AUSTRALIAN ENERGY REGULATOR

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Manager, MCE Secretariat,
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Dear Ms Taylor,

The Australian Energy Regulator (AER) welcomes the opportunity to comment on the third Working Paper prepared by Allens Arthur Robinson (AAR) for the Retail Policy Working Group (RPWG).

The AER's comments in relation to each of the areas covered by the Working Paper are set out in turn below.

Business authorisation
The AER is generally supportive of the approach to national business authorisations recommended in the Working Paper. The role contemplated for the AER appropriately reflects the agreed governance arrangements for the new national framework.

The proposal for a single, national authorisation regime retains the benefits of an authorisation regime while offering a welcome rationalisation of current licensing arrangements, whereby energy businesses are required to hold licences in multiple jurisdictions in order to provide the same service in each. The AER supports AAR's recommendation that substantive obligations not be imposed through licence conditions, which is consistent with the stated objective of simplicity and transparency in regulatory obligations, and the organisational separation of rule-making and enforcement functions.

The AER is, however, concerned that the policy objectives behind authorisation requirements for distribution businesses have not been fully articulated. The objectives of an authorisation/registration framework for distributors will necessarily inform the AER's administration of that framework. The AER would encourage the RPWG to provide a clear statement of the purpose of the proposed authorisation framework and the policy principles underlying it, to inform both submissions in response to this consultation and the administration of the scheme ultimately adopted.

The AER notes that the terminology used in regard to this aspect of the working paper is somewhat confusing. In setting out recommendations for a "national business

authorisation", the paper recommends a system of "registration". The term "registration" already has an accepted meaning in the National Electricity Law (NEL) and National Electricity Rules (NER), in the context of the National Electricity Market Management Company's (NEMMCO) registration of participants, and the AER's role in exempting network service providers (NSP) from the NEMMCO registration process. The Exposure Draft of the National Gas Law (NGL) proposes a role for the Australian Energy Market Commission (AEMC) in maintaining a "scheme register" (of covered pipelines, coverage decisions etc), thus introducing the concept of registers into gas economic regulation.

Use of a common term to refer to different regimes within the same instrument(s) has the potential to create confusion. Adoption of the term "registration" in the context of distributor and retailer entry requirements would mean that the NEL and NER would contain two separate "registration" processes (with the AER managing two separate registration exemption processes), and the NGL and National Gas Rules (NGR) would require both the AER and AEMC to maintain "registers" of regulated businesses, albeit for different purposes. For these reasons it may be preferable if the national framework referred consistently to national business authorisations, the AER's functions as administrator of authorisations, and so forth, to distinguish these entry requirements from wholesale market and economic regulatory schemes.

The AER notes that a number of detailed implementation issues have not been addressed in the working paper. These issues are discussed below. Going forward, the AER considers that these issues should be addressed in the development of the 2007 legislative package.

Transitional arrangements for treatment of existing licences

The AER notes that AAR do not propose to address transitional issues in the working papers it prepares for RPWG, and notes that AAR has recommended that the task of reviewing and removing inconsistent jurisdictional regulation and formulation of appropriate transitional provisions is one that will be undertaken on a jurisdictional basis once the national framework has been settled.

However, the AER is concerned that the issue of how existing licenses are to be treated for the purposes of the new authorisation regime is not addressed. A requirement for holders of current jurisdictional licences to 're-apply' for national registration places a significant compliance impost on licensed businesses. This aspect of transition also has significant implications for the AER as the body responsible for granting national authorisations under the new national entry criteria.

The AER would support a recommendation to transition existing licensees to the national register without further processes.

Transfer of national business authorisations

In the current environment of energy-sector merger activity, it is notable that the working paper is silent on the issue of authorisation transfers between companies. While not suggesting that authorisations should be assignable by the holder of the authorisation, the AER considers that there is benefit in at least providing for an

abridged registration process where a national authorisation has been issued to a particular entity, and the legal identity of the authorised entity then changes following acquisition, merger or corporate restructure. Such a process could allow for the transfer of the authorisation between related/reconstituted companies where it can be demonstrated that the relevant capacities (prudential, technical, fitness and propriety) have been retained.

