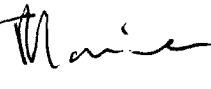


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22 February 2007

Manager, MCE Secretariat,
Department of Industry, Tourism and Resources,
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MCEMarketReform@industry.gov.au

Dear Ms Taylor, 

The Australian Energy Regulator (AER) welcomes the opportunity to comment on the Exposure Draft National Electricity Law Amendment Bill.

The AER supports the proposed legislative amendments giving effect to the recommendations of the Expert Panel report of April 2006 on achieving a common approach to revenue and network pricing across the gas and electricity industries, including changes to the overarching objective of the National Electricity Law.

This submission does not reproduce the AER's comments on equivalent provisions of the Exposure Draft National Gas Law. Where provisions are common to the Exposure Draft National Gas Law and the Exposure Draft National Electricity Law Amendment Bill, the AER has previously provided comments in its joint submission with the Economic Regulation Authority of Western Australia on the Exposure Draft National Gas Law. The AER reiterates those comments, in particular in relation to regulatory information gathering, disclosure and reporting powers, performance reporting in relation to network businesses, AER arbitration of access disputes and merits review. A copy of the joint submission on the Exposure Draft National Gas Law is attached to this submission. The AER also supports the proposed legislative amendments to the AER's enforcement and investigation powers and functions.

The AER considers that there are four key issues arising in the context of the Exposure Draft NEL Amendment Bill. These issues are the arrangements for access arbitrations, decisions on the "form of regulation" for individual electricity services in the context of distribution economic regulation, the need for ring fencing provisions to be included in the NEL amendments, and the need to ensure effective regulatory performance reporting powers and functions.

Access dispute arbitration arrangements

The AER notes that the proposed access dispute arbitration arrangements in the NEL Amendment Bill are consistent with the model proposed by the MCE for gas access disputes, and are also consistent with the arbitration arrangements used in telecommunications in Part XIC of the Trade Practices Act 1974, as well as the model adopted for existing access regimes in Part IIIA of the Trade Practices Act. Consistent with these regimes, the AER considers that the provisions should include an ability for the regulator to join other parties to an access dispute, where for example a party has sufficient interest as a result of a contractual relationship with one of the parties to the dispute. The AER also notes the NEL Amendment Bill does not contain an equivalent to clause 202 of the Exposure Draft National Gas Law, which enables the regulator to require parties to a dispute to engage in alternative dispute resolution, and suggests that the gas and electricity legislation should be aligned.

The AER also considers that an ability to join two or more separate disputes together on the grounds that they raise common issues should be considered as part of the legislation. The AER supports including provisions to this effect, based on the telecommunications access dispute regime in Part XIC of the *Trade Practices Act 1974*.

Form of Regulation

Under the framework in the Exposure Draft NEL Amendment Bill, services will be categorised as either direct control network services, negotiated services or unregulated services. Network services will be allocated to these categories based on the “form of regulation” factors in new section 2E. In distribution, these categories of regulated services will replace the current classifications of “prescribed” distribution services, “excluded” distribution services and unregulated distribution services.

This issue of categorising individual network services is particularly significant in the context of distribution regulation. Whereas a comparatively small number of services are offered by transmission network service providers, there are a significant number of services currently offered by distribution network service providers. The AER has undertaken a review of the range of services provided by electricity distribution businesses, and found that approximately eighty different types of services are currently offered by electricity distributors across the NEM. A consultancy by Network Advisory Services on the range of distribution services currently provided by distributors is attached (see Attachment 1).

In the absence of a default arrangement for categorising and in some circumstances aggregating individual network services, the application of the “form of regulation” factors in section 2E of the NEL will impose a substantial cost on both regulated distribution businesses and the AER. The requirement to categorise individual distribution services would have implications not only for the regulatory reset process, but also for other aspects of the regulatory regime. For example, proposed new section 2D of the NEL contemplates that regulated network service providers would be required to prepare, maintain and keep separate accounts for each direct control network service they provide, rather than grouping direct control network services together and allowing for a single account for these services. A requirement to keep separate accounts in respect of *each* direct control network service is likely to be onerous.

The AER considers that there is a need to provide transitional arrangements for each jurisdiction's initial regulatory reset. The AER suggests the following transitional arrangements:

- The existing jurisdictional arrangements should be adopted as the default position on the form of regulation for direct control network services. That is, distribution services which are currently regulated as prescribed services under a price or revenue cap, or a hybrid approach, could be deemed to be direct control network services to be regulated by the building block methodology, unless an assessment against the form of regulation factors indicates that a different classification is required. The form of regulation for services currently categorised as excluded services would need to be considered on a case-by-case basis.
- Over time, uniform provisions on the classification of services should be implemented, with some flexibility to address a network service provider's particular circumstances on a case-by-case basis. This may take several regulatory control periods to achieve.

Whatever option is adopted for determining the form of regulation, the AER recommends providing distributors with a decision on the allocation of services across categories before reset applications are due. This will provide certainty about which services are regulated and which form of regulation (building blocks etc) will apply.

To achieve this, the AER suggests a two stage approach. The first stage would involve determining whether distribution services should be categorised as direct control network services, negotiated network services or unregulated services for the purposes of the network service provider's reset application. At that time, the AER would also need to make a decision on the form of price control methodology for services regulated under the building block approach (revenue cap, price cap or hybrid). The timeframe for the first stage of the process should allow sufficient time for distributors to subsequently prepare their reset application. The second stage would commence around 13 months before the decision date, when the distributor lodges their reset application.

The AER considers that these arrangements would provide greater predictability for businesses, and facilitate a smooth transition to a national approach to the form of regulation for individual services where this is appropriate. In particular, the AER recommends that existing jurisdictional arrangements should be adopted as the default position for New South Wales and Australian Capital Territory distribution resets to be determined in 2009.

