

MAJOR ENERGY USERS INC

Comments on

**A National Framework for Energy Distribution
and Retail Regulation**

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1. Introduction

The Major Energy Users (MEU) Inc., comprising some 20 major electricity and gas users in South Australia, Victoria, Queensland, New South Wales and Tasmania, welcomes the opportunity to comment on the NERA/Gilbert & Tobin paper on *A National Framework for Energy Distribution and Retail Regulation*. Included at appendix A is the response MEU provided in relation to the *Proposed Framework Schedule for Transfer of Distribution and Retail Functions*. This should be read in conjunction with the body of this submission.

The MEU strongly supports the development of a sustainable and competitive national energy market, because it will enhance the competitiveness of downstream industries, sustain investments and promote employment opportunities for Australians.

The MEU congratulates the Ministerial Council on Energy in making substantial progress in advancing the implementation of the Australian Energy Market Agreement, specifically the agreement to:

“.....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” (Ministerial Council on Energy Communiqué, Hobart, 4 November 2005).

The **retail and distribution network functions** are important activities and have major price and non-price implications for major energy users. These impacts vary across the various States and regions.

Almost all major electricity users in the National Energy Market now source their **electricity** requirements through retailers, rather than directly from the wholesale pool. Even those consumers prepared to take some exposure to the electricity pool still almost entirely operate through a retailer to help manage their affairs.

In the case of **gas**, most industrial customer contracts are via gas retailers, although a few major industrial customers contract directly with producers and/or contract directly with network service providers for their own transport requirements. Such consumer arrangements of bypassing retailers are very few and usually made to lock in long term supply for an essential input to match the investment duration of the consumer.

Due to the challenges (geographic, technical and commercial) of connecting directly to the transmission networks, few consumers are connected to the transmission supply systems, relying on the distribution networks to deliver their gas and electricity. Thus there is a deep interest in the aspects of distribution by almost all consumers, regardless of their demand for energy.

After an initial period of **price** reductions, electricity distribution network charges have begun to rise substantially and now represent an increasing proportion of the delivered cost of electricity. Gas distribution pipeline charges have fallen over the past 5 to 6 years, especially in New South Wales, but this change has not been generally observed in the other States, with a number seeing significant increases.

Service performance **standards**, especially for electricity distribution networks are variable across the various States and minimal, but variable, incentive systems are in place for service performance improvements. Quality standards are not readily measurable (often because there has been no attempt to install the necessary hardware and therefore they are not recorded), but consumers have seen that quality standards are deteriorating in some areas.

Major electricity users have experienced, on the basis of retail supply tenders, very substantial price differentials for network electricity charges, including for REC's and NGAC's. These price differentials can be very wide and suggest that there is likely insufficient **competitive neutrality** amongst retailers. Some explanatory factors may be seen in the benefits provided to State-owned retailers through State-based arrangements.

Against this background of widening diversity and variability in price and performance outcomes of the electricity distribution and retail sectors, and with the objective of moving towards a national and consistent legal architecture for the retail and distribution sector, there is likely to be a very pressing requirement to pay close attention to ensuring that there is competitive neutrality between State-owned and private sector retailers and distributors: e.g. all State-based schemes for "equalising" end use tariffs (such as the NSW ETEF and Queensland BPA schemes) must be abolished, (as these are anti-competitive and highly distortive) as should all arrangements that provide State-owned retailers with an unfair advantage over private sector counterparts.

A more fundamental issue impacting on competitiveness in the electricity distribution retail sector (and hence price outcomes) may be the result of **reaggregation** in the electricity supply industry – both

vertical and horizontal integration, as well as multi-fuel integration by a number of major suppliers.

These issues (more details are provided later in this section) raise very important questions about the adequacy of competition laws in regulating market behaviour, and in a more immediate sense, the adequacy or otherwise of ring-fencing requirements, accounting standards, the ability of regulators to pierce corporate veils, and even the adequacy, and the form, of economic regulation.

MEU Observations relating to distribution and retail functions

The MEU is vitally interested in these two functions of the energy markets as its members are directly impacted by the need for economic regulation of natural monopoly sectors of the energy markets to replicate competition as much as is possible and for contestable sectors to be exposed to competitive market pressures.

In this regard the MEU provides a series of observations relating to the retailing and distribution functions of the NEM and the gas markets.

- Consumers have seen that disaggregation of the gas and electricity supply chains has resulted in no one entity being responsible for the security of supply of energy, or for its reliability and quality. Consumers now have to be fully aware of these changes so that their own involvement and actions can be properly focused.

Of all the changes made the one which has the most impact on consumers concerns the separation of retail and distribution functions. This separation has allowed the businesses of both functions to disclaim direct responsibility for, say service quality, and to direct any problems arising onto the other party.

Thus, it is essential that there be close examination of the **interfaces** in the Rules and Codes relating to the various separate functions to ensure that there are no responsibilities which are not formally allocated to one party or the other.

- Most consumers need to have the services of an energy aggregator in order to minimise the individual risks each would have if directly exposed to the energy markets.
- Retailers fulfill this role and effectively become large purchasers of energy in their own right. Despite this, where retailers can pass through costs to their customers (end users) without affecting their commercial position, retailers tend not to act in the interests of

consumers and assist in cost minimisation. Thus, whilst there might be an expectation that retailers would represent the interest of consumers, this has not been the case.

- Some consumers have attempted to institute demand side responses, including through self generation, in order to risk manage their energy exposure, but the experience has not been encouraging.
- Consumers and potential self generators have seen that **embedded generation** disadvantages all of the NEM supply side entities – retailers see a loss of sales, distribution and transmission businesses see a reduction in usage of their networks, distribution businesses see competition due to alternatives other than networks solutions, and generators lose sales. As a result, they have tended to use the Rules to create barriers to this form of demand side responsiveness. With all NEM Participants allied against self- and embedded generation, there is a need to ensure that embedded generation is not disadvantaged by the Rules for retailing and distribution. There is, in fact, an argument that the Rules should be actively supportive of it rather than seeking to be neutral.

Consumers have seen that **demand side responses** (in both gas and electricity) cause disadvantages to many of the same Participants – retailers lose sales, distribution and transmission lose usage of their networks and get competition for their network solutions, and generators and gas producers loses sales. The current application of Rules and Codes disadvantages demand side responses and there is an argument that the Rules and Codes should provide active incentives for demand side responsiveness.

- Access to the electricity wholesale markets (which is highly volatile) is complex, expensive and highly risky, providing a barrier to entry by consumers. Together with the need to aggregate demand to reduce risks this factor leads to almost all consumers desiring to avoid too close an involvement in the wholesale market. Consumers therefore rely on retailers to avoid or minimize these risks.
- Distribution tariffs set from price caps have allowed the businesses to over-recover regulated revenue even after allowing for increased demand, by manipulation of tariffs or rebalancing tariffs

It is accepted that most of the failures to supply electricity, or where the quality of supply falls outside the minimal standards of supply, are caused by difficulties, failures and constraints within the distribution networks. There is a need to encourage distribution businesses to allocate capex to the poorest performing feeders, and not to allocate

capex for providing above standard quality to those consumers already well served. To achieve this, there is a requirement that the distribution businesses should be required to monitor performance on all feeders and sub-feeders and that their incentive payments are related to improvements where they are most needed. Averaging across the distribution network provides a false image of true performance.

MEU views on re-aggregation and competition

Consumers oppose any further horizontal aggregation of generation and retail activities by merger and acquisition activity, especially in Victoria and South Australia. Market concentration levels are already 'highly concentrated' by international standards.

The size of the market is a relevant factor for considering the desirable level of aggregation. It could be considered that 4-6 large providers and a number of smaller niche providers competing for market share across a range of customer groups may be sufficient to ensure competitive outcomes in regions of the NEM. However, there needs to be consideration whether the 4-6 large providers have similar market shares. Bardak¹ highlights that generally 3 businesses only have the bulk of the market share – over 90% of retail and of generation capacity.

Further when the market is tight, it has to be considered whether one party can exercise market power. Bardak again highlights that this is the case. Concerns have arisen where the large providers have sought to merge so that the level of aggregation in the market reduces to something in the order of 2-3 providers, which is unlikely to benefit consumers in the long term. Comparing market shares, Bardak shows this to be the case.

