existing access arrangements and the fundamental interactions across the market.

4 Operation of the Legal Architecture in practice

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.

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.

The legal architecture provides for a clear separation of the functions of:

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

Subject to more detailed comments to be lodged in response to the Consultants' Paper, Multinet and UED note that the proposed legal architecture is consistent with the criteria advocated by ENA (see section 3 above) and on this basis, the companies concur with the proposed architecture.

It is noteworthy however, that in practice the distinction between policy-making, rule-making and enforcement is likely to be somewhat more blurred than the architecture depicted in Figure 1. Indeed, the two page list of high-level functions set out in the *Proposed Framework Schedule for Transfer of Distribution and Retail Functions* provides an example of this "blurring":

- The *Proposed Framework Schedule* is a document published by the MCE, and provides a vehicle to facilitate public consultation in relation to policy making.
- The third item in the proposed framework schedule for transfer to a national framework is described as "regulatory requirements in relation to tariff settings". Interested parties

have been asked to comment on whether they agree that this function should be transferred to the national framework.

- On the (reasonable) basis that regulatory requirements in relation to tariff setting should be specified at a national level, it would also be reasonable to assume that such requirements might be set out in the Rules (being the province of the AEMC) or be left to the discretion of the AER. One would not expect the determination of regulatory requirements in relation to tariff setting to be a matter for policy makers.
- However, the *Proposed Framework Schedule* paper seems to advocate a particular regulatory requirement in relation to network tariff-setting, by stating: "Tariffs for small customers which should lie between the incremental cost (lower bound) and the stand-alone cost (upper bound) of serving them."

Whilst this example may not, on its face, raise material concerns, it does serve to illustrate the ease with which the distinction between policy-making, rule-making and rule-enforcement in economic regulation can be blurred. In reality, the distinction is often far from clear. In particular, we note that the AEMC as rule-maker must take account of policy direction from the MCE in setting Rules that will in turn determine the extent of the AER's discretion. In this framework, the extent of the AER's role will depend on the detail of the policy direction and the Rules - it is not logically defined by the legislative structure.

In light of these considerations, 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.

5 Implications of the AEMC's Review of Chapter 6

The AEMC has a statutory obligation to review, and as required, rewrite the rules for electricity transmission revenue and price setting in the National Electricity Market by 1 July 2006. In view of this requirement, Multinet and UED consider it is reasonable to expect that by the middle of next year the transmission revenue and price setting rules contained in the National Electricity Rules will reflect the state-of-the-art in regulatory design. The Consultants' Paper notes that the question of consistency between arrangements for transmission and distribution is a relevant matter for consideration in the design of the national regime for regulation of distribution and retail. Page 21 of the Consultants' Paper also states:

"The AEMC will be working on the content of the National Electricity Rules relating to electricity transmission as an early priority this year. The final national approach to the form of distribution price regulation may need to be determined taking [that] work stream into account."

Given the scope and timing of the AEMC review, Multinet and UED would urge the SCO to ensure that there is proper co-ordination of the pricing principles between the distribution and transmission sector. The companies support the full implementation of the Productivity Commission Inquiry into the National Gas Access regime and the use of these pricing principles as the basis of a national uniform approach to distribution and transmission regulation.

6 Principles governing the transition and timing for transferring functions to the national framework

The SCO has asked respondents to provide their views on the appropriate timing of transfer of functions to the national regulatory framework.

At this stage, Multinet and UED have no firm views regarding the precise timing of such transfers. However, the companies consider it important to note that the transition to the new arrangements and the timing of transfers of functions should be subject to the following high-level principles:

- 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.

7 Detailed comments on the proposed framework schedule

Multinet's and UED's detailed comments on each function listed in the *Proposed Framework Schedule* document are set out in Attachment 1.

