



## Northern Territory Major Energy Users

Comments

On

Utilities Commission's review

Of

Electricity Ring-Fencing Code – Proposed Variations

February 2008

<b>TABLE OF CONTENTS</b>	<b>Page</b>
<b>EXECUTIVE SUMMARY_____</b>	<b>3</b>
<b>1. Introduction_____</b>	<b>4</b>
<b>2. Revocation and Replacement of the Existing code_____</b>	<b>6</b>
<b>3. Reasons for the Proposed Changes to the Code_____</b>	<b>9</b>
<b>3.1 Reasons for the proposed changes</b>	
<b>3.1.1 Barriers to entry</b>	
<b>4. Specific Proposed Variations_____</b>	<b>13</b>
<b>4.1 A core assumption</b>	
<b>4.2 On terms and conditions</b>	
<b>4.3 Observations and comments to specific clauses of the Proposed code</b>	
<b>5. Issues for Commission’s Consideration_____</b>	<b>20</b>

## **EXECUTIVE SUMMARY**

The Northern Territory Major Energy Users Group (NTMEU) fully supports the Utilities Commission's approach in addressing the regulatory deficiencies (beginning with this review of the ring-fencing Code) currently existing in the Northern Territory electricity market.

The UC's review is of greater import when considered against the background of the NT Government's recent decision to defer the introduction of contestability for the next tranche of consumer class on the basis that there is no competition in the Territory's electricity market.

It is important to recognize that, contrary to popular belief, large electricity users have little or no countervailing power vis-à-vis an entrenched vertically integrated business monopoly, such as Power and Water. Accordingly, an effective ring-fencing code is a necessary, albeit insufficient condition, for negating the market power of Power and Water.

NTMEU questions whether the UC is correct in proposing not to have legal, as well as physical, separation of the various monopoly businesses.

Specific comments are provided on the major aspects of the proposed variations in the ring-fencing Code.

## **1. Introduction**

The Northern Territory Major Energy Users (NTMEU) welcomes the opportunity to comment on the Utilities Commission's Paper on the Proposed Variations of the NT's Electricity Ring-Fencing Code. The NTMEU strongly supports the Utilities Commission's decision to bring up for public review, proposed variations to the Code which will necessitate the issue of a new Code.

The NTMEU has urged the NT Government to keep in step with developments in the National Electricity and Gas Markets and act more expeditiously in developing a broader electricity (and gas) policy reform programme, in the interests of consumers and of downstream industries in the NT. The NTMEU considers that implementation of a pro-competitive policy reform programme would help expand and benefit investment and employment opportunities in the Territory.

The NTMEU has previously observed (and reiterates this observation) that despite the government's intentions to provide a competitive market for electricity, this has not eventuated. The NTMEU considers that this is in part due to the ability of PWC not having to divulge information essential to a new entrant seeking to join the NT market, and to practices of PWC which have effectively prevented new entrants from gaining a sufficient understanding of the market necessary for commercial decisions to be made prior to entry.

In the meantime, the UC has the NTMEU's full support in addressing aspects of the regulatory deficiencies (including this review of the ring-fencing code) currently in the NT electricity market. It is important that NT consumers have the full benefit of electricity policy and administrative reforms similar to best practice developments elsewhere in Australia.

NTMEU members are fully aware of the substantial and significant on-going energy reform developments in the National Electricity Market and urgently seek to have the benefits that such competition can provide.

NTMEU members also note that the UC has, as a primary consideration, the avoidance of unnecessary costs and duplication, against the background of the proposed policy options that the NT Government has foreshadowed for 2008.

The NTMEU provides its comments on the issues raised by the UC below.

## 2. **Revocation and Replacement of the Existing Code**

The NTMEU has already identified significant concerns about the efficacy of the current ring-fencing requirements. Additionally, the NTMEU notes that the government has announced that it intends to defer the introduction of contestability for the next tranche of consumer class, on the basis that there is no competition in the NT electricity market and that these consumers have lobbied (successfully) that certainty is preferred over contestability<sup>1</sup>.