The Trade Practices Act 1974 (Cth) (TPA) is the nation wide competition law, and is generally seen as the most appropriate framework for addressing market issues such as the re-aggregation of retail and generation functions, and retail and distribution functions. The Australian Competition and Consumer Commission (ACCC) has the ability to take appropriate action to address issues associated with horizontal aggregation as part of its general competition regulation (Part IV of the TPA). Rather than adopting a set position on mergers in particular industries (e.g. blanket ban) the ACCC assesses mergers on a case-by-case basis given the competitive conditions applying in that industry. The ACCC² has already stated in its recent submission to the

¹ **The Effect of Industry Structure on Generation Competition and End-User Prices in the National Electricity Market.** A Report for the Energy Users Association of Australia, Energy Action Group, Energy Markets Reform Forum, Electricity Consumers Coalition of South Australia and Energy Users Coalition of Victoria, May 2nd 2005 by Bardak Ventures P/L

² Australian Competition and Consumer Commission, Cross – ownership Rules for the Energy Sector, Submission to the Victorian Department of Infrastructure April 2005

Victorian Department of Infrastructure, that the TPA is inadequate for regulating mergers in the energy sectors.

This means that either the energy market Rules and Codes are strengthened or there is a need to enhance the ability for the TPA to address specific concerns associated with aggregation in the electricity market. As there is apprehension about the effective operation of the provisions of the TPA (for instance, section 50, prohibiting mergers and acquisitions that would result in a substantial lessening of competition) across the national economy, then consideration must be given to strengthening the energy market controls. If the (ACCC) which is responsible for this aspect of market behaviour considers the TPA is inadequate in the energy markets, then this issue **must** be addressed by the MCE.

There is a view that much of the recent merger activity in the electricity markets does not appear to present a genuine problem that requires significant attention at this stage of the market development. The fact that the three dominant retailers in SA and Vic (TRU, Origin and AGL) are all developing (or have developed) cross ownership arrangements with significant levels of generation must be seen as a major concern as their actions have effectively replicated the anti-competitive and highly distortive ETEF and BPA schemes in NSW and Queensland. As has been seen in Queensland and NSW, re-aggregation is now endemic in all four states and will limit new retailers from entry to the markets.

Despite the new arrangements creating the Australian Energy Market Commission (AEMC) as the body responsible for rule making and market development, and the Australian Energy Regulator (AER) as the body responsible for economic regulation and enforcement, they are constrained by the Rules and Codes that they are required to work within. The Rules and Codes need to be strengthened to prevent competition weakening re-aggregation as this disadvantages consumer interests and can encourage anti-competitive market behaviour.

Consumers have carefully examined any further moves towards vertical integration. Vertical integration will rarely avoid loss of diversification of ownership and of independent action, and thus will reduce competitive pressures in a market, which is short of such pressures.

Although increased integration between the retail and generation sectors could reduce the level of liquidity in the financial markets (as generation capacity is retained for physical hedging by the integrated retailer rather than being available for contracting with a competing retailer), vertical integration can also be beneficial to consumers. Retailers can potentially reduce the cost of risk management by obtaining a lower cost and more effective physical hedge, thereby internalising the transaction costs and market risks. This is a valid concept and is the principle behind the universally criticised NSW ETEF scheme and the Queensland BPA

arrangement. Both of these have been criticised widely but at least they have government control. The continuing vertical integration in the South Australian and Victorian retail/generator sectors has no direct government (public interest) oversight and inevitably this will allow the risk premiums to be held by the private companies and also used to prevent other retailers from entering the markets.

Economics supports the view that the risks associated with vertical integration are lower when there is greater competition, and this requires new entrants into the market. Unfortunately the entry cost of new generation (and gas production) is very high and the ability of the incumbent generators to create circumstances where the likely returns can be manipulated at will (such as pool price manipulation), also cause new entrants to be concerned and have doubts as to the long term revenue stream to support their investment.

A competitive and separated generation and retail market structure is essential to ensure true competition. The initial break up of the NEM assets was predicated on this principle. The original separation has been reduced and consumers are seeing this occurring now as most of the large base/intermediate generation is now allied to retail and the tied retailers are only offering from their own related generation, as would be expected.

Integration of retail and generation is eliminating new retail entrants unless the new retailers build their own generation (such as the acquisition of Red Energy by Snowy Hydro). The new costs for base/intermediate load generation are very high, either from a capital cost basis or from sourcing new fuel sources. The only other generation built in South Australia and Victoria since deregulation (these states at least had originally a separation between retail and generation), has been augmentation of existing generators or low capital cost open cycle gas turbines for peaking.

The focus of the energy markets must be predicated on ensuring a competitive market structure for generation/gas production and retail activity to remove any concerns that maybe associated with vertical integration. Such a result will not occur whilst dominant retail and dominant generation become more allied and so prevent new entrants.

Whilst it is acknowledged that some of these issues may belong to another place for review, they are nevertheless, the market environment faced by major energy users in the current National Energy market. Recognition that these are the prevailing environmental factors should inform the review of what purports to be the objective of developing a national framework for energy distribution and retail regulation. A policy objective for a national framework for energy distribution and retail regulation is meaningless unless the anti-competitive and distortive elements

currently present resulting from the developing energy market are addressed as a priority.

2. Executive Summary

The Major Energy Users (MEU) Inc. strongly supports the development of a sustainable and competitive national energy market, because it will enhance the competitiveness of downstream industries, sustain investments and promote employment opportunities for Australians.

The November 2005 decision by the Ministerial Council on Energy for national regulatory arrangements for retail and distribution functions and for economic regulation of distribution networks is supported and is consistent with the development of a sustainable and competitive national energy market.

The gas and electricity markets have evolved over the past decade and significant changes in the legislative and regulatory architecture are urgently required in order to remove anomalies, and identified anti-competitive and distortive elements, that are impeding the attainment of a sustainable and competitive national energy market.

There is now a national imperative for leadership, in the context of this review to establish a national framework for energy distribution and retail regulation, for addressing the following issues:-

- achieving competitive neutrality between States-owned and private sector businesses by the removal or phasing out of State-based arrangements, such as the NSW ETEF and the Queensland BPA
- removing the provisions for Jurisdictional Direction, particularly those relating to imposition of State levies and taxes, determination of asset valuations and CSO's. All CSO's should be Budget-funded and not introduced via regulatory intervention by Jurisdictions
- focus on the interfaces in the Rules and Codes relating to the various separate functions in the disaggregated energy supply industry and the allocation of clear responsibilities to specific parties
- focus on the Rules that have impeded the development of effective demand side responses, self generation and embedded generation.
- address the increasing concentration of the energy industry vertical and horizontal reaggregation and the limits of the relevant provisions of the TPA in regulating market behaviour and mergers in the energy sector
- apply best practice models with regard to the Regulatory Framework for example, by adopting (as identified by the MEU) the ESCoV approach for performance standards and regulatory processes, etc,
- address the requirement for adequate information disclosures, especially the ability of regulators to pierce corporate veils,

outsourcing arrangements, and the ability to require collection of data in between regulatory resets.

The attached submission contains numerous MEU suggestions for improvements in the proposed national framework for energy distribution and retail regulation.

The MEU makes the point that while some of the issues it has raised in this submission may belong to another place for review, they are nevertheless, the market environment faced by major energy users in the current National Energy market. Recognition that these are the prevailing environmental factors should inform the review of what purports to be the objective of developing a national framework for energy distribution and retail regulation. A policy objective for a national framework for energy distribution and retail regulation is meaningless unless the anti-competitive and distortive elements currently present resulting from the developing energy market are addressed as a priority.

Comments on the 'framework' follow the structure of the NERA/Gilbert & Tobin paper.

PART A

1. Overview of Recommended Legal Architecture and Key Recommendations

The legal architecture recommended in the paper is as follows:

- A separate national legislative scheme for each of electricity and gas, applied by a common National Electricity Law and a National Gas Law.
- Subordinate legislative instruments - Rules - for the gas and electricity sectors, with changes to the Rules to be undertaken by the AEMC, with the Rules governing:-
 - (i) distribution network price regulation, quality of supply, tariff setting and service standards ;
 - (ii) consumer protection;
 - (iii) certain other issues such as the interface between distributors and retailers, distributors and embedded generators and retailer failure arrangements; and
 - (iv) for electricity only, balancing, settlements, effective customer transfers, metering and load shedding or curtailment.
- The Rules concerning pricing determinations would be applied and enforced by the AER, with the AER issuing mandatory Statements of requirements on specific regulatory functions such as ring fencing regulatory accounts and capital contributions.
- In respect of the gas sector, certain matters that should continue to be governed on a jurisdictional basis by Independent Administrators, such as Vencorp, REMMCO and GMC concerning balancing, load shedding or curtailment arrangements, etc.

