

00922SBA

22 September 2000

Mr Alan Tregilgas
Northern Territories Utilities Commissioner
GPO Box 915
DARWIN NT 0801

RE: RING FENCING SUBMISSION

Dear Mr Tregilgas,

NT Power Generation Pty Ltd (NTPG) is pleased to make this submission on the NT Utilities Commissioner's Ring Fencing discussion paper.

NTPG considers Ring Fencing to be critical to effective competition in the market.

In this regard, NTPG would like to highlight a few key points from our submission:

- Prevention is more effective than punishment. In NTPG's view, sanctions imposed after a breach of ring fencing obligations are equivalent to 'closing the barn door after the horse has bolted'.
- This principle is most important in the access to and sharing of information. NTPG is strongly of the view that clear requirements restricting access to information is the most effective way to safeguard against its misuse.
- The commission must be very cautious in its definition of cross subsidies. In particular, the economic definition of 'cross subsidy' is so broad that it will be critical for the Commission to define clear cost allocation rules to ensure that costs are not inappropriately allocated between the various business divisions (particularly between the contestable and monopoly parts of the business), or between customer classes. These cost allocations must also clearly specify cost allocation rules between PAWA and the various government agencies that provide support services to PAWA. NTPG is of the view that these clear cost allocation rules are not present in the National Third Party Gas Access Code's Ring Fencing requirements, and therefore the Gas Code's guidelines are not sufficiently robust to meet the Territory's competition needs.
- NTPG agrees with PAWA that a clear set of principles must be enunciated. However, these principles must be backed up by clear ring fencing rules to give credibility to those

principles, and we must insist that the principles are prepared by the Utilities commission and agreed in principle by the Auditor General of the Northern Territory.

- To the extent possible, decision making should be separated between incompatible segments of the integrated organisation.

We at NTPG would be pleased to discuss these issues with you in greater detail at your convenience.

Yours sincerely

NT Power Generation Pty Ltd

Jeff Hutchison
Chief Executive

NT Power Generation

Northern Territory Ring Fencing Guidelines

September 2000

This report contains 2 pages

NTP-00f18937RingFencingSubmission0609scr.doc

Contents

1	Introduction	1
1.1	Legislative requirements	1
1.2	PAWA's comments and proposals	2
2	Objectives and principles	3
3	Draft replacement code	4
3.1	A more prescriptive approach?	4
3.2	The National Gas Code	5
3.3	Amendments to code obligations	6
4	Notable features of the current code	7
4.1	Ring-Fencing of generation	7
4.2	Public availability of separate financial reports	8
4.3	Franchise and contestable retail separation	8
4.4	Coverage	8
5	Accounting separation	10
6	Cross subsidies	11
6.1	Definition of 'cross subsidy'	11
6.2	Support for incumbent proposals	14
7	Limits on information flows	15
8	Separation of decision-making	17
8.1	Purpose of Part D requirement of current Code	17
8.2	Legal separation or functional separation?	17
	Appendix 1: Excerpt from NT Power's submission to the NCC	20

1 Introduction

NT Power welcomes the opportunity to make a submission to the Northern Territory Utilities Commission on the effectiveness of the Commission's proposed Ring Fencing Code for access to electricity networks. This is a crucial issue for us, as an owner of electricity generation and transmission assets in the Northern Territory.

However, while we welcome the development of an access regime, we consider that it 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. We call on the Commission not to accept the ring fencing guidelines as proposed by PAWA and to implement a comprehensive set of ring fencing guidelines that will not deter competition in the Territory. In particular, NT Power calls on the commission 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.

Throughout this submission, the reader will find comments regarding potential actions that management could undertake in various situations. For ease of understanding, NT Power has used the names of PAWA's various entities. These comments are in no way meant to reflect NT Power's views on PAWA management's integrity. Rather, these comments are meant to highlight areas in which clearer guidelines could increase the confidence levels of all market participants.

1.1 Legislative requirements

NT Power is 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,

legal advice from the Crown Solicitor's office) 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. NT Power is keen to work with the NT government to assist in making any required legislative changes.

1.2 PAWA's comments and proposals

NT Power's comments on PAWA's proposals are discussed in the relevant sections of this document. However, NT Power is of the view that PAWA has incorrectly characterised the views of the NSW Independent Pricing and Regulatory Tribunal on ring fencing matters by incorrectly quoting IPART's views on ring fencing guidelines.¹ IPART said:²

While supporting the work that the ACCC has commenced on ring fencing guidelines, the Tribunal believes that it requires further refining. In particular, the Tribunal would like to see:

- the setting of clear cost allocation rules
- the inclusion of strong non-discrimination rules to ensure that DNSP's dealings with related retailers are consistent with their dealings with other retailers
- the tightening of requirements relating to the disclosure of confidential information.