The observation made by the government that there is a lack of competition to PWC (thereby causing its decision) supports the view of NTMEU that the processes put in place to encourage new entrants into the electricity market have been insufficient to create this desired increased competition in the NT electricity market. Despite this lack of competition, large consumers have been exposed to a monopoly supplier without adequate protection from its ability to cause large consumers significant costs. The only residual protection for large consumers has been that PWC is a government corporation and therefore subject to some government oversight. Despite this oversight, large consumers have seen significant increases in the prices for electricity levied by PWC (because of limited countervailing power) and this has resulted in a concern that large contestable consumers are providing a larger share of the revenue for PWC than would be the case if PWC was exposed to real competition, as distinct from the current limited regulatory oversight provided by the Utilities Commission and government.

The unfortunate governmental decision to defer the next tranche of consumers to the contestable market has a number of potential adverse outcomes:-

---

<sup>1</sup> Delia Lawrie, Treasurer, Media Release: Small Business Power Price Certainty, 22 February 2008.

---

- The introduction of competition will be even further delayed as the amount of contestable electricity available to a new entrant to base its business is constrained
- There will be a delay in introducing competitive drivers on PWC to be more efficient
- PWC will retain its market power to allocate costs in a discriminatory, non cost reflective manner, possibly to the detriment of large consumers exposed to “contestability”
- PWC will not allocate its costs on a cost reflective basis, preferring to allocate costs (by cost shifting) to the elements that are not subject to contestability such as its networks and for a period its generation, but also to its franchise customer base

The Act requires the Commission to have regard to:-

- (a) promoting competitive and fair market conduct;
- (b) preventing misuse of monopoly or market power;
- (c) facilitating entry into relevant markets;
- (d) promoting economic efficiency;
- (e) ensuring consumers benefit from competition and efficiency;
- (f) protecting the interests of consumers with respect to reliability and quality of services and supply in regulated industries;
- (g) facilitating maintenance of the financial viability of regulated industries; and
- (h) ensuring an appropriate rate of return on regulated infrastructure assets.

The NTMEU considers that with these (at times) competing goals and the decision to delay the further expansion of the contestable base, the Commission must now develop a set of ring fencing rules that will be comprehensive and effective and address the concerns of consumers who have been exposed to the contestable market as provided and operated by PWC.

Therefore, the NTMEU agrees strongly with the UC's proposal to reissue a new Code, rather than just making amendments to the existing Code, as a new Code has the potential to provide some constraint on the ability of PWC to exercise its undoubted market power.



### **3. Reasons for the Proposed Changes to the Code**

The NTMEU notes that the UC is proposing changes relating to two broad topics, viz. ring-fencing minimum requirements and default terms and conditions for goods and services provided by a Prescribed Business to a Related Business.

#### **3.1 Reasons for the proposed changes**

##### **3.1.1 Barriers to entry**

The UC is correct in observing that:-

*“...currently there are no publicly observable **de facto** contracts or service level agreements in place between Power and Water’s generation and retail arms defining Retail’s terms of purchasing of wholesale energy from Generation.”*

The UC further noted that:-

*“...if a stand-alone retailer was to seek entry into the NT electricity market (or a large contestable customer to seek to directly source wholesale power), they face at least two major hurdles.*

*...The first is in trying to understand the exact nature of the bilateral contracting framework currently in place and the equality of regulatory treatment afforded a new retailer (or customer) compared to Power and Water Retail.*

*...The second is in having sufficient comfort that the ring-fencing processes in place are effective enough to ensure they obtain access to wholesale energy on competitively-neutral commercial terms from Power and Water Generation” (UC, page 8).*

The NTMEU notes, as had the UC, that Power and Water is a vertically integrated business involving generation, networks and retail activities, with a lack of legal

separation between all elements of the supply chain, including between the franchise and contestable retail businesses. Thus there is a real need to ensure that the allocation of costs between contestable retail, franchise retail, network and generation businesses is developed on a non-discriminatory and cost reflective basis, and that consumers can be confident that such is the case

Accordingly, the ring-fencing processes need to be effective to ensure competitively-neutral commercial terms between the networks, the generation and the retail businesses. For example, a potential new retailer (or a large customer) needs to be able to obtain competitively-neutral access to Power and Water's networks on the *same* terms and conditions available to Power and Water's generation and retail business. The same principle applies in regard to the terms of access for franchise and contestable customers.

In addition, cost allocation between contestable and non-contestable activities in each of Power and Water's generation, network and retail businesses needs to be on a cost attributable basis and not allow for cross-subsidisation between contestable and non-contestable activities. Ring-fencing requirements thus become an essential part of ensuring that there is demonstrable equity for all consumers.