The Rules for consumer protection would set out those that are appropriately specific to the energy supply. There will be no duplication of consumer protection delivered via other national or State legislation (e.g. TPA, Vic FTA), including the prohibition against misleading or deceptive conduct, the conscionable conduct and door to door sales provisions.

Also, the use of other forms of regulatory instruments (e.g. codes, licences, guidelines and regulation) would be discontinued.

A limited exception is for a Jurisdictional Direction in which the Government of each jurisdiction could require that the AER must have regard for tariff equalisation matters, specific values for certain assets, CSO's, environmental obligations and taxes or levies; and requirements for retailers and distributors to comply with distribution tariff equalisation, CSO's, environmental obligations and taxes and levies. (Our emphasis).

Technical and safety requirements will remain with the States, but within a simplified business authorisation or licence arrangement.

Comment

The MEU supports the above broad framework with the exception of the Jurisdictional Direction provisions (shown in bold above).

Whilst it is commendable that the recommendations in totality are in the interest of simplifying the regulatory environment, improving the transparency of the regulatory arrangements and reducing regulatory compliance for energy suppliers, there is absolutely **no** reason why tariff equalisation, levies, utility taxes and asset valuations should remain as a provision under which State jurisdictions could direct the AER in its determinations. In the interests of national consistency, they have no place in the scheme of things. They operate against the achievement of a nationally, competitive electricity market, distort the market, contradict the objective of competitive neutrality, and in any case, in respect of taxes, probably contravenes the constitution which limits States' taxing powers. In addition, there is no economic reason why States that wish to provide CSO's should intervene with AER determinations by retaining the power to direct the AER on such matters. CSO's should only be Budget-funded and **not** introduced via regulatory intervention by jurisdictions.

The proposed architecture for a new national regulatory framework falls apart (by allowing States to distort the market and competitive neutrality) and is much **diminished** by the proposed retention of 'Jurisdictional Direction' over the issues identified. This is similar to reversing the principle of removing the 'shield of the crown', which was introduced to enhance competition in the Australian economy.

The Major Energy Users Inc. applauds the MCE's stated objectives (as described on page 1 of the Framework Paper) as:-

- (a) Providing national oversight and coordination of policy developments to address the opportunities and challenges facing Australia's energy sector; and

- (b) Providing national leadership so that consideration of broader convergence issues and environmental impacts are effectively integrated into energy sector decision making.

Retention of the Jurisdictional Direction provisions is in direct contravention of the MCE stated objectives. It neither provides “national oversight and coordination of policy developments to address the opportunities and challenges facing Australia’s energy sector” nor is it consistent with “providing national leadership ... (in) energy sector decision making”.

Retention of the Jurisdictional Direction provisions in the context of the MCE reform objectives is akin to taking “one step forward and two steps backward”, and its retention will certainly disallow the Framework Paper to describe itself as a “best practice” approach.

2. Price Regulation of Distribution

The Framework Paper³ states that:

“The scope of distribution price regulation should be determined on a national basis, across all jurisdictions. That is, the same activities should either be included or excluded from regulation regardless of jurisdiction. There should also be consistency between the electricity and gas sectors in terms of the *criteria* used to determine the scope of regulation and the *process* followed for including or excluding services from the scope of regulation, although the precise services included in the scope of regulation in the electricity and gas sectors may differ.

The key principles of the recommended approach in relation to determining the scope of regulation are as follows:

- (i) there should be a standard definition of a basic regulated distribution service, set out for both the electricity sector and the gas sector;
- (ii) this basic service is to be subject to price cap regulation (see Part B: section 3);
- (iii) on application, or at the initiation of the AEMC, the AEMC is to review whether a given service (or an

³ PUBLIC CONSULTATION ON A NATIONAL FRAMEWORK FOR ENERGY DISTRIBUTION AND RETAIL REGULATION, Prepared by NERA Economic Consulting and Gilbert + Tobin, May 2005, pages 13, 14

element of a service) should be withdrawn from or added to the scope of regulation and enable the AEMC to reconsider these inclusions or exclusions over time as developments emerge;

- (iv) whether services are added or removed from the scope of regulation should be determined by reference to clear, economic criteria;
- (v) where the AEMC determines that services (or elements of services) should be included within the scope of regulation, the AEMC is also to determine the appropriate form of regulation. This form of regulation can be (but is not required to be) other than a form of price cap;
- (vi) the AEMC's determination on the form of regulation is to be made on the basis of whether regulation contributes to the objective set out in the NEL/NGL, taking into account:
 - A. administrative cost (on all parties); and
 - B. prospects for competition; and
- (vii) where services are regulated other than by price cap, the AEMC is to set out clearly the process to be followed at the time at which it sets out the approach to regulation.”

Whilst there is agreement with the break down of the factors to be settled, there is not necessarily agreement with the recommendations which then follow. Where there is disagreement with the recommendations, this disagreement is predicated on direct experience of consumers operating in the deregulated energy markets.

2.1. The Scope of Services within Price Regulation

The Consultation Paper⁴ recommends that:

“The key principles of the recommended approach in relation to the form of regulation for distribution prices are as follows:

- (i) there should be a limited number of specific, focused objectives set out for distribution price regulation. These

⁴ PUBLIC CONSULTATION ON A NATIONAL FRAMEWORK FOR ENERGY DISTRIBUTION AND RETAIL REGULATION, Prepared by NERA Economic Consulting and Gilbert + Tobin, May 2005, pages 13, 14

objectives should be internally consistent and should be set out in the NEL/NGL;

- (ii) services falling under the basic definition of a regulated service should be regulated on the basis of a form of CPI-X price cap. This principle should be set out in the NEL/NGL;
- (iii) the NEL/NGL should not contain any further prescription in relation to the form of distribution price regulation, or the form of price control adopted within any given form of regulation;
- (iv) the Rules should specify one or more forms of price regulation (eg, building blocks, tender process). Where the Rules allow for more than one form of regulation, the Rules should also set out the circumstances in which the AER is to adopt each of the forms specified.
- (v) the Rules should provide substantive guidance in relation to the application of the form(s) of regulation specified;
- (vi) the AER would apply the form(s) of regulation detailed in the Rules;
- (vii) the form of regulation should be allowed to evolve over time, to reflect changing circumstances, through the consultation and decision making process for Rule changes, administered by the AEMC.”

The MEU agrees with the Framework Paper’s proposed definition of basic regulated services, the proposed criteria for including/excluding services from the scope of regulation, and the proposal concerning non-interconnected distribution networks.

However, the separation between regulated and non-regulated (or contestable) activities is increasingly blurred, for example, in areas such as combined electricity poles and communications tower equipment and electricity sub-stations and commercial building development.

Network businesses are also increasingly outsourcing activities, either with related or non-related parties. These are increasingly becoming contentious issues of transparency and ring-fencing and the MEU would recommend that the Framework Paper would need to establish criteria (based on economic principles) for these issues especially with regard to:-

- transparency
- ring-fencing
- cost allocations
- accounting methodology and standards
- robustness and arms-length nature of related party transactions.

Further, consumers are seeing that even though some activities are seen as “contestable” (eg augmentation of the network to serve a specific consumer) the actuality of such a service is not truly contestable as to secure an alternative supplier is not always (experience is that this should state “is seldom”!) economic and so the augmentation has no effective competition to the distribution entity. Analysis of whether there is effective competition should not be left to the supplier, but should be permitted as an appeal to the regulator and/or the appropriate ombudsman, and should be assessed on a case by case basis.

The recommendations provide for a transitional approach where there is variation between different jurisdictions for what constitutes included and excluded services. Whilst it is accepted there needs to be a transition period, the recommendations fail to provide a maximum time for the rationalization of the definitions and their transfer to the national approach.

The MEU supports the view that the form of regulation should be allowed to evolve, but a time limit must be set on this evolution to a national approach. In this regard we would recommend that the definitions should be agreed within 2 years of the new regime commencing and that there is national consistency within 4 years of commencement.