PAWA did not refer to the cost allocation or non-discrimination rules in its comments, and this is of concern to NT Power. In NT Power's view, these issues are of critical importance and should not be overlooked.

¹ NT Utilities Commission ring fencing discussion paper, page 30.

² *Pricing for Electricity Networks and Retail Supply - Report of the Special Reference on Electricity*; IPART; July 1999, p 185

2 Objectives and principles

Issues for Comment:

- Is this statement of objectives sufficient?
- Are there any other objectives/elements which should be referred to in such a statement of objectives?

NT Power agrees with the Commission's statement of Objectives – “to assist in creating an environment where the price, quantity and quality of electricity sold to end-use consumers—be they contestable or non-contestable customers—are not biased as a result of PAWA's vertical integration, irrespective of the degree of integration” at the higher levels of principle.

Such a broad statement of objectives, however, can be used as justification for a host of unintended consequences. For example, the NT Government may conclude that government owned utilities are endemically less efficient than privately owned utilities, and pay an operating subsidy to PAWA. This would cause PAWA to enjoy an advantage over any competitors, although not be related to PAWA's vertical integration.

NT Power recommends that the statement of objectives of the ring fencing guidelines be more specific in addressing the more detailed operational objectives of ring fencing, rather than the broader policy objectives.

NT Power suggests including the following elements in the statement of objectives:

- Information is also important and should be ring fenced. NT Power understands that NT Gas (related to PAWA) is aware of the gas price paid by NT Power for generation. This is a vital piece of commercial information, and the current objectives would not restrict NT Gas from passing such commercial information to PAWA.
- Decision making should be separated between incompatible segments of the integrated organisation. To the extent there are any common members on the NT Gas and PAWA boards, it will not be possible to ensure independent decision making, particularly where a decision in one part of the organisation (say, the network division) could disadvantage another part of the organisation (say, the incumbent retailer).

3 Draft replacement code

Issues for comment:

- Do PAWA's proposed ring-fencing policies, practices and procedures (at Attachment C) justify the Commission taking a more prescriptive approach in a replacement Code?
- Does the National Gas Code model represent an appropriate model for the replacement Code?
- Is the consultative approach proposed in the draft replacement Code sufficient when decisions are to be made about waiving or amending obligations under the Code?

3.1 A more prescriptive approach?

It is the view of NT Power that the commission **MUST** take a more prescriptive approach to ring fencing.

Importantly, while the focus of the code is correctly placed on protocols to prevent ring fencing abuses, the incumbent and new entrants must have a clear understanding as to the types of the behaviour that would be considered to be outside the spirit of the code. To leave this definition largely to the incumbent's management (a light handed approach) places the incumbent's management in the untenable position of defining behavioural rules that may not be in the incumbent company's best interests.

This would force any ring fencing disputes to be subject to a complaint and investigation process. This would then require the regulator to enter any dispute to determine whether the subject behaviour was outside the spirit and objectives of the ring fencing code. The regulator then becomes the arbiter of such disputes.

More importantly, the complaint and investigation process would only occur *after* a perceived breach of the ring fencing guidelines had occurred. Once the incumbent had breached the ring fencing guidelines to secure a customer to a long term contract, the customer is lost to the new entrant. An approach based on closing the gate after the horse has bolted will not provide adequate assurance to market participants.

NT Power is of the view that the ring fencing code should focus on *prevention* of ring fencing abuses. Defining appropriate and inappropriate behaviours in advance will go a long way to ensuring there is confidence in the market.

In light of the significant sums of money involved, NT Power is of the view that prevention, compliance and enforcement issues should be clearly addressed in the code. While the spirit of the ring fencing code is to prevent abuses of information, it should be made clear that there are significant penalties for non-compliance. NT Power is concerned that, given the choice of gaining millions of dollars in revenue or complying with a toothless code, an

incumbent's management would be inclined to act in favour of the revenues. NT Power is also concerned that the British Police approach to enforcement³ would not be adequate for the incumbent's management to resist the temptation to breach a code with no consequences.

NT Power recognises that in emerging markets, perception of fair treatment is often as important as the fact of fair treatment. In NT Power's view, that perception will be greatly enhanced by a more rigorous ring fencing code.

NT Power recognises that defining a more specific ring fencing code will be a difficult job, which may not be able to be accomplished in the time period currently set aside by the Commission. However, it is critical that this job be done right. NT Power is of the view that such an investment in advance will be more than rewarded through greater market confidence, reduced disputation, and ultimately greater competition benefits to customers.