The Commission goes on to detail that it proposes to address the requirements of how the Prescribed Business is to relate to an associated Related Business, with particular reference to managing the differences between Prescribed Business and a Related Contestable Business. The NTMEU supports the proposition that such relationships need to be clearly detailed but adds that it is necessary to ensure that such relationships are not proscribed such that the business can use the Code to undertake a discriminatory approach between prescribed (franchise) customers and contestable customers.

For example, there should be a contract(s) between PWC generation and PWC Retail for the supply of all generation, not just generation for contestable customers.

By covering all generation, it provides clarity for a new generation entrant to be able to provide contracts for specific elements of the generation portfolio provided by PWC generation. Similarly, it provides a large customer to be able to match its demand profile with those elements of the PWC generation portfolio as offered to PWC Retail. Such a portfolio approach would recognise the costs and attributes of base load, intermediate and peaking loads, and the costs associated with each of the base generation structures. **In this regard, NTMEU would recommend that the three basic classifications of generation in the portfolio be subdivided to reflect the time of day, and the demand shape as a tool to be able to partly replicate the way generation is priced in a competitive environment.**

**The publication of such information would allow a new entrant the ability to identify which part of the generation portfolio that it might address ahead of another and where it might be able to best provide competition to PWC generation. At a future time, when there is sufficient competition available to PWC generation, then this requirement can be scaled back.**

**In a similar way, PWC networks should enter into a contract with PWC retail which details the network charges which are to be used by PWC retail for development of the prices for both contestable and franchise customers. This set of tariffs would be made publicly available so that both franchise and contestable customers can see that there is no discrimination between these two fundamentally different classes of consumer.**

The Commission makes the observation that it intends that such contracts and arrangements between Generation and Retail and Networks and Retail should be at “arms length”, and that there are default terms which can be varied by agreement and with the concurrence of the Commission.

The NTMEU sees that overall the approach proposed by the Commission will act to provide greater transparency, equity and the ability for new entrants to join the NT market with confidence and certainty.

## **4. Specific Proposed Variations**

### **4.1 A core assumption**

In assessing the revised code the NTMEU has reviewed the Electricity Reform Act (ERA) and observes that:-

Section 4 Definitions:

An "electricity entity" means a person licensed under Part 3 to carry on operations in the electricity supply industry and includes (where the context requires) a person who has been licensed to carry on operations in the electricity supply industry under that Part whose licence has been suspended or cancelled or has expired;

Section 14: Requirement for licence

- (1) A person must not carry on operations in the electricity supply industry for which a licence is required unless the person holds a licence under this Part authorising the relevant operations.
- (2) Subsection (1) does not apply to a person, or to a person carrying on an operation, exempted [by the UC] under section 87.
- (3) The operations in the electricity supply industry for which a licence is required are -
  - (a) generation of electricity;
  - (b) owning or operating an electricity network;
  - (c) selling electricity;
  - (d) system control over a power system; or
  - (e) other operations for which a licence is required by the Regulations.

The NTMEU views that under these definitions and licensing requirements, an entity as referred to in the proposed code reflects each of the supply chain elements noted under ERA Section 14(3)(a)-(d). The NTMEU therefore

considers that even though a single person holds all of these licences (as does PWC), that it is still considered to be a separate electricity entity in respect of each licence it holds. Thus PWC generation is considered to be one “electricity entity” and PWC networks another entity and PWC retail a third entity for the purposes of the code. The NTMEU comments below are based on this assumption.

Further, the NTMEU notes that many of the requirements of the Code apply to an “electricity entity providing a prescribed business”. The NTMEU is concerned that for a period, PWC generation should be considered to be a prescribed business until it is demonstrated that there is sufficient non-PWC generation being provided in the NT, that there can be considered to be adequate competition to PWC generation. At that point in time, the Commission could determine that PWC generation can be exempted from these requirements under clause 9 of the new Code.

## **4.2 On Terms and Conditions**

In assessing the revised code the NTMEU notes that the Code makes reference to “Terms and Conditions”. The NTMEU assumes that these terms and conditions also include price information. In this regard, the NTMEU notes that unless prices are explicitly included to be part of Terms and Conditions, this may create some confusion and concern.