2.2. Price Cap Regulation for Distribution Services

The Framework Paper⁵ recommends that:

“... the content of the Rules should provide guidance on the various elements of costs, as follows:

- (viii) asset values should reflect past regulatory determinations, rolled forward on the basis of additions

⁵ PUBLIC CONSULTATION ON A NATIONAL FRAMEWORK FOR ENERGY DISTRIBUTION AND RETAIL REGULATION, Prepared by NERA Economic Consulting and Gilbert + Tobin, May 2005, pages 13, 14

(that have been assessed as prudent), depreciation, disposals and inflation;

- (ix) in assessing additions to the capital base for prudence, the regulator may consider the extent to which the distributor has taken into account appropriate alternatives to network augmentation (eg, for electricity this may include DSM measures) ;
- (x) the business's assessed costs should reflect the cost of complying with government obligations as outlined in the Jurisdictional Direction;
- (xi) the business's assessed costs should reflect obligations arising as a result of other elements of the regulatory framework, eg, metering; service standard requirements;
- (xii) for electricity distribution businesses, any payments made to embedded generators to reflect reductions in TUOS costs and avoided network augmentation⁷ should be able to be recovered via distribution charges; and
- (xiii) the regulator should use market based rates of return.”

Whilst the MEU agrees with the key principles in the recommended approach in relation to the form of regulation for distribution prices (ie a price cap approach) it does so with some deep concerns which need to be addressed if the price cap regime is to be the national standard for all distribution network pricing.

- The first issue is that some jurisdictions (eg Queensland) do not use price caps for distribution regulation. To change this approach in these jurisdictions may result in price shock, especially if the current approach has not been applied in a cost reflective manner.
- The second issue, and one which has had a significant impact on consumers in a number of jurisdictions, is the extent to which there is regulatory review of the tariffs developed from the AARR. This matter is further developed below.

The proposed objectives should be limited and based on economic efficiency criteria in relation to cost recovery, incentive regulation and importantly, consistent with “the long term interest of consumers”.

It is important that the NEL/NGL does not contain any further prescription (other than the CPI-X price cap) in relation to the form of distribution price regulation or the form of price control. In addition, the Rules should specify the forms of price regulation, including the circumstances in which the AER is to adopt each form of regulation. The provision of increased certainty to regulated businesses is important, but it is equally important that the AER is not excessively constrained in the exercise of its regulatory functions, and a certain level of flexibility is essential. This is because a wide range of outcomes are possible, for example, in the use of the CAPM in the building block approach. A heavily constrained and prescribed AER can be exposed to increased numbers of merits reviews (see MEU earlier submission to MCE SCO on this issue).

We agree with the possible adoption of the Total Factor Productivity mechanism as an alternative form of regulation and that it should be reviewed by the AEMC. Our major concern with using any form of indexing to set elements of the building block approach is that for such an approach to be equitable, the values used when moving to the index approach, must be accurate – understating the values can cause severe financial hardship to the regulated business resulting in under investment in the network, whereas overstating the value results in consumers paying monopoly rents.

However, we also suggest that other forms of regulation be evaluated, such as **yardstick competition**. **Yardstick competition** has been used in the UK for the past 20 years (and by regulators in other international jurisdictions) to incentivise companies to reveal their efficient level of costs; this method has the approval of the UK Competition Commission (which is the appeals body for regulatory reviews). The AEMC should also be directed to review yardstick competition as a form of regulation.

With regard to the content of the Rules, MEU agrees with the proposals in the Framework Paper, but considers that guidance on the various elements of costs should include:-

1. asset values should be **optimised** (and redundant assets subtracted from the asset base), and rolled forward on the basis of additions that have been assessed as prudent and efficient

2. the regulator **must** (not may) consider the extent to which the distributor has taken into account appropriate alternatives to network augmentation in assessing additions to the capital base for prudence. There may be provision for principles to be established to guide such assessments.
3. there should **not** be Jurisdictional Direction provisions in relation to the business's assessed costs.
4. treatment of regulated and non-regulated activities, including the allocation of costs.

The price cap approach to regulation has the advantage in that it incentivises the network business to increase the utilization of its existing assets.

On the downside, a price cap approach:

- provides the business with reasons to minimize demand side responses from consumers, as the outcome of DSR is ultimately a reduction of utilization of the supply side assets.
- encourages the distribution business to use the tariff structure as a tool to maximize revenue without doing anything other than financial engineering. In this regard, the ESCoV in its recent EDPR highlighted that the businesses had received significant amounts (upward of \$100m pa) of effectively unearned revenue through the careful manipulation of tariffs within the control mechanisms designed to allow some flexibility of tariff movement needed to provide continuing cost reflectivity of asset usage⁶.

Because of these two major drawbacks of using a price cap approach, MEU strongly recommends that the Rules included for:

- (i) The Regulator to have to review and investigate in detail the tariffs developed by the business to ensure that these are close to being cost reflective, and that excessive revenue earned each year above that expected

⁶ This issue is addressed at length in the Energy Users Coalition of Victoria submission to ESCoV in the 2005 Electricity Distribution Price Review. See Response to the Draft Determination by The Energy Users Coalition of Victoria (EUCV) August 2005, section 4

from the increase in utilization is examined for unearned income. If the review reveals that tariff manipulation has resulted in unearned income, then the business will be required to adjust its tariffs to prevent similar earnings occurring in the following year.

- (ii) That there be active incentives to consumers to enter into demand side responsiveness, and that if the consumer identifies that the pricing or non-pricing approaches by the business results in a disincentive to undertake DSR, then either the regulator will seek a change to the Rules, or the regulator will impose a requirement on the business to provide active support for the DSR.

With regard to transitional arrangements, it is proposed that the fixed principles contained in access arrangements for some gas distribution businesses that relate to the form of regulation should be taken into account by the AER until they expire or until the distributor proposes a change to the fixed principle to adopt the national regime. However, there should be a sunset clause of say, 5 years. The argument that distributors may have made investments on the basis of these principles should not be put at risk does not hold, as business is all about taking and managing risks. A sunset clause of say, 5 years should be more than sufficient to assuage the ire of the distributors!

The MEU has no difficulty with requiring the AER to have regard to decisions of previous jurisdictional regulators. However, where the jurisdictional regulator's previous decisions are demonstrated to have been in error (e.g. where they are due to errors, omissions and oversights) the AER must be allowed to rectify such errors. What the MEU does require is that should a regulated asset be sold to another party, the regulatory asset value should be the lesser of the previous adjusted regulatory value and the sale price.

2.3. Regulatory Requirement in Relation to Tariff Setting

The Framework Paper⁷ recommends the following policies should be applied:

⁷ PUBLIC CONSULTATION ON A NATIONAL FRAMEWORK FOR ENERGY DISTRIBUTION AND RETAIL REGULATION, Prepared by NERA Economic Consulting and Gilbert + Tobin, May 2005, pages 13, 14

“The following regulatory policy criteria are proposed for tariff setting:

- (i) regulatory requirements relating to tariff setting should be limited and should relate to clear, economic criteria;
- (ii) the principles for tariff setting should be set out in the Rules;
- (iii) the same principles should apply on a national basis and should be consistent between the electricity and gas sectors; and
- (iv) regulated distribution businesses should be allowed discretion in determining their tariff policy consistent with these principles.”

The MEU agrees with the proposed regulatory policy criteria for tariff setting and for the criteria to be set out in the MEC/NGL. However, there should be some constraints on the allowed businesses in determining their tariff policy. For example, the discretion should only be extended so long as the outcomes for individual customers are efficient, and provide reasonable locational signals. It should not be used to allow distribution businesses to maximise revenues at the expense of individual customers, but yet meet the global principles in relation to tariff setting.

In the Framework Paper, the following principles have been recommended:

“The following principles are proposed in relation to tariff setting:

- (v) tariffs for individual customers should lie between the incremental cost (lower bound) and stand-alone cost (upper bound) of serving them;
- (vi) the allocation of fixed or common costs should be transparent;
- (vii) there should be constraints on the extent to which tariffs can be changed year-on-year
- (viii) distributors should be permitted to give discounts on published tariffs where this reduces costs for all

customers, compared to a situation in which discounts were not allowed. Distributors should be allowed to recover the revenue foregone as a result of such discounts from other customers; and

- (ix) tariffs should take into account any explicit jurisdictional policy requirements as set out in the Jurisdictional Direction.”