3.2 The National Gas Code

NT Power's broad view is that the national gas code's requirements for legal separation is a good model only if there is an accompanying separation of management control over those entities (as in the UK disposition approach). Where common management is making strategic decisions with a view of the consolidated entity, there is little assurance to be gained that business practices will not be discriminatory to new entrants.

NT Power is also of the view that the small size of the Northern Territory electricity system could require users to bear additional administrative costs in the case of mandated legal separation. The NT Government's decision to retain PAWA as an integrated public sector organisation would also seem to preclude the legal separation approach.

This suggests that there will be limited scope for genuine separation of management decision making. NT Power is of the view that, in the absence of separate decision making, the incumbent's management will require clear guidelines on those matters that are crucial to effective ring fencing.

The national gas code's ring fencing guidelines also do not give adequate direction on the allocation of costs (either among divisions in the corporate group or between customer classes) to avoid cross subsidisation or anti competitive pricing. NT Power sees this as a major shortcoming on the national gas code's ring fencing guidelines, which the NT Utilities Commission has an opportunity to correct in its own ring fencing guidelines.

Together, these comments suggest that the national gas code's ring fencing guidelines, taken as they are, would be neither appropriate nor useful to the NT situation.

³ "Stop, or I'll say 'stop' again."

Rather, NT Power prefers to focus on the communication, cost allocation, and information sharing protocols that are absent in the national gas code. These matters make up the focus of this submission.

3.3 Amendments to code obligations

As the PAWA monopoly continues to have dominant market power, processes to limit abuse of this power must be clearly understood by interested parties. NT Power believes that in keeping with other processes, it is important that affected parties have a clear understanding of any amendments and the potential consequences of those amendments.

NT Power is strongly of the view that any amendments to the ring fencing code and obligations should remain a public process. This should include the use of a public process in establishing or amending the ring fencing code, waiving obligations under the code, or amending obligations under the code.

4 Notable features of the current code

Issues for Comment:

Should a business enjoying substantial market barriers to entry but which does not benefit from any legislated barriers to entry (PAWA Generation) be subject to the same ring-fencing obligations as businesses (networks and franchise retail) protected by legislated barriers to entry?

Should PAWA's franchise retail and generation businesses continue to receive waivers on the requirement to publicly provide separate financial statements?

Should PAWA's franchise retail business continue to be exempt from the requirement that monopoly businesses not operate a related contestable business (contestable retail)?

Should PAWA's franchise retail business continue to receive a waiver on the requirement to ring-fence customer information and major decisions from its contestable retail business?

Should the ring-fencing code be extended to all licensed businesses, not just those operating a business with monopoly powers or in a dominant market position?

4.1 Ring-Fencing of generation

In an environment in which the monopoly businesses are clearly separated, both legally and operationally, from all incompatible business, it would be unnecessary to impose any ring fencing obligations on businesses operating in genuinely competitive markets. However, primarily due to the NT Government's decision to retain PAWA as an integrated entity, this is not the environment expected to be in place in the Northern Territory.

NT Power is aware that PAWA Generation does come across commercial information relating to NT Power from time to time. In the absence of ring fencing guidelines on the generation business, this information could be provided to the network or retail businesses, which information could then be used to NT Power's disadvantage.

Exempting one link in the value chain could open an avenue for the incumbent to circumvent the guidelines put in place. For example, if PAWA Generation is exempt from information sharing guidelines, then it would be possible for PAWA Distribution to provide information to PAWA Generation, which could then provide it to PAWA Retail, without breaching the specific restrictions in the code.

NT Power is of the view that all PAWA's divisions should be subject to the same ring fencing requirements. This is particularly important given the NT Government's decision to retain PAWA as an integrated entity.

4.2 Public availability of separate financial reports

NT Power believes that all participants in the industry should be the subject of the same reporting requirements. NT Power is subject to reporting by virtue of the Corporations law. PAWA as a monopoly provider needs to provide sufficient information to the regulator so that the regulator can establish that the business has been operated fairly. Separate reporting of the various business segments can assist the regulator in monitoring allocation of common costs among business segments to ensure the spirit of the ring fencing guidelines are being complied with.

NT Power believes that PAWA's franchise retail and generation businesses should not receive a waiver from the requirements to publicly provide separate financial statements. In this regard, NT Power believes it will be important to work closely with the NT Auditor General to ensure that meaningful accounts are prepared and audited.

4.3 Franchise and contestable retail separation

PAWA Retail has a significant information advantage over its competitors. In particular, PAWA knows when a customer will become contestable in the future. While the contestable and non-contestable businesses are operated together, PAWA has the advantage of 'lifting its service' or reducing its price to the customer as it approaches becoming contestable. Indeed, PAWA may be tempted to sign long term contracts with these customer which straddle the date of contestability. There is some anecdotal evidence that this has occurred in other jurisdictions as contestability approached, and NT Power is concerned that this may have already occurred in the Territory.