Additionally, the NTMEU points out that unless prices (and the associated development of these prices from the LRMC for the assets involved) are explicitly included in the terms and conditions, then there is the possibility that the costs allocated to prescribed and contestable consumers might not reflect the benefits of sharing the use of assets between the different classes of consumer ie that PWC might have the ability to bias the allocation of costs between different elements of the supply chain.

For example, overhead costs might be incorporated into the network cost allocation “bucket” as this is the true monopoly of the electricity system. By doing so, this would reduce the costs for retail and generation and make them unrealistically more competitive, and directly impacting on the emergence of new entrants.

Equally, prices for network services have historically been required to be between marginal cost and stand alone cost – the Baumol-Willig range. In fact, the new transmission and distribution Rules in the NEM now require prices to be reflective of the LRMC to provide the service, with there being no intention for any customer class to be considered as a marginal addition and thereby gaining a price benefit.

#### **4.3 Observations and comments to specific clauses of the proposed Code.**

As a general comment, the NTMEU considers that the Code as written (with the proposed variations) provides a sound basis for a new Code to be implemented. Aspects where NTMEU has an observation or concern are detailed as follows.

##### **Clause 2.2**

##### **Scope**

NTMEU supports the new provision.

Clause 2.2(a) (ii) (minimum ring-fencing requirements) and clause 2.2(a) (iv) (accounting procedures, cost allocation procedures, and information procedures) **must** require the UC to develop appropriate guidelines (clause 1.6 – not clause 1.5 as noted on page 12 of the UC paper), and not *may* produce these guidelines. These guidelines are critical elements of an effective ring-fencing Code and the NTMEU considers that they must be seen as such.

### **Clause 3.3**

#### **Provision to third parties of goods and services of a Prescribed Business provided to a Related Contestable Business**

The NTMEU supports this new provision – i.e. the goods and services must be provided on terms and conditions that are fair, reasonable and non-discriminatory, and reflect the value to all users of sharing common assets.

It is important that the UC establishes to its satisfaction that it has the powers to pierce corporate veils to establish the facts. There was a legal challenge by a Victorian network service provider to the Essential Services Commission of Victoria's (ESCV) information collection powers when it sought information on certain related party transactions. The UC's attention is directed to this case as the ESCV's powers were upheld by the Court.

In this case a regulated business had subcontracted some of the services it required to a related party. The related party considered that as it was not a regulated entity, the requirement to divulge information to the regulator did not apply to it, and the regulated entity advised that its contract with its contractor did not require the contractor to divulge this information. The Court held that the ECSV was entitled to have the required information as if the regulated entity provided the service rather than a contractor.

### **Clause 3.4**

#### **Provision of goods and services of a Prescribed Business to a Related Contestable Business**

The NTMEU supports this clause.

However, the NTMEU would like to see a provision whereby the UC, at its discretion, can seek public comment on such contracts (depending on the significance or magnitude of the transaction) in the interest of transparency and information gathering by the UC.



The NTMEU considers that whilst there is little or no competition in the NT electricity market, contestable [franchise] customers must be able to see that the costs they incur from PWC Retail are based on the same contracts and price structures that apply to franchise [contestable] customers with similar load profiles and supply arrangements. By addressing this, both franchise and contestable consumers can see that PWC is not providing a cross subsidy to the other.

### **Clauses 3.5 and 3.6**

#### **Related Party Transactions**

These clauses are supported.

The UC should ensure that it has adequate information gathering powers to pierce corporate veils and/or require the collection and presentation of data (including historical data) in between resets in a reasonable way. Experience in the NEM has shown that this is a sensitive issue and has been contested in the courts.

### **Clause 3.7**

#### **Marketing Staff**

This clause is supported.

A related issue concerns cost allocation principles, and needs to be cross referenced to ensure there is no cross subsidy.

### **Clause 3.8**

#### **Branding and Marketing**

This is supported.

The clause is consistent with competitive neutrality principles.

### **Clause 3.9**

---

### **Claims about service standards**

This clause is supported.

We suggest also that the UC would need to prescribe minimum standards on reliability, quality and safety for all prescribed services.

### **Clause 4**

#### **Default Terms and Conditions**

This clause is supported.

With respect to clause 4.9 (Review and consultation with Commission about default terms and conditions) the UC should ensure that appropriate public consultations are undertaken. Potential new retail competitors would have important contributions to make, as would major electricity users. Such transparency will directly assist in gaining new entrants to the market

### **Clause 5**

#### **Compliance with Approved Procedures**

These procedures (accounting, cost allocation and information) must be exposed for public consultation when the electricity entity submits a draft for approval by the Commission.