With regard to the proposed principles for tariff setting, the MEU provides the following comments:-

1. As noted above we have a serious concern that such a large range is available to the business for setting its tariffs. Whilst the tariffs must lie between these two extremes to ensure economic efficiency, economic efficiency also assumes that each user will pay for its share of asset usage. Once it is accepted that there is a move away from this principle of cost reflectivity, one tariff becomes subsidized by another. Economic efficiency is at its maximum point when there is no cross subsidization. Thus it is the most efficient to attempt to maximize cost reflectivity in tariff setting. At the same time maximizing cost reflectivity also minimizes the ability of a business to manipulate tariffs as a means to increase revenue

This matter is further developed more in Appendix B

2. The allocation of fixed or common costs should be transparent, provided criteria are provided with regard to allocation of costs between regulated and non-regulated activities, the appropriate treatment of outsourcing activities, and related party transactions.
3. There should be constraints on the extent to which tariffs can be changed year-on-year, including the extent of changes to reflect reclassification of peak and off-peak periods. It should be noted the greater freedom given to a distribution business the greater the incentive to use tariff adjustments as a basis for maximizing revenue.
4. Distributors should be allowed to give discounts, but in principle we are implacably opposed to allowing them to recover such discounts from other customers. However, where a discount is appropriate to prevent the loss of a consumer to bypass, and the retained revenue after the discount is greater than otherwise would be lost if the

bypass did occur, then it is economically efficient to permit the discount to be recovered from other consumers i.e. the increase in cost to other consumers due to the bypass must be greater than the increase in costs due to re-allocating the discount granted to prevent the bypass.

This provision would be anti-competitive if discounts are provided to affiliate retailers at the expense of other customers, including non-affiliate retailers.

5. There should not be any ability for jurisdictional policy requirements to dictate tariff setting by distributors or regulators.

3. Service Performance Targets

The Framework Paper⁸ recommends the following policies should be applied:

“The key principles of the proposed approach in relation to service performance targets are:

- (i) service performance targets for distribution services should be explicitly incorporated within the national regulatory regime, so that they are transparent;
- (ii) performance targets for distribution services should be specified at both:
 - A. the average service level; and
 - B. as minimum performance targets (or ‘guaranteed service levels’) for any particular customer, below which either some form of financial compensation becomes payable or reporting occurs.
- (iii) minimum service performance targets should:
 - A. reflect attributes of service performance that customers care about;
 - B. be specified in a meaningful manner; and
 - C. be measurable.
- (v) service performance targets should be determined separately for the gas and electricity sectors (with the exception of

⁸ PUBLIC CONSULTATION ON A NATIONAL FRAMEWORK FOR ENERGY DISTRIBUTION AND RETAIL REGULATION, Prepared by NERA Economic Consulting and Gilbert + Tobin, May 2005, pages 13, 14

measures relating to customer service, where a higher degree of consistency may be achievable);

- (vi) average and minimum service performance targets should be determined by each jurisdiction or, where the jurisdiction has not specified any targets, by the AER;
- (vii) average and minimum performance targets may vary between jurisdictions and may differ between distributors within each jurisdiction; and
- (viii) 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.’”

Generally the MEU supports the approach outlined. The concern that MEU has is of a general nature in that it would be that the jurisdictions are nominated to set the performance standards for each jurisdiction. This is not in keeping with the national approach to the NEM. It should be the AER which sets the minimum and average performance standards as this is an explicit element of the regulatory bargain which relates the cost of the service to the provision of the service and the expectation of the performance required for the payment. To decouple this element provides the potential for destroying the very basis of the regulatory bargain between consumer and provider.

The AER should therefore be the independent party tasked with this responsibility and that the general improvement in performance (if required by consumers) is related to the payment for the improved service. In this way there is the ultimate goal for all consumers to receive a minimum standard of service regardless of jurisdictional boundaries.

The MEU is concerned that the Framework Paper has described ‘service quality’ (voltage fluctuation and gas composition) as ‘typically determined by safety and technical considerations and not subject to economic regulation’ (page 30).

With the introduction of highly sensitive equipment required to maintain operations at the highest level of productivity, the **quality** of energy supply has become increasingly important, with the focus being appropriately on the performance of the distribution networks because they control the quality of electricity voltage (especially voltage sags, momentary interruptions, and transients) and gas pressure by small amounts now has the ability to shut down critical

elements of many production processes. Therefore, it is entirely appropriate that customers demand a certain level of energy supply quality from distributors.

Whilst the service quality of the electricity system is almost entirely in the hands of the distribution business (voltage stability, reliability, harmonics, etc, Equally, gas pressure stability and leakage loss is totally in the hands of the gas distribution businesses. To have the setting of these standards set purely on a technical basis and not directly linked to the regulatory bargain divides the responsibilities, leading to the reduction of control of the regulatory bargain.

We are strongly of the view that the AER should have:

- a. primacy in the setting of the service standards (and the rewards and penalties attached to them)
- b. should seek advice from technical sources as to the appropriate standards to be set.
- c. responsibility for identifying where, what and how the distribution business measures performance, as it is necessary that performance be measured deeply into the networks as this is where consumers are and, where the poor performance impacts.

This approach is one which the ESCoV has very well managed for over a decade

The National Framework must provide for the AER to determine appropriate requirements as to quality standards, collect and monitor the relevant data, and introduce an incentive scheme where appropriate. Service quality is considered by customers as an economic issue, and should not be simply set aside on “safety and technical considerations”. It is important that the energy legislative and regulatory architecture evolve and respond to modern industrial needs and practices.

4. Process for Regulation for Price Capped Services

The Framework Paper⁹ recommends the following policies should be applied:

⁹ PUBLIC CONSULTATION ON A NATIONAL FRAMEWORK FOR ENERGY DISTRIBUTION AND RETAIL REGULATION, Prepared by NERA Economic Consulting and Gilbert + Tobin, May 2005, pages 13, 14

“The key principles in relation to the development of a process for distribution price regulation are as follows:

- (i) the process should involve public consultation, in order to provide transparency;
- (ii) the AER should be required to provide reason and supporting information for decisions (ie, the AER’s decision should be replicable); and
- (iii) there should be a clear dispute process.”

The Paper then goes on to describe the current approach used by regulators in price and other reviews as the recommended approach for the AER to use in its reviews of the retail and distribution approach.

The proposed process for regulation is supported provided there are clear timelines and penalties prescribed (to prevent excessive delays, often, in MEU’s extensive experience resulting from non-provision of adequate information by the access arrangement applicant). In this regard, the Victorian gas and electricity distribution regulatory model is considered to be best practice, as the issuing of a Framework Paper covering what the regulator would like to see in distributors’ proposals, can avoid undue delays in regulatory reviews and enhances the efficiency of the whole process. This should be the model for all gas and electricity reviews.

In addition, adequate scope for consultative processes and transparency in the process must be prescribed.

5. Information Disclosure

Information disclosure is one of the most, if not the most, important aspect in ensuring that consumer interests are protected, especially in highly volatile and highly concentrated markets. In MEU’s extensive experience involving every major gas and electricity regulatory review (in the past 2 regulatory resets), the adequacy of information disclosure has consistently been a contested area between customers, regulators and access arrangement applicants.

The Framework Paper¹⁰ recommends the following policies should be applied:

“In relation to information disclosure, the following principles are proposed to apply:

- (a) the Rules should require that network businesses collect, compile and provide to the AER information that the AER reasonably requires for the purposes of its regulatory functions; and
- (b) the Rules should:
 - (i) provide that the AER should develop standard, national Statements of Requirements for Ringfencing, which should be consistent between electricity and gas businesses;
 - (ii) the Statement of Requirements should cover ringfencing between regulated and non-regulated activities, and between different regulated activities; and
 - (iii) set out the circumstances in which the Statement of Requirements for Ringfencing apply.
- (c) the Rules should:
 - (i) provide that the AER can develop standard national Statements of Requirements for Regulatory Accounts, consistent across electricity and gas businesses; and
 - (ii) set out the circumstances in which the Statement of Requirements for Regulatory Accounts apply.”

The Paper goes on to recommend

“The Rules should require the Ringfencing Statement of Requirements to cover:

- (a) clear requirements relating to the allocation of common costs between regulated and non-regulated businesses, and between different regulated businesses;
- (b) requirements relating to the required operational separation of businesses; and
- (c) prohibitions on preferential self-dealing.”

¹⁰ PUBLIC CONSULTATION ON A NATIONAL FRAMEWORK FOR ENERGY DISTRIBUTION AND RETAIL REGULATION, Prepared by NERA Economic Consulting and Gilbert + Tobin, May 2005, pages 13, 14

The proposals recommended in the Framework Paper are as good as it gets and are fully supported by the MEU.

