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5 March 2001

Mr Alan Tregilgas  
Utilities Commissioner  
NT Utilities Commission  
GPO Box 915  
DARWIN NT 0801

Dear Alan,

Please find enclosed response to your revised Draft Ring Fencing Guidelines, NT Power Generation (NTPG) must state they have extreme concerns in the apparent inability of these guidelines to effectively control issues of cross subsidisation and correct cost allocations, which are the major cornerstones that provide comfort to market participants when competing with PAWA the dominant incumbent.

NTPG have copied our comments to the NCC

Regards

**NT Power Generation Pty Ltd**

**Jeff W. Hutchison**  
**Chief Executive**

**NT Power Generation**

**Revised draft ring fencing  
guidelines**

**Submission to the Northern  
Territory Utilities  
Commissioner**

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## Introduction

NT Power Group welcomes the revised draft ring fencing guidelines released by the Utilities Commission. In NT Power's view, these revised guidelines represent significant progress from the previous draft ring fencing guidelines.

However, while we welcome the progress made in developing these ring fencing guidelines, we consider that the guidelines (and indeed the access regime in general) will be of little benefit for NT consumers and businesses if the incumbent generation and retailing businesses are able to retain competitive advantages through cost allocation and information sharing.

In particular, NT Power is disappointed that the Commission has failed to develop rigorous guidelines addressing:

- Access to and sharing of information
- Cost allocation between the competitive and monopoly businesses, and between the contestable and non-contestable parts of the monopoly business
- Cost allocation between government (as owner of PAWA) in the provision of services to PAWA, and
- Specification of cost allocation guidelines.
- Time frames to implement correct and fundamental changes is totally unacceptable, NT Power Group is faced with "Shutting the stable door after the horse has bolted"

## Legislative requirements

NT Power remains concerned about one major shortcoming of the legislative requirements. Given the NT Government's decision to retain PAWA as a government-owned vertically and horizontally integrated entity, the ring fencing guidelines should include government and government departments and agencies among the entities from which the electricity distribution business should be ring fenced.

NT Power is concerned to ensure that the application of any government support, subsidies or development incentives are conducted through a clear Community Service Obligation (CSO) payment rather than through any manipulation of PAWA's prices, dividend payments, or accounts. Further, Government's provision of services to PAWA (for example, IT support provided by the NT Department of Corporate and Information Services) should be charged to PAWA at an arm's length equivalent transfer price.

These concerns may require legislative amendment to address. There would be considerable uncertainty regarding enforcement if such requirements were to be written into a Territory ring fencing code without legislative backing. While NT Power is keen to work with the NT government to assist in making any required legislative changes, it will be necessary for the NT ring fencing code to capture these types of transactions.

## Coverage

NT Power applauds the Commission's initiative in attempting to capture more entities under the provisions of the Code. In particular, NT Power agrees that redrafting the Code so that it applies to any "Electricity Entity" that carries on a prescribed business (rather than purporting to impose the obligation on a prescribed business) is a positive step forward. NT Power agrees that it is only possible to impose an obligation upon an entity as a whole as compared to a particular part of that entity, and that this approach avoids the problems caused by the definition of "Related Body Corporate" in the ERA as it applies to PAWA.

The revised draft code starts (section 2) by stating that "This Code will apply to all Electricity Entities who carry on a Prescribed Business in the Northern Territory as and from the Commencement Date."

'Electricity entity' is defined in section 10.2, as follows:

"Electricity Entity" will have the same meaning as is given to that term in the Electricity Reform Act 2000 and includes, where the context requires, the Associates of that person;

and 'Associates is defined as:

"Associate" means in relation to an Electricity Entity, a body corporate that is related to that Electricity Entity (if any) under Division 2 of Part 1.2 of the Corporations Law if sections 13 [references to Chapter 7 - Securities], 14 [references to Chapter 8 – The Futures Industry], 16(2) [Exclusions – securities businesses] and 17 [Associates of composite persons] of that Law were repealed;

NT Power notes that whilst the definition of "Associates" has been retained, we note that it will only apply where an electricity entity is a Corporations Law company.