Jurisdictional licensing of transmission and generation businesses

The paper is silent on existing licensing arrangements for electricity transmission and generation. While generation and transmission are outside the RPWG's terms of reference, the AER considers that a review of existing frameworks for licensing electricity transmission and generation businesses should be considered in the context of this consultation, as common frameworks often apply to these licences and the distribution and retail licences currently under consideration.

The AER would welcome the inclusion of this issue in the MCE's 2007 work program.

Ring-fencing

Ring fencing separates regulated services from other parts of a business. It is used by the regulator to help identify the assets and costs required to provide regulated services and determine revenue or tariff outcomes.

The AER supports the RPWG's intention to establish robust ring fencing arrangements. The following comments address specific issues raised in AAR's working paper.

National Gas Law

The proposed National Gas Law framework incorporates the following provisions which may be thought of as general ring fencing requirements:

- Service provider to not carry on a related business – s. 117
- Marketing staff to not be employed in related businesses – s. 118
- Separate accounts for regulated pipelines and consolidated accounts for whole business to be kept – s. 119
- Imposition of additional ring fencing requirements – s. 120
- Waivers (exemptions) – s. 121
- Prohibition on associate contracts which are inconsistent with Part 3.5 of the NGL[1], or ring fencing requirements, or additional ring fencing requirements – s. 122
- Prohibition on associate contracts that have an anti-competitive effect – s. 123
- Prohibition on associate contracts that are inconsistent with a defined ring-fencing principle – s. 124

[1] Part 3.5 – *Overriding duties for provision of pipeline services by covered pipelines*. This part incorporates the ring fencing provisions.

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 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 NGL exposure draft 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 Part 3.6 (Divisions 1 to 3) of the Exposure Draft NGL in the NEL amendments. The AER does not consider that the associate contract provisions in Part 3.6, Division 4 of the Exposure Draft NGL are required in the electricity legislation.

At the Stakeholders' Reference Group meeting on 8 February 2007 interested parties were invited to comment on whether stakeholder submissions on ring fencing should be considered as part of the current NEL Amendments package. The AER affirms that adopting the Exposure Draft NGL provisions in the NEL Amendment Bill will ensure a comprehensive response to the Expert Panel's recommendations.

Legal architecture

AAR discusses three models for ring fencing legal architecture. The AER is particularly concerned to see consistency across sectors, and a high degree of regulatory certainty regarding the fundamentals of the regime in the future.

Consolidation of network ownership means that the larger infrastructure players (including Alinta, SP Ausnet and APT) own electricity networks as well as gas distribution networks and/or transmission pipelines. Having sector specific ring fencing provisions increases compliance costs to the businesses and raises the prospect that by complying with one set of ring fencing provisions the businesses will breach the requirement of another.

Both option 1 (where the NEL would contain overarching ring fencing provisions) and option 3 (where the AER is required to develop ring fencing guidelines) would allow for consistency across two sectors at least. As noted above, the AER supports option 1 on the basis that it elevates high level ring fencing principles appropriately to the national legislative framework. Principles such as legal separation and maintenance of separate accounts for regulated entities are particularly suited to legislative requirements and can be expected to be applied consistently across the electricity and gas distribution sectors.

The AER considers that option 2 (ring fencing provisions in the rules) raises the possibility of divergence in ring fencing requirements for the electricity and gas distribution and transmission sectors, with evolution of these regimes proceeding through different mechanisms. It is undesirable that rules changes could be proposed and assessed for the electricity distribution sector in isolation from other regulated sectors.

The AER is also concerned to enhance regulatory certainty regarding the ring fencing obligations of the national framework. Adopting option 1, where ring fencing

measures can practicably be placed in the NGL/NEL framework, there is resulting certainty for all industry participants as to the ongoing ring fencing obligations with which they must comply. This reduces the regulatory burden as businesses will not be exposed to the potential for short term changes in their required legal and accounting structures. The enhanced regulatory certainty under this option also has important benefits both for the regulator in the way it may plan for long term compliance administration within the ring fencing framework.

Additional requirements

AAR identifies many further common and additional ring fencing provisions currently imposed on distributors by the various jurisdictions. Some further provisions that are not highlighted in its scoping work include:

- Distributors must ensure that subcontracted parties carry out their functions in accordance with the guidelines (or as if they were an employee of the distributor).
- Distributors must be a legal entity.
- Distributors must advise customers that they have competitive choices from unrelated businesses where appropriate.
- The regulator may, or distributor must, appoint an auditor to assess compliance with specified provisions.
- Distributors must notify regulator of breaches of obligations under guidelines.
- Non-discrimination toward customers (no discrimination on basis of choice of retailer).
- Distributors must provide marketing staff with compliance training or pro-forma responses to ensure compliance.
- Distributors' board membership must contain a certain number of members who are not directors of related businesses.