However, there are at least two key issues missing:-

1. The AER must be able (through the Rules) to penetrate corporate veils and obtain adequate information for related party and outsourced transactions to enable it to establish the veracity, robustness and 'arms-length' nature of the transactions.
2. The AER must be empowered (through the Rules) to specify the collection and the provision of information in between regulatory resets. (There are some doubts about the ability of regulators to do this under the current Gas Code). These provisions will ensure that the legislative and regulatory architecture is able to reflect commercial reality and evolve as industry practice changes.

6. Connection and Capital Contributions Requirements

The Framework Paper¹¹ recommends the following policies should be applied:

“The regulatory arrangements need to provide for the distributors to be able to levy charges:

- (i) for connecting customers to the distribution network; and
- (ii) in relation to any additional (upstream) augmentation that is required to the network as a result of that customer connecting to the network, over and above the direct connection works.”

The MEU agrees with the Framework Paper proposals for connection and capital contributions, but with two provisos.

1. An increased demand on the system provides additional revenue to the business under the price cap approach. The revenue that the additional demand provides must be related back to a capital sum using the regulated rate of return, and over a reasonable period reflecting either the life expectancy of

¹¹ PUBLIC CONSULTATION ON A NATIONAL FRAMEWORK FOR ENERGY DISTRIBUTION AND RETAIL REGULATION, Prepared by NERA Economic Consulting and Gilbert + Tobin, May 2005, pages 13, 14

the consumer asset or the life expectancy of the distribution assets, whichever is the shorter. This capitalized revenue (the capital contribution discount) should be deducted from the capital contribution required for the new/upgraded connection.

Some current jurisdictional approaches to discounting the increased revenue from an expansion (and therefore reducing the cost to the consumer of the upgraded connection) are evaluated over extremely short periods of time. Usually a consumer investment is based on long term investments, sometimes expected to be as long as the investment life of the network, and to value the increased revenue from usage of the network over a short period, actively disadvantages the consumer, and requires them to pay a capital contribution in the short term, and to pay a premium for use of the network over the long term.

When assessing the prudent discount to a capital contribution, the expected life of the new investment causing the demand increase should be used to assess the discount to the capital contribution.

2. A reduced demand will result from the embedded generator or a demand side response. This in turn will reduce the need for future capital works in the network. The value of the delay in upgrading the network for future demand must be valued and provided to the embedded generator. Failure to do so will disincentivise demand side responsiveness and provide a barrier to embedded generation. As it is policy to incentivise demand side responsiveness and embedded generation, to overlook the network benefits of such options provides an active barrier to these options.

As it is not in the interests of the network provider to encourage non-network options, there must be an appeal mechanism to the AER by demand side or embedded generator proponents to the regulator to ensure that equity prevails in the valuation of the benefits.

7. Distribution Network Expansion Rules

The MEU agrees with the Framework Paper proposals for a nationally consistent set of Rules in relation to network expansion and levying of charges, but with due recognition that Rules may differ for gas and electricity.

PART B

1. Consumer Protection

The MEU agrees with the proposal that consumer protection obligations should be imposed **directly** on relevant parties rather than (as presently is the case) via a condition attached to energy licences or energy business authorisations. In addition, the MEU considers that the Framework should:-

1. Incorporate a description of electricity and gas as **essential services**, and universal access to such services must be provided, within certain specified conditions e.g. must not be denied because of financial hardship and safety considerations.
2. Provide for mandatory Codes of Practice as a means of protecting consumers.
3. Require the AER to take specific action where systemic issues occur involving retailer non-compliance with Codes of Practice e.g. in relation to incapacity to pay resulting from financial hardship.
4. Provide for transparent and effective mechanisms for consumer complaints to the Energy Ombudsman and for these to be addressed by the AER. The Energy Ombudsman must be required to identify systemic issues occurring in the market place and to advise the AER of these issues for the AER to take actions.
5. Recognize that the Energy Ombudsman may also be required to address matters of principle rather than just costs. The Energy Ombudsman must be authorized to address and resolve such issues. Currently Energy Ombudsmen are limited as to the value of a determination made by them. If this limitation approach is to continue then there has to be an intermediate step to achieve resolution before there is a requirement to take the matter to the expensive option of the Court Process. (eg compulsory arbitration under the direction of the Ombudsman or the AER).
6. Recognise the problem of information asymmetry is especially acute with respect to small, household consumers and safety net provisions must be explicit to ensure protection of small consumers to a fair price service.

PART C

1. Business Authorisation

The MEU agrees with the Framework Paper's statement (page 65) that:-

“Licensing/authorisation regimes create barriers to entry and regulatory costs that should be imposed where it is clear that the benefits of the regime outweigh its costs.”

The Framework Paper then goes on to recommend that retailers be subject to direct legal obligations covering:

- (a) compliance with Consumer Protection Rules;
- (b) compliance with Gas Retail Market Rules;
- (c) compliance with Metering Rules; and
- (d) compliance with Retailer Failure Rules.

and that distribution businesses be subject to direct legal obligations covering:

- (a) compliance with Price Regulation Rules;
- (b) compliance with Consumer Protection Rules;
- (c) compliance with Gas Retail Market Rules;
- (d) compliance with Metering Rules;
- (e) compliance with Curtailment and Load Shedding Rules.

In general, the MEU considers that a nationally consistent licensing/authorisation regime should be introduced. This is possible if a system of 'mutual recognition' could be introduced, so that a business licensed or authorised in a jurisdiction is able to operate in another jurisdiction within the terms of the licensing or authorising requirements. As well as reducing costs for entry, the concept is to discourage individual jurisdictions from imposing 'special' obligations on businesses, and avoid a proliferation of such uniquely jurisdictional obligations.

Distribution businesses operating across jurisdictions, if required to have individual licences or authorisations could face heavy compliance costs. These, in turn, translate into high transactions costs.

The MEU is also concerned by the need to avoid any possibility of anti-competitive situations – whether intended or not – from arising, especially in jurisdictions that also own utility assets.

Finally, while there is agreement for Rules concerning prudential soundness of retailers, there is some concern that the existing prudential requirements are constraining the growth of smaller retailers and energy brokers. This matter should also be addressed, as it is by the entrance of such smaller retailers that competitive pressure will be applied to the dominant retailers (AGL, TRUenergy and Origin in SA and Victoria, EnergyAustralia and Integral Energy On NSW, Energex and Ergon in Queensland and Aurora in Tasmania) which currently effectively control the energy market place in those jurisdictions.

2. Distributor Interface with Retailers

The Framework Paper recommends that

“Regulations dealing with the relationship between distributors and retailers should be transparent and established by a party independent of the participants.”

Given that the structure of the energy relationships is that there is an implied contract between consumer and distribution based on the regulatory bargain, but that the retailer is nominated by the consumer to carry out certain functions with the distribution business on behalf of the consumer to have such a complex arrangement being structured between one party which has no responsibility (the retailer) and the other half of the consumer/distribution business, is fraught with danger to the consumer.

The MEU agrees that there be regulation dealing with the relationship between distributors and retailers, so that the consumer is not disadvantaged due to its lack of knowledge or understanding of the issues. This arrangement must be clear, transparent and established by a party independent of the participants. Further these obligations and the principles underlying the arrangement must be stated within the NEL and NGL, although the details of the arrangement can be provided in a document developed by the independent party. Where

possible the detailed arrangements should be consistent across all jurisdictions.

The MEU totally supports the Framework Paper's recommended approach.

3. Distributor Interface with Embedded Generators

The relationship between distributors and embedded generators is described in the Framework Paper as covering:-

- (a) the terms and conditions governing the connection of embedded generators to the distribution network; and
- (b) permitted payments by the distributor to embedded generators relating to costs that the distributor avoids as a result of the presence of the embedded generator.

We agree with the need to have a transparent and nationally consistent set of terms and conditions governing the connection of embedded generators to distribution networks, in order to remove potential barriers to entry. In addition, there should be pro-competitive principles established to guide negotiations, dispute settlement and payments and these should be detailed in the Rules.

Experience in attempting to develop embedded generation and demand side responsiveness has shown that there are significant barriers to entry, and the network businesses use these to the maximum to prevent the loss of revenue which results from these options (whether this loss of revenue is due to precluding network options and the revenue that results from these, or due to the actual loss of revenue which results from the price cap approach used where demand reduction means revenue loss).