This would not be a problem except that it is not clear that PAWA is a Corporations Law entity. PAWA is established as an entity under the PAWA Act. Subsidiary companies established under the corporations' law would also not be captured because their association would only be by virtue of its relationship with PAWA, which is not a corporation's law entity.

In this case, it is not clear that PAWA Contestable Retail and PAWA Networks are associates. While both are clearly associates of PAWA, it is not clear that they are associates of each other by virtue of PAWA not being a Corporations Law corporation. This is an area where competent legal advice should be sought and the Code clarified accordingly.

## Causation as a measure of cross subsidies

In its previous submission on the previous draft ring fencing code, NT Power commented that the economists' definition of cross subsidies should not be applied in a case where a primary goal of the regime was fairness. NT Power recommended that the Commission define a clear set of fully distributed cost allocation guidelines, which reflected this fairness objective.

NT Power is disappointed that the Commission did not accept this recommendation, and is concerned at the use of the 'causation' principle as the basis for cost allocation. In essence, the 'causation' approach will only serve to identify the stand-alone costs of serving a particular market. The balance to total costs would then be assigned to other markets, resulting in marginal costing to those markets. In the event that the franchise market is said to 'cause' costs to be incurred, the contestable market would be marginally costed.

An example might best demonstrate this. Suppose a particular section of 132 kV transmission line is used by two market segments, A and B. Segment A requires 110 kV of capacity, and segment B requires 22 kV of capacity. Analysing the capacity caused by segment A first would result in the costs of a 132 kV line being fully assigned to segment A (that being the size of line in use in Australia to serve demands of that magnitude). The balance of the costs (zero in this example) would be assigned to segment B. This approach results in stand alone costs being assigned to the market whose demands are first measured (segment A in this example) and marginal costs being assigned to any remaining segments.

If segment B's causation were to be measured first, then the costs of an 11 kV line would be allocated to segment B and the remainder to segment A.

At the end of the day, this 'causation' approach has simply resulted in defining the stand alone and avoidable costs, and the broad "economists' subsidy-free zone" (see Figure 1).

As stated in our previous submission, economic concepts do not cope well with the allocation of sunk costs. While economic principles are important to provide signals for future investment, the allocation of sunk costs should be on the basis of equity rather than the blind application of economics.

### **Identification of cross subsidies**

The revised draft ring fencing code makes it clear that the identification of cross subsidies is a matter of some priority to the commission. NT Power applauds the commission's recognition of this as a critical issue.

However, there are a number of provisions of the revised draft code that work in concert to counteract this initiative. NT Power presumes that this is an unfortunate oversight, in which case we look forward to a speedy resolution.

The commission correctly identifies that cross subsidisation among the businesses should be evident from the accounts:

[P]rovided a contestable business is registering accounting losses, this may provide evidence that cost shifting to prescribed businesses is not occurring. Provided costs are allocated to the prescribed businesses and the prices charged by those business are regulated so that only a normal return on capital can be earned, the prescribed business will not be in a position to cross subsidise any of its related businesses. (Appendix D, Para 21)

However, this principle could only apply where there is confidence in the integrity of the accounting records. We have stated earlier, we do not have confidence in PAWA's accounting records or the treatment of costs in their accounts. The NT Auditor General is clearly in agreement in this matter.

The NTUC presumably concludes that, given that cross subsidisation should be evident from the accounts, it should be acceptable for a business to carry on both a prescribed and a contestable business (Appendix A, para 68).

But then the NTUC removes the requirements to prepare those financial statements:

Clause 3(a) - Financial accounts The Commission has decided to restrict the obligation to provide financial accounts to each prescribed business conducted by an electricity entity. In particular, the Code has been amended to remove the requirement to provide financial accounts in relation to related businesses or financial accounts in respect of the business of an electricity entity as a whole. (Appendix A, para 70).