Attachment 1 - Multinet's and UED's comments on proposed functional allocations

No	Function	Multinet's and UED's Comment
	National	
1	Scope of distribution price regulation (services included, services excluded) – determination of basic regulated services/core services which are to be included in price regulation.	<p>It is appropriate that this be determined at a national level, and it should be the AEMC's responsibility to determine the approach to be applied.</p> <p>It seems reasonable that the definition of regulated services should be uniform, but the application of the definition may differ across sectors and regionally depending on the particular circumstances.</p> <p>We note that the proposed definition of regulated services probably needs further development to ensure that it is clear, meaningful and universally applicable.</p> <p>Multinet and UED do not have strong views on the timing of transfer, but there should be a principle governing transition to ensure that regulated businesses are not exposed to financial or economic loss as a result of transition.</p>
2	Price cap regulation for distribution services - CPI-X price or revenue cap (or some incentive-based variant) form of regulation.	It is appropriate that this matter is addressed at the national level. The AEMC should ensure that the Rules provide reasonable scope to the AER to consider alternative regulatory arrangements, including price monitoring where appropriate.
3	Regulatory requirements in relation to tariff settings – Tariffs for small customers which should lie between the incremental cost (lower bound) and the stand-alone cost (upper bound) of serving them.	It is appropriate that this matter is addressed at the national level. However, it is not clear whether the detail proposed in the Rules is appropriate, or whether in fact this detail should be set by the AER following suitable industry-wide consultation.
4	Service performance targets – Service reliability, service quality and customer service measures.	<p>It is appropriate to develop a service standard regulatory framework at a national level in order to provide incentives in relation to service reliability. However, service quality issues are a matter for jurisdictional regulators. It will be important to establish appropriate memoranda of understanding between jurisdictional and national regulators to ensure that appropriate linkages exist between the setting of service quality standards and the determination of allowances for the regulated businesses' costs of meeting these standards.</p> <p>Multinet and UED do not believe that it is appropriate to set at a national level the same reliability incentive schemes and targets for each business. However, it does seem appropriate that a common framework is applied across the companies. It is a matter for the AEMC to establish this common framework, but to provide the AER with sufficient scope to exercise discretion in setting specific parameters for each business.</p>

No	Function	Multinet's and UED's Comment
5	Information disclosure – Rules that define the information that must be provided to AER by distributors for regulatory functions.	It is appropriate that this matter is addressed at the national level. It is noted that the critical issues relate to ensuring that requests for information are subject to a transparent and well-defined process that avoids ad hoc requests for information. It is essential that Rules require the AER to take explicit account of the costs and benefits of seeking information, having particular regard to their statutory objectives and functions.
6	Connection and capital contributions requirements – basis for the distributor to charge for new connections and capital contributions for capital works.	<p>It is appropriate to set Rules at a national level. In particular, we should support rules for determining capital contributions from customers, as they reduce disputes over connection charges, simplify terms of connection offers, provide transparency and provide assurance that the required contributions are based on fair and reasonable rules approved by the regulator.</p> <p>However, it will be important for the AEMC to have regard as to whether uniformity at a national level is achievable in practice and, if so, the costs and benefits of achieving uniformity.</p> <p>Multinet and UED note in particular that changing existing arrangements for a particular distributor may create substantial costs in terms of changing existing processes, and these costs may substantially outweigh any potential benefit from national uniformity.</p> <p>For instance, In Victoria, there is a limited “Pioneer Scheme” for a period of 10 years, which is only applied to rural extensions. If this approach is extended to customer connections in urban areas, it will severely increase administrative costs. Changes to existing developer funded contributions to greenfield subdivisions would also lead to a substantial increase in costs and administrative burden.</p> <p>Multinet and UED also note that there is no single objectively correct approach to setting capital contributions, and this to some extent explains the range of current practices across the businesses.</p>
7	Distribution network expansion rules – rules clarifying when extensions are part of a regulated service and how charges are levied on a national basis.	<p>It is appropriate that this matter should be addressed at the national level. Multinet and UED believe, however, that further thinking needs to be done before the MCE commits to the policy advocated in the Consultants’ Paper. In particular, consideration should be given to the role of conducting prudency reviews after the investment decision has been made. In this regard it is noteworthy that the Victorian Essential Services Commission has developed and clearly articulated a policy which states that the incentives for cost containment faced by Victorian distributors allows an inference to be drawn that all actual investment is efficient. This obviates the need for resource-consuming ex-post expenditure reviews, and removes the disincentives for investment that would otherwise be present if the distributor faced the risk of capital loss through the threat of “regulatory stranding” of assets.</p> <p>It would be appropriate for the AEMC to consider this important issue in further detail in the development of the Rules.</p>