There is no countervailing incentive on a distribution business to support demand side responses or embedded generation, with the net result that such approaches are made as difficult to implement as possible by the distribution businesses.

What is needed is that a set of Rules needs to be developed which at least provides a reasonable valuation for the benefit provided (if not an active incentive to do so) and for this valuation to recognize the benefit in the long term, rather than (as seen in some jurisdictions) and benefit which is measured over a very short time period.

It has been noted extensively that networks are a long term investment. In the same vein, the very commercial validity of embedded generation and many demand side responses is also predicated on the long term benefit. To allocate only a short term benefit to these responses, is tacitly supporting network augmentation to the detriment of other options.

The other major concern MEU has also concerns the relationship between the retailer **and** the embedded generator, as the common practice is for the embedded generator, able to export surplus energy, to negotiate overall contractual arrangements, involving export and import of energy, network and other ancillary charges. Here, pro-competitive Rules must be provided, as experience to date shows:-

- Retailers unwilling to negotiate pro-competitive demand management contracts or even to encourage demand management.
- Retailers unwilling to negotiate fair prices for energy exported.
- Retailers passing through network charges even though no real network usage has been incurred.

4. System Balancing

System balancing within the electricity networks is carried out effectively under the auspices of NEMMCo with support from the network operators. By and large the Rules as prepared fully detail how this is to be carried out.

In gas there is a totally different arrangement in every jurisdiction. Whilst there is some argument to continue with the current separate jurisdictional approaches, this can no longer apply within the interconnected gas network which supplies gas to NSW, SA Victoria, NSW, ACT and Tasmania. The rules for balancing gas supplies in the interconnected network need to be made consistent, and just as importantly, permit demand side responsiveness in the rebalancing. As each isolated jurisdiction is incorporated into the interconnected network, then it must comply with the national approach.

Currently there is a process underway for developing a methodology for rebalancing under the aegis of the MCE Gas Market Leaders Group (GLMG). This is based either on a Bulletin Board approach (referred to as Option 2 which will not achieve the outcomes of a nationally consistent balancing system), or a more comprehensive commercially

based approach which provides pricing signals at critical points in the interconnected network (referred to as Option 3 the City Gate approach)

The recommendations within the Framework Paper may be at odds with the final recommendation reached by the MCE GLMG. With this in mind the MEU recommends that no decision be reached in relation to the Distribution and Retail review until this other activity provides a detailed response on the issue.

The Framework Paper recommends that:

“Rules for balancing systems, supply/consumption reconciliation and settlements and customer transfers should:

- (a) be made or approved by a party independent of the market participants;
- (b) be administered by a party independent of the market participants (an Independent Market Administrator) in regions where the distribution network owner/operator is vertically integrated into either production or retailing of gas (which is commonly the case);
- (c) be as consistent as reasonably possible between gas and electricity;
- (d) be as consistent as possible on a national basis, having regard (in gas) to the different architecture and operation of the gas distribution networks in the Jurisdictions;
- (e) while conforming with the required safety and reliability standards, provide incentives to balance injections and withdrawals;
- (f) make full and efficient use of the infrastructure available in each system;
- (g) facilitate generator/producer and retailer competition including by effecting efficient customer transfers;
- (h) accurately measure and allocate the costs of theft and leakages; (i) be transparent and as simple as possible and have an efficient and open process for rule change; and
- (i) be compatible with the metering, consumer protection requirements and retailer failure arrangements..”

Whilst accepting the disclaimer relating to concurrent work on this issue MEU would recommend that for the interconnected network:

- Balancing be carried out by (or at least under the supervision) an independent body
- There must be pricing signals available at critical points (nodes) where demand side responses or other more economically efficient tools can be used to rebalance
- There is no need for consistency between gas and electricity as technically the two energy forms are quite different and require totally different methods to achieve balance (eg whereas electricity can be injected from many sources, balancing of the gas system requires quite specific location for injection of gas to achieve balance
- The interconnected network should have a single approach to balancing
- Must have commercial signals available so that demand side and side responses can be best used to alleviate constraints, and so ensure that every commercial option has been utilized before applying jurisdictional emergency responses.
- That in order to enable the development of a secondary market in gas (and to enhance the development of the secondary market in electricity) there must be clear and transparent price signals prepared under the auspices of an independent operator. Without there being such, the secondary market will most likely never develop.

5. Metering

The MEU fully agrees with the Framework Paper proposals for metering, covering the aspects and principles that the NEL and NGL should contain. It strongly agrees that the rules for metering have the capacity to deter or facilitate retail competition, and that failure to incorporate a fully transparent methodology under the control of a body fully independent of Participants and Jurisdictions will result in a less than optimal system.

6. Load Shedding and Curtailment

Load shedding and curtailment of energy supplies must only be used when there is danger of failure of the systems. Unfortunately, there is a tendency to curtail a few large loads when the system is subject to potential failure. This results in an inequitable “share of the pain” to certain large consumers, with the result losses being more frequently being carried by these consumers.

Consequently there should be a methodology whereby these frequently curtailed consumers are either excluded from being curtailed or recompensed for being a first choice for consistent curtailment. It is accepted that curtailing a few large loads is the most effective and quickest way of reducing demand in the system when there is an emergency, but it is inequitable.

Thus any Rules established which provide for curtailment must also include for a method to provide some recompense to those parties that are usually called upon first for curtailment.

Such an approach might be that the affected consumers are reimbursed:

- At an agreed amount (eg VoLL) for the loss of supply and that this payment is levied on all other consumers which are not impacted by curtailment.
- At an amount (less than VoLL) set by the consumer reflecting the impact the loss of supply. This would allow the scheduler of the curtailment a “price stack” for scheduling the consumers prepared to be involved in a curtailment process.

This pattern follows the principles used for selection of suppliers of ancillary services in the national electricity market and in the gas market in Victoria.

Once commercial options for curtailment have been implemented the MEU supports the establishment of a national regulatory framework for emergency load shedding/curtailment for electricity and gas.

The MEU agrees with the approach recommended in the Framework Paper for electricity as the National Electricity Rules are already consistent with the Recommended Policy Criteria. With respect to gas, work by the Gas Emergency Protocol Working Group is continuing

with the MEU participating. With respect to Curtailment Rules, the MEU:

- agrees that loads affecting human safety should be shed/curtailed as a last resort, followed by loads where shedding/curtailment may cause substantial asset damage to the assets of energy suppliers or **energy users**;
- non-discrimination between customers within the same class in the curtailment table, although there should be recognition that some customers may be willing/able to be curtailed on a voluntary basis, provided property rights are preserved;
- the cost of implementing load shedding/curtailment and reconnection should be minimised and there should be non-discrimination between customer classes;
- load shedding/curtailment should only commence in the event of a gas supply emergency (as distinct from a gas supply incident). Jurisdictional curtailment action should be deferred for as long as possible, short of an emergency, with major gas loads provided with a mechanism to enable voluntary curtailment.

7. Retailer Failure Arrangements

The potential for a consumer to lose its contracted retailer applies equally across all consumers, and the loss of supply has a major impact to any consumer, as the supply of electricity and gas is an essential service. When such services were provided by governments then this risk was seen as minimal. Now that supply of electricity and gas is in the control of private enterprise, the potential financial failure of an independent entity is much greater, providing greater risk on consumers. As pointed out in the Framework Paper exposure of consumers to pool price risk (currently \$10,000/MWh for electricity and \$800/GJ for gas) when the energy has already been used, has the potential to bankrupt any consumer – large or small.

There are two basic means for avoiding this eventuality occurring:

- Ensuring that the retailers which are licensed are sufficiently resourced that financial failure is an unlikely outcome
- The principle of having a retailer of last resort. The controls establishing the ROLR should be structured to ensure that

bankruptcy of a consumer is not an outcome from the failure of the retailer contracted to supply the energy.

The MEU agrees with the Framework Paper proposals for retailer failure arrangements and recommends that there be no differentiation between consumer classes which access this “back stop” position..

8. Jurisdictional Directions

The Framework Paper takes the view that separate Jurisdictions should be able to control certain aspects of the way the energy markets operate, despite the fact that there is an attempt to provide a national approach to managing the electricity and gas markets.