Whilst these provisions and those additional requirements identified by AAR have merit in some cases in ensuring appropriate operational separation of distributors, the AER considers that not all these provisions need be imposed in all circumstances through general provisions.

The AER, under AAR's options 1 and 2, would set additional obligations on a service provider-specific basis. Where any of the above provisions are considered appropriate for general applications they should be incorporated into the Law or Rules as appropriate under the model adopted.

Where non-universal obligations are concerned, it is important that any ring fencing framework contain a clear and simple test for imposing additional requirements and issuing waivers, in a consistent manner and where appropriate, as part of the AER's service provider-specific powers.

The AER notes and endorses AAR's recommendation that cost allocation requirements be imposed as regulatory information instruments under the NEL. These requirements are broadly applicable principles of accounting and should be adhered to by all service providers.

Retailer Failure arrangements

The working paper notes that submissions to the NERA/G&T May 2005 Consultation Paper addressing retailer failure arrangements contained a variety of responses. The AER recognises that in 2005, and generally in jurisdictional reviews, a variety of views have been expressed on how best to deal with, amongst other things, in the event of retailer failure:

- treatment of pool price / additional contracting risk;
- who should bear the burden of any costs; and
- the appropriate method by which to allocate the Retailer of Last Resort (RoLR) role to party(s).

The AER broadly supports AAR's option 2, and the recommendation that the framework for RoLR not be fully developed as part of the 2007 legislative package. Existing timeframes to accommodate legislative changes are not well suited to a comprehensive development of a model for retailer failure arrangements. Trying to develop a retailer failure arrangement in truncated timeframes is unlikely to produce the best result. A RoLR event in the market, if it were to occur, would represent a significant event, and consultation on the framework to be put in place warrants a focussed consideration.

The AER is conscious that a RoLR event has never occurred in Australia and that there is an associated degree of uncertainty in the market as to what the outcomes of a RoLR event might be. Some of this uncertainty surrounds the adequacy of arrangements in place to facilitate the transfer of customers through billing systems. Complicating factors may also arise if there were to be cumulative failures across jurisdictions, across gas and electricity or along the supply chain. There appears to be consensus that many years of discussion of these issues has not amounted to a clear resolution of how to deal with RoLR events.

A RoLR event has the potential to cause a large degree of market harm. A considered, focussed assessment of RoLR arrangements, supported by appropriate technical expertise, should therefore be given high priority. As a matter of urgency, a timeline needs to be put in place to facilitate the making of policy decisions and for the development of workable legislation and arrangements to support desired policy outcomes. The AER notes the working paper's recommendation that the NEL create a role for the AEMC in enabling consultation on retailer failure arrangements through its rule making processes. The AER considers that, in order to give appropriate priority to the resolution of outstanding policy issues and the development of robust retailer failure arrangements, it may be preferable for the MCE to facilitate the creation of a specialised panel to commence this process prior to the introduction of the 2007 legislative package.

The AER notes that in the United Kingdom there are a number of case studies of retailer failure, where retailers have entered into administration and been sold as a going concern. More recently, in 2006, the Office of Gas and Electricity Markets (Ofgem) appointed a new supplier for customers of a retailer. The AER considers that overseas experiences and lessons, including the workability and fairness of any schemes in place should be considered.

The AER notes the proposal for it to take on the administration of existing jurisdictional schemes until such time as the national framework for retailer failure arrangements is settled. The AER considers that comprehensive due diligence of existing jurisdictional schemes should occur prior to any handover, to ensure that workable processes for RoLR events are in place and the AER's responsibilities in the event of retailer failure are clear. In the interim, the AER recognises that taking on the jurisdictional schemes in place provides a practical solution to provide more time to facilitate the development of a comprehensive national framework.

Thank you for the opportunity to comment on the third Working Paper. We look forward to ongoing involvement in this consultation.

Yours sincerely

Michelle Groves
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Australian Energy Regulator