No	Function	Multinet's and UED's Comment
8	Distributor obligation to provide connection services – distributor to provide connection and related services to users; the contractual relationship between distributor, retailer and end-use customer.	<p>It is important to establish an approach at the national level. However, it is also important that the AEMC does not seek to establish the terms and conditions of Use of System Agreements, where existing agreements are already in place. Such an endeavour, if pursued would be potentially very costly whilst delivering little if any benefit.</p> <p>It is also noted that gas access arrangements set out the terms and conditions of access, and that these matters should not be revisited simply to achieve national consistency.</p> <p>The MCE should be careful to ensure that there are likely to be net benefits from national consistency, taking account of the costs of changing existing arrangements especially where these arrangements are the product of extensive negotiation between the parties.</p>
9	Distributor disconnections and reconnections of small end-customers – regulation of circumstances in which a distributor can disconnect or reconnect a small end-user customer and circumstances in which a retailer can arrange a disconnection.	<p>It should be noted that disconnections may occur for either financial or technical/safety reasons. Rules relating to disconnections for financial reasons are appropriate at the national level. Rules relating to disconnections for technical and safety reasons are linked to safety and technical regulation which is expected to remain at the jurisdictional level.</p>
10	Distributor interface with embedded generators – regulation of relationship between electricity distribution businesses and embedded generators.	<p>It is preferable to have a consistent framework at the national level. It may be appropriate for the AEMC to develop this framework, especially in the light of its chapter 6 review of transmission pricing arrangements. The national arrangements should establish a reasonable transitional timetable which allow companies to develop internal processes in order to accommodate any change from existing arrangements.</p>
11	Distributor interface with retailers – regulations relating to dealings between retailers and distributors including use of system agreements.	<p>See earlier comments. UED and Multinet would be concerned if the intention of the SCO is to seek to re-open existing arrangements in order to achieve national consistency on all terms and conditions. It would be reasonable to establish a consistent template for use of system agreements nationally, but the content will need to differ across fuels, jurisdictions and companies. To do otherwise is likely to lead to increased costs and inefficiencies.</p>
12	Other distribution related market rules.	<p>UED and Multinet are not aware of any other distribution related market rules – but further analysis will no doubt be undertaken as part of the MCE's proposed process.</p>

No	Function	Multinet's and UED's Comment
13	Network planning – determination of network investments.	Distribution network planning is currently undertaken by distribution businesses as part of normal business operation and is <u>not</u> supervised by jurisdictional regulators in the same way that transmission planning is. Any regulatory issues arising from network investment should already be adequately addressed through other aspects of the regulatory framework, in particular: service standards and reliability incentive arrangements, and incentive arrangements for cost containment.
14	Metering – obligations to install, maintain and read meters. Includes the rights in relation to entry of premises for metering purposes.	It is appropriate for this matter to be addressed at the national level.
15	Retail price regulation – relates to the model to be developed by the Commonwealth.	This is primarily a retail issue.
16	Retailer obligation to supply to small end-customer – obligations on designated retailers (local retailers) to supply customers and minimum protections in terms and conditions of default/standing offers.	This is primarily a retail issue, although a retailer's obligation to "sell" must be consistent with distributors' obligations to "connect and supply".
17	Retailer failure arrangements – arrangements to ensure the continuity of energy supply to customers and integrity of wholesale market settlements.	<p>It is appropriate for this to be addressed at the national level, noting however that some aspects of retail failure are already addressed in existing Use of System agreements. Earlier comments highlighted the importance of not revisiting existing agreements where these are working well and have been the subject of extensive negotiation between the relevant parties. It is only appropriate to revisit such agreements where there is a demonstrable net benefit in achieving national consistency.</p> <p>It is noted that retailer failure involves significant obligations on the distributor to manage metering arrangements and immediate customer transfer to default retailer. It is appropriate that there is consistency regarding these processes on a national basis. However we recognise it may be difficult to gain consistency where a distributor may need to be the ROLR in a single host retailer state.</p>
18	Retailer: Small end-customer market contracts – retailers must obtain informed customer consent to enter Market Contracts.	This is primarily a retail issue.
19	Retailer: Small end customer marketing – regulation of marketing conduct of energy retailers.	This is primarily a retail issue.