The Paper recommends that the following jurisdictional powers should be able to be exercised:

“The NEL/NGL will include a provision that the AER in making regulatory determinations must either give effect to or have regard to the Jurisdictional Direction on the following matters:

- (a) the equalisation of distribution tariff across specified classes of customers;
- (b) the values to be included by the AER in the regulated asset base for specifically identified network infrastructure assets (Victoria and South Australia only);
- (c) community service obligations (CSOs) to apply to distributors;
- (d) environmental obligations relating to energy, including greenhouse gas emissions, consideration of demand-side management or undergrounding; and
- (e) taxes and levies.”

The MEU is opposed to the retention of provisions for Jurisdictional Direction, as discussed in section 2 above.

Appendix A

MEU comments relating to the Proposed Framework Schedule for Transfer of Distribution and Retail Functions

Ministerial Council On Energy

Proposed Framework Schedule For Transfer Of

Distribution and Retail Functions

Comments on the Framework

by

The Major Energy Users Inc

November 2005

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MEU Comments On Proposed Framework Schedule For Transfer Of Distribution and Retail Functions¹

The Major Energy Users (MEU) comprising some 20 major energy using companies in NSW, Victoria, SA, Tasmania and Queensland welcomes the opportunity to provide comments on the Proposed Framework Schedule for Transfer of Distribution and Retail Functions.

The companies represented by the MEU (and their suppliers) have identified that they have an interest in the **cost** of the distribution networks services as these comprise the largest cost element in their electricity and gas bills.

Electricity is now the main source of energy required by each MEU member in order to maintain their operations. A failure of supply of electricity or gas effectively shuts down any business now operating MEU members are no different. Thus the **reliable supply** of electricity and gas is an essential element of each MEU member's business.

With the introduction of highly sensitive equipment required to maintain operations at the highest level of productivity, the **quality** of energy supplies is becoming increasingly important and it is effectively the distribution businesses that control the quality of electricity and gas supplies. The variation of electricity voltage and gas pressure by even small amounts now has the ability to shut down critical elements of many production processes. Thus MEU members have become increasingly more dependent on the quality of electricity and gas supplies.

Each of the businesses represented by MEU has invested considerable capital in establishing their operations and in order that they can recover the capital costs invested, long-term **availability** of energy supplies is required. If reliable supplies of energy are not available into the future these investments will have little value.

It is therefore essential that MEU addresses the issues which impact on the cost, reliability, quality and the long term availability of their gas and electricity supplies.

The MEU applauds the MCE decision on 4 November 2005 which agreed inter alia, on "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 ministerial decision is a significant step towards achieving a National Energy Market in Australia, an objective that is strongly supported by major energy users.

The high-level listing of functions drawn from the Consultant's paper and categorised under "National" and "States/Territories" shown in the consultations paper appear to be correct and supported.

It is noted that service performance targets and standards will be transferred to the National regulator. End users have noted that there is considerable variation between the States and territories (even between regions within each State) with regard to service standards. To commence a program to bring all service standards to the same high level is to be supported.

We do, however, note that the rules for licensing distribution businesses for technical competence and dispute resolution are to remain with the States and Territories. We accept the logic behind this need for regional attention but we do point to the need for a degree of coordination and standardisation between the different regions. Many users have multi-State operations and to have a degree of commonality between the technical requirements and capability and dispute resolution will be a distinct advantage. Currently there is a need for end users with multi-State operations to have experts based in each region knowledgeable of the local requirements and different approaches.

With regard to the abolition of:-

1. General Business authorisations we support the approach but query whether that is a need to ensure the commercial viability of the businesses, which is part of the regional requirements. Failure of a retailer of distribution business can lead to significant disruption of end user activities, and to have an independent assessment of the financial viability of these businesses will give consumers a degree of comfort.
2. Regional taxes and levies, we strongly applaud the abolition of these regionally based imposts. The Victorian Smelter Levy and the NSW distribution levy and the Transmission Operator's levy (currently suspended) have provided a distinct disincentive to end users in these States and their abolition is welcomed

However, there are three other issues that warrant specific comment by MEU:

Firstly, we understand that the setting of network service providers performance standards is not proposed (from the MCE meeting on 4 November) to be transferred to national jurisdiction. This is unfortunate and we ask that the issue be reconsidered.

Reliability and performance are very important issues for major end users and NSP performance standards currently vary widely in the different jurisdictions. Regulatory standards and requirements are also variable between different jurisdictions, as is the collection of performance data and the incentive regimes that are operating.

There is a very strong imperative for a national approach in this area.

Secondly, the actual protocols for retail price regulatory functions appear not to have been agreed at the MCE 4 November 2005 meeting. It is imperative that the protocols that are to be developed are guided by the objective of establishing a competitive national energy market that is free from inter-jurisdictional economic intervention.

All state-based schemes for “equalising” retail tariffs must be abolished in order that the market can be effectively competitive. There should not be State based regulation other than in the areas of environmental standards, safety (Occupational health & Safety) consumer fair trading protection, licensing and community service obligations.

Thirdly, we have noted that there are distinct benefits provided to State owned incumbent retailers, particularly in NSW, Queensland and Tasmania, which provide them with unique opportunities to retain their customer base, to the detriment of competitive tension between retailers. We would recommend that the transfer of powers includes the ability of the national regulator to assess the competitive relationships between incumbent retailers (in the interest of competitive neutrality) and those seeking access to these relatively uncontested regions.

Appendix B

Extract from a recent submission¹² of MEU to AEMC on cost allocations and tariff pricing

However as pricing signals are the tools on which economic drivers are based, the more these signals are muted or distorted the less value they have in achieving the economic outcomes sought. Further to leave the development of these signals largely in the purview of a regulated entity allows the entity to use the freedoms allowed by minimal oversight to enhance the profitability of the entity at the expense of gaining the NEM outcomes desired.

Such approaches which can be used by regulated entities include:

- Internal price adjustments to prevent economically sensible bypass.
- Pricing to prevent alternative mechanisms to network augmentation
- Pricing to prevent inter-regional connections
- Pricing to prevent demand side responses
- Pricing adjustments in a “basket of tariffs” in a price cap arrangement to improve profitability

Regulators seldom, if ever, examine in detail the tariffs developed by the NSP to ensure that the tariffs are truly cost reflective, relying on the requirement that the tariffs lie between two extremes of avoided cost and stand alone cost. Even where the outcomes show that there is a distortion in the tariffs (by returning higher than expected revenue) the regulators still do not take action.

Thus the allocation of costs is essentially left to the business to carry out without recognizing that the business has other objectives which could well preclude it from developing truly cost reflective tariffs from the approved revenue – the Rules give the task to a party which has a different set of drivers from those needed to develop maximum cost reflectivity in cost allocations.

By allowing the business to set its approach to cost allocation effectively allows the business to establish the allocation to best suit its aspirations which do not necessarily coincide with the aspirations of the NEM which is to provide clear and sensible signals to develop the most economic responses.

Currently regulators only assess the proposed cost allocations in the broadest terms, and then by assessing the ‘over’ or ‘under’ recovery of revenue. This is

¹² Review of the Electricity Transmission Revenue and Pricing Rules, Comments on the Pricing Requirements Issues Paper, by The Major Energy Users Inc And Major Employers Group Tasmania
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effectively price monitoring. What does not occur, is the in-depth analysis required to ensure that costs allocations are truly cost reflective, or whether the cost allocations provide a strong enough commercial signal to initiate the most appropriate response to an issue.

Most TNSPs use the commercial cost allocation program “T-Price” yet most TNSPs apply different base criteria (some use each half hour of the year, others only apply the program to maximum peak days). This difference creates a significant difference in cost allocations.

Applying the half hourly allocation results in allocation of costs based on low usage rates of the assets, whereas using the program for a few high demand days results in an allocation which reflects the share of the assets used when operating near their peak capacity. The former approach allocates more cost to continuous users of the system (the flat load demands), and the latter allocates more costs to occasional users of the system (the ones which drive the network to be underutilized for much of the time). Thus major end users are entirely dependent upon, or exposed to, the methodology that best suits the network service provider.

Because TNSPs commonly operate under a revenue cap, they are driven to expand their networks in order to increase the return for their shareholders. This incentivises them to oppose non-network solutions to constraints and to attempt to minimize embedded and self generation. By structuring their tariffs in particular ways, the TNSPs can ensure that these demand side responses and alternatives to non-network solutions are effectively marginalized.

Because of the power of cost allocation in providing signals, this matter is far too important to be left to the TNSPs discretion without the establishment to sound principles, close supervision, and verification of the outcomes.