Indeed, the NTUC exempts the most critical businesses from the requirements to prepare financial accounts on request. S8.1 exempts the Franchise Retail and Generation entities from complying with the financial accounts requirements, as outlined in Schedule 1 of the Code:

SCHEDULE 1 Exemptions as at Commencement Date

Column (1) – Electricity Entity	Column (2) – Code Obligation	Column (3) – Prescribed Business
Power and Water Authority	Clause 4.10 (Provision of accounts on request)	Franchise Retail
Power and Water Authority	Clause 4.10 (Provision of accounts on request)	Generation

This is clearly a problem when considered in conjunction with the OK to conduct a related business in the same legal entity.

In conjunction, these provisions act to;

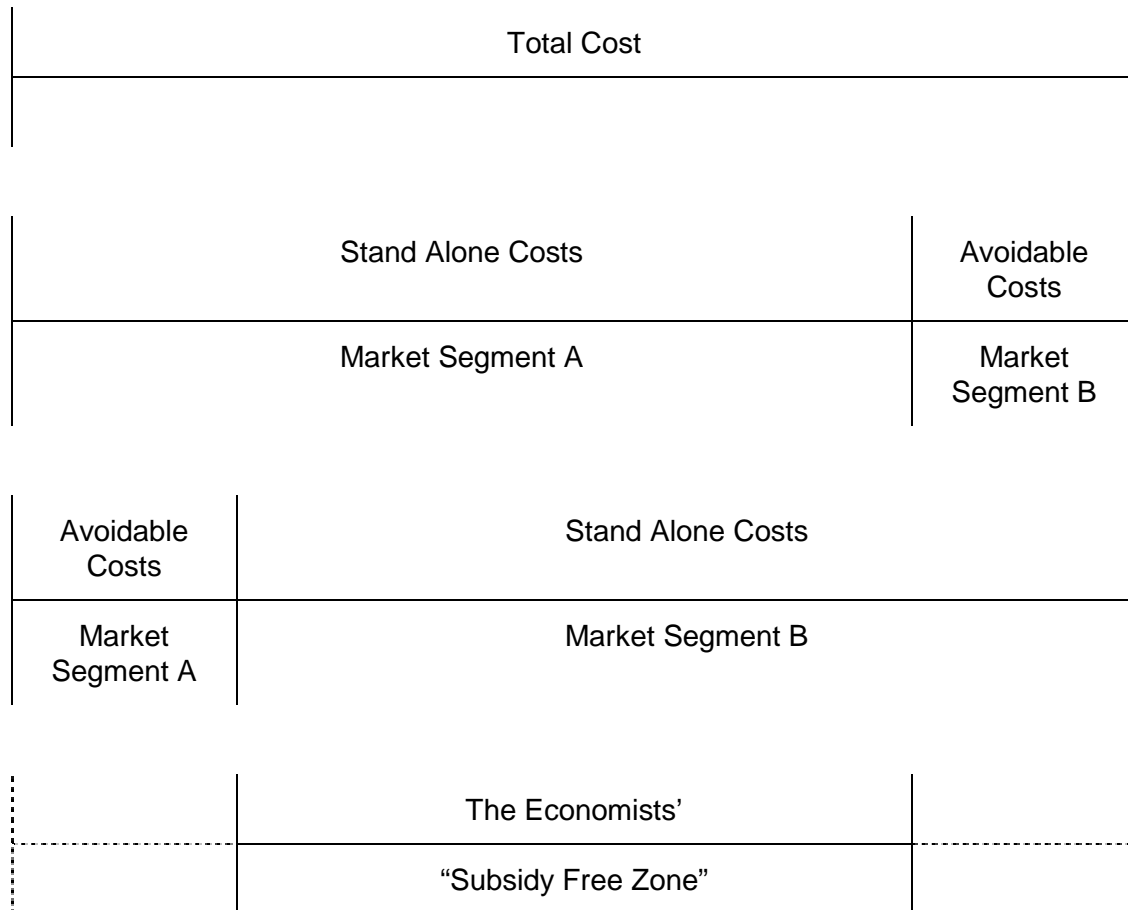
- State the commission's reliance on accounting information to identify cross subsidies;
- Exempt the prescribed part of the business from providing accounts on request;
- Exempt the contestable part of the business from providing accounts;
- Exempt the Electricity Entity from providing accounts.