### **Clause 7**

#### **Procedures for Adding to or Amending Ring-Fencing Obligations**

This is supported.

The Commission, in seeking submissions must publish a notice in the daily papers to alert the public to its review.

### **Clause 10**

#### **Outsourcing**

This clause is supported.

Outsourcing services is now a common business feature with the key issue being the disclosure of the information to verify claims by the regulated business. It is noted that many NTMEU businesses also outsource work as this is more efficient than providing the service using in-house resources, but this approach should not be used to prevent disclosure of information. As noted above, NTMEU is aware that regulated businesses have attempted to avoid providing detailed information to the regulator by outsourcing work. The NTMEU is fully supportive of this Code requirement

### **Clause 13**

#### **Interpretation**

The NTMEU notes that the Commission has defined the meaning of competition as “actual or potential rivalry”. In this regard the NTMEU points out that even where there is apparent competition, often the appearance of competition is not supported by the economics of providing the competitive service.

For example, in theory PWC networks might allude to there being competition because the ERA and Rules permit another party to build and operate a network. In practice, the economics of a competitor being able to commercially provide this competition is non-existent. So even though competition is theoretically possible, it is not practical. This aspect has been recognised by the NEM Rules, and the regulator (AER) has the power to determine whether competition is in fact real or only apparent.

With this in mind, the NTMEU suggests the Code provides for the UC to determine whether there is competition or not.

## **5. Issues For Commission’s Consideration**

The NTMEU has noted the recent release of the government’s decision to extend by two years the period before the next tranche of customers become contestable. This delay is seen by the Government as a benefit for smaller consumer as it creates price certainty. The press release from the government states that:-

“Contestable customers negotiate individual contracts with their electricity supplier and do not pay set tariff prices. Because there are no major competitors in the NT electricity market, requiring small business to negotiate the price they pay for power would not offer any advantages.”

This statement is of great concern as the reasons the government gives for delaying the introduction of the next tranche of contestability equally apply to large contestable customers, and the clear implication is that the government seems not to consider that large customers need a similar protection.

In fact, the only protection large contestable customers have is from the UC requiring PWC to properly and adequately ring-fence its network, retail and generation elements so that each element of the PWC supply chain is:-

- demonstrably operating at LRMC in relation to each element for each customer class and demand profile
- not cross subsidizing between PWC elements
- not providing a cross subsidy between contestable and non-contestable customers

The NTMEU strongly endorses the UC’s proposed variations to the ring-fencing Code. The draft Code is an effective way of addressing certain of the regulatory deficiencies which currently exist in the NT. Given that the NT market may not develop into a fully mature and competitive market for the foreseeable future, it is necessary that the Commission errs on the side of promoting the public benefit in its current review. Concerns about not imposing too great a regulatory burden on Power and Water need to be seen in that light.

In this regard, the NTMEU would welcome some elucidation from the Commission concerning the following:-

*“3.19 The Commission has considered whether or not it should include any ‘legal separation’ requirements (as between Prescribed Businesses or as between Prescribed Businesses and Related Businesses) in the Draft Code but, on balance, has decided not to further pursue that more prescriptive option at this stage.”*

The NTMEU considers that ring-fencing of any type is a second best outcome when compared to a competitive market.

Accepting that it is second best, the most effective form of ring-fencing is by a combination of legal and physical separation, and requiring “arms length” formality between related entities. To achieve this level of ring-fencing does have a significant cost, and as this cost becomes a cost to consumers, the cost of the ring fencing needs to be balanced against the additional benefits that will accrue. Currently PWC is neither legally nor effectively physically separated and so there is little confidence that the current ring-fencing procedures are likely to be effective. By the UC’s observation that it had (page 8)

*“...decided not to further pursue that more prescriptive option [of legal separation] at this stage...”*

There is an implication that the Commission had assessed that the costs of doing so would outweigh the benefits of its implementation. We would welcome discussion of this important issue.

With this in mind, the NTMEU would welcome the Commission’s thinking on whether there should be at least **physical separation** of retail marketing staff (for both contestable and franchise consumers) from network and generation to ensure that there is a high degree of transparency to demonstrate adequate ring-fencing.