Ring fencing

The AER notes that ring-fencing arrangements for electricity distribution are being considered as part of the MCE's Retail Policy Work Group's work program. The AER has commented on the ring fencing proposals in its submission to working paper number 3 recently released by the Retail Policy Working Group. The comments in this submission reflect those comments.

The AER is of the view that legal separation of networks infrastructure operators from related businesses and maintenance of separate accounts by service providers are minimum requirements for an effective ring fencing regime. The AER considers that the Exposure

Draft National Gas Law addresses these minimum requirements and appropriately includes a number of additional measures. The AER supports replicating the ring-fencing provisions in Part 3.5 and Divisions 1 to 3 of Part 3.6 of the Exposure Draft National Gas Law in the NEL amendments. This would provide a consistent set of high level ring-fencing arrangements across gas and electricity, and would allow further details to be included in the rules or regulatory instruments if required.

As noted by the Expert Panel, effective ring-fencing measures are important for the removal of barriers to entry to the contestable energy sectors where vertical integration remains. The AER considers that adopting the Exposure Draft National Gas Law provisions in the NEL Amendment Bill will ensure a comprehensive response to the Expert Panel's recommendations.

The AER also notes that the ring-fencing provisions which clause 36 of the NEL Amendment Bill will insert in a new Division 3A of the NEL will make any AER decision to require a regulated network service provider to comply with a ring-fencing requirement subject to merits review. The MCE's decision on merits review released on 2 June 2006 indicated that "AER decisions not to exempt entities from ring fencing guidelines or impose additional ring fencing requirements" will be subject to merits review. The AER queries whether the effect of the drafting in new Division 3A would enable merits review to be sought for ring-fencing requirements that are imposed by the AER through instruments of general application (s. 71A(c)). This provision should be redrafted to clarify that merits review is only available where additional ring-fencing requirements, above and beyond those imposed in any instrument of general application, are imposed on a specific service provider.

Performance reporting

The AER supports the information collection and publication provisions in the Exposure Draft of the NEL. The provisions allow the AER to collect and publish information on service providers' price and revenue proposals and to publish annual regulatory reports. This submission comments on the provisions, focusing on publication.

Publication

Publication is an essential step in the continuum of a regulator's work: information is collected and analysed, used to set revenue/price caps, and published to inform stakeholders and policy makers about specific outcomes and trends in the electricity industry. There are three main benefits of publication:

Firstly, publication is necessary for informed policy making.

The AER currently publishes annual reports covering the financial and service standards performance of transmission network service providers (TNSPs) in the National Electricity Market (NEM). The reports are factual and focus on the TNSPs' profitability and investment outcomes. After several years, trends are becoming apparent. First (and contrary to some commentators), capital investment is relatively high in the NEM. Second, service standards are improving with most TNSPs outperforming against their historic performance. Third, profit performance is improving.

All of the jurisdictional regulators also produce annual regulatory reports. The Essential Services Commission of Victoria, for example, publishes an annual comparative performance report on the distribution network service providers (DNSPs) it currently regulates. The report deals with profitability and service standards performance. Matters covered include return on assets, revenues, expenditures, and a range of financial and other ratios such as revenue per customer and capital expenditure as a percentage of asset value.

Regulatory reports bring together information from a number of sources to build a complete picture of network performance including financial, operational and service standards performance. Policy makers need this information in assessing whether the regulatory regime is meeting its objectives. Interest groups with vested interests will present arguments from their particular points of view, such as concerns over regulatory failure and under-investment and it is important this is assessed against the facts as published.

The proposed information and publication provisions will allow the AER to continue publication of the reports.

The second benefit of publication is improved consultation processes. Publication of information supporting revenue/price proposals and the annual regulatory reports provide stakeholders with information on performance outcomes of the businesses. This facilitates informed public input into future decisions by the AER and other processes.

The published information will provide a comparison of actual and forecast performance of the businesses, allowing stakeholders to judge if the NEM objective is being met: Are cost control incentives effective? Are investment and operating practices efficient? Is the electricity supply reliable and secure?

Publication of annual reports includes well accepted financial indicators such as return on assets, return on equity and gearing levels. This helps inform stakeholders about the efficiency with which assets are employed by the business and the potential stresses it may face if servicing high levels of debt to maintain investment in infrastructure. Measures of profitability inform the reader of the financial health of the business and the likely outcomes of revenue/price cap decisions made by the AER.

The disclosure of this information allows customers, industry and all stakeholders to make informed assessments and feedback to the regulator. This is a useful counter measure to the problem of information asymmetry that otherwise faces the AER.

The third benefit of publication is transparency. The increased scrutiny that flows from publication is likely to improve service provider incentives in areas such as service standards performance and capital expenditure against forecasts.

Confidential information

The AER supports specific safeguards in relation to genuinely commercially sensitive information. The NEL Amendment Bill provides such safeguards by including a net public benefit test which must be met before commercial information can be released. The AER supports the provisions in the NEL Amendment Bill and notes that they are consistent with safeguards in the *Trade Practices Act 1974*.

Good regulatory practice

The proposed information collection and publication powers are consistent with good regulatory practice. Dilution of these powers could compromise the AER's capacity to effectively assess revenue/price proposals, the effectiveness of consultation processes, policy makers' capacity to assess whether legislative and rule settings are meeting their objectives and more generally reduce transparency about service provider performance.

The AER encourages the MCE to retain the proposed provisions.

Yours sincerely



Michelle Groves
Chief Executive Officer
Australian Energy Regulator

Attachment 1 – Review of Services provided by Distribution Network Service Providers,
Network Advisory Services, November 2006

Attachment 2 – AER/ERA submission to the Exposure Draft National Gas Law.