No	Function	Multinet's and UED's Comment
20	TPA and Privacy Act provisions relevant to market contracts and marketing.	This is primarily a retail issue.
21	Other retail related market rules not covered elsewhere.	Appropriate that this is managed/approved nationally allowing for particular jurisdictional issues. It needs to be recognised that the approach is to continue the separate jurisdictional gas retail market rules
22	Balancing regime and settlements, effecting customer transfer in balancing and settlements system – regulation to ensure settlements and accurate financial reconciliation of supply/consumption transactions and regulate churn of contestable customers.	It is appropriate for this matter to be addressed at the national level. It is noted that the Rules relate to settlements rather than network and retail regulation per se.
23	Merits and judicial review.	Multinet and UED strongly supports national arrangements for merits and judicial review. Effective reviews are an essential component of an efficient regulatory process.
	States/Territories	
24	Business authorisation – refers to licensing and authorisation schemes that require distributors to demonstrate technical capability.	Authorisation should continue to be administered at state/territory level. However, it is important that there is not duplication of regulation at a national and state level, particularly in relation to reliability standards and reporting requirements.
25	Distributor – Small end-consumers dispute resolution – distributors' requirement to have internal dispute resolution schemes for the small end-customers and participate in independent alternative dispute resolution schemes.	Regulatory oversight of this matter at Jurisdictional level is appropriate.
26	Retailer – Small end-customer dispute resolution – obligation of retailers to have internal dispute resolution/record keeping procedures and participate in independent alternative dispute resolution schemes.	Regulatory oversight of this matter at Jurisdictional level is appropriate.
27	Load Shedding and curtailment – rules for reduction of supply of energy to customers in order to maintain system security.	Regulatory oversight of this matter at Jurisdictional level is appropriate, although there may be some guiding principles at the national level.

No	Function	Multinet's and UED's Comment
28	Community Service Obligations – jurisdictionally based service obligations applied on distributors and retailers.	Regulatory oversight of this matter at Jurisdictional level is appropriate. There should, however, be some guiding principles at the national level regarding transparency and funding of CSOs.
29	Environmental obligations – relates to jurisdictionally based greenhouse gas abatement schemes and consideration of demand side response.	Regulatory oversight of environmental obligation at Jurisdictional level is appropriate. It is an open question as to whether it is appropriate for all demand side measures to be included in environmental obligations. It is noted that demand side measures may be addressed as part of the economic regulatory framework – and therefore some guiding principles should apply at the national level.
30	Local gas market arrangements.	Regulatory oversight of this matter at Jurisdictional level is appropriate.
31	Fair trading legislation provisions relevant to market contracts and marketing.	Regulatory oversight of this matter at Jurisdictional level is appropriate.
32	General business authorisations (licensing) for Abolish retailers and distributors – <i>includes any matters other than technical capability and safety.</i>	It is noted that abolition of licences potentially impacts the rights of distribution businesses. Further industry consultation is required as to the legal consequences of removing licences from the regulatory framework before approach can be supported. Certainly some of the licence terms such as information gathering powers may be able to be removed to ensure national coordination in the Rules and Law.
33	Taxes and levies – jurisdictionally based which are linked to energy services.	May need more consideration.
34	Redundant regulatory instruments – recognising that some requirements may have been incorporated elsewhere.	Multinet and UED supports the removal of redundant and duplicative regulation, especially where this regulation poses the risk of dual (state/territory and federal) regulation or inconsistent regulatory rules.