It seems incongruous for the Commission to exempt the Electricity Entity from the requirement to provide accounts when those accounts form the cornerstone of the Commission's strategy on investigating the existence of cross subsidies. This exemption would render impossible any attempts by the Commission to see if one business is bearing too great a proportionate share of the corporate overheads relative to other parts of the business. It would be very easy for the franchise retail business to bear the greater share of corporate overheads relative to the contestable retail business.

Particularly considering the waiver for the franchise retail and generation businesses from providing separate accounts on request (S8.1), this will make it much easier for PAWA to subsidise a competitive business with the revenues from a regulated business. For example, PAWA Retail could serve both franchise customers (a prescribed business) and contestable customers (not a prescribed business). Since PAWA Retail does not have to provide separate accounts, it would be possible for PAWA Retail to charge marginal costs to the contestable market, and the reduced aggregate profitability of the retail business would not be visible.

To the extent that PAWA is to be retained as an integrated organization, provision of accounts of these businesses is critical. In particular, the franchise retail business accounts must be a matter of public record, if for no other reason than to maintain transparency and accountability of CSO payments.

Figure 1: The Economists’ “Subsidy Free Zone”



**Summary:**

These revised guidelines represent significant progress from the previous draft ring fencing guidelines, however, while we welcome the progress made in developing these ring fencing guidelines, we consider that the guidelines (and



indeed the access regime in general) will be of little benefit for NT consumers and businesses if the incumbent generation and retailing businesses are able to retain competitive advantages through cost allocation and information sharing.

In particular, NT Power is disappointed that the Commission has failed to develop rigorous guidelines addressing:

1. Access to and sharing of information
2. Cost allocation between the competitive and monopoly businesses, and between the contestable and non-contestable parts of the monopoly business
3. Cost allocation between government (as owner of PAWA) in the provision of services to PAWA.
4. Specification of cost allocation guidelines.
5. Time frames to implement correct and fundamental changes have not been made in a reasonable time

Given the NT Government's decision to retain PAWA as a government-owned vertically and horizontally integrated entity, the ring fencing guidelines should include government and government departments and agencies among the entities from which the electricity distribution business should be ring fenced. NT Power is concerned to ensure that the application of any Government support, subsidies or development incentives are conducted through a clear Community Service Obligation (CSO) payment rather than through any manipulation of PAWA's prices, dividend payments, or accounts.

NT Power agrees that it is only possible to impose an obligation upon an entity as a whole as compared to a particular part of that entity. However, it is not clear that PAWA Contestable Retail and PAWA Networks are associates. While both are clearly associates of PAWA, it is not clear that they are associates of each other by virtue of PAWA not being a Corporations Law corporation.

NT Power is disappointed that the Commission has indicated a desire to use the 'causation' principle as the basis for cost allocation. In essence, the 'causation' approach will only serve to identify the stand alone costs of serving a particular market. The balance to total costs would then be assigned to other markets, resulting in marginal costing to contestable markets. At the end of the day, this 'causation' approach has simply resulted in defining the stand alone and avoidable costs. As stated in our previous submission, economic concepts do not cope well with the allocation of sunk costs. While economic principles are important to provide signals for future investment, the allocation of sunk costs should be on the basis of equity rather than the blind application of economics.

The revised draft ring fencing code makes it clear that the identification of cross subsidies is a matter of some priority to the commission. NT Power applauds the commission's recognition of this as a critical issue. However, as discussed in the paper, there are a number of provisions of the revised draft code that work in concert to counteract this initiative. The key areas of concern are the Commission's reliance on financial information of

dubious integrity, and the release of PAWA Generation and Retail from the reporting requirements.