NT Power firmly believes that the PAWA contestable business should operate separately from the franchise business. Importantly, the contestable business should not be able to access the franchise customer data base, and the contestable business should not be able to arrange access to the transmission and distribution system on behalf of a customer until such time as that customer has become contestable.

NT Power strongly believes that PAWA should not be exempt from the requirement that monopoly businesses not operate a related contestable business (contestable retail). Further, NT Power is of the view that it is critical that the franchise retail business be required to ring fence its customer information and decision making from the contestable retail business.

4.4 Coverage

Ring fencing is a methodology of placing constraints on monopoly business or businesses with dominant market power in order to limit the ability of the organisation to abuse its monopoly power. Clearly where a business has a monopoly, the ring fencing should be applied.

Further, ring fencing obligations should be extended to those businesses which, although not subject to legislative ring fencing requirements, do have a dominant market power position. This is a different set of criteria than suggesting that all holders of a license should be subject to ring fencing requirements.

Apart from the monopoly business, NT Power believes that PAWA (the various divisions of the integrated entity) holds a dominant market power position in generation and retail (both franchise and contestable). NT Power is not aware of any other business with such market power.

We believe therefore that the policy of ring fencing should be applied to all monopoly businesses but that PAWA is the only market participant to which it could be applied. NT Power is of the view that its generation and retail businesses are not in an dominant market power position, and therefore ring fencing obligations should not be applied to these businesses.

Note that this submission relates to PAWA's operation of the monopoly and dominant market power businesses, as distinct from the integration issue. While NT Power is of the view that PAWA's integration is an indication of the joint operation of the business from management's perspective, it is the fact of the combination of monopoly and dominant elements that should drive these ring fencing requirements.

5 Accounting separation

Issues for Comment:

Should the Commission take the initiative in preparing regulatory accounting guidelines, or is it appropriate to leave it to PAWA (within a specified time frame) to prepare and submit such guidelines for the Commission's approval?

Throughout this submission, NT Power expresses its concern at the level of control PAWA wishes to retain over its accounting separation, cost allocation, and financial reporting. NT Power is very concerned that this level of control would allow PAWA to commit and conceal actions which disadvantage market entrants.

As discussed in the next section NT Power is most concerned with the lack of direction on cost allocation, and the potential this raises for anti-competitive behaviour that would arguably be within the scope of the ring fencing guidelines. Surely this is not the intention of putting the ring fencing code in place.

For example, PAWA has commented:⁴

Those accounts and records that are not directly attributable will be allocated to the regulated and unregulated parts of the business using an appropriate allocator. PAWA's basis of allocation of its accounts and records will be set out and approved by PAWA senior management.

NT Power is concerned that what might be considered 'appropriate' to be approved by PAWA's senior management is not defined in any way. Indeed, an allocation which PAWA senior management considers 'appropriate', considering senior management's view of the entire organisation, may be anti competitive towards new entrants. NT Power is concerned that accounting guidelines prepared by PAWA would reflect the senior management's view of the organisation, and may (intentionally or unintentionally) contain anti competitive features.

NT Power believes that the Commission should in the first instance take the initiative by requiring PAWA to follow a set of clear accounting guidelines. If PAWA is to be left with the responsibility of preparing its accounting guidelines, it should be given detailed instructions on its accounting requirements and a specified timetable to achieve the issue of the guidelines and the full implementation of these guidelines.

⁴ See discussion paper page 12.

6 Cross subsidies

Issues for Comment:

Is the Commission's proposed definition of a 'cross subsidy' (based on long-run avoidable costs) acceptable, or is an alternative definition based on the fully distributed cost approach preferable?

Is the Commission's preference for the monopoly businesses putting forward their preferred cost allocation methodologies for approval generally supported?

6.1 Definition of 'cross subsidy'

NT Power notes that the Commission proposes to use an 'avoidable cost' approach to define cross subsidies. There is considerable discussion within the regulatory community on the definition of cross subsidies, as discussed by IPART in its recent review of electricity prices:⁵

The term 'cross subsidy' is frequently used, but is often poorly defined.

A subsidy is a payment or a financial commitment which usually results in consumers paying prices below the cost of supply ... [a] cross subsidy occurs when the subsidy to one group of consumers is financed by a higher price [paid by] the other consumers supplied by the same firm.⁶

Cost of supply is the key issue. It is often difficult to assign costs to an individual group of customers, particularly as many of the costs are incurred to serve customers together. Joint and common costs are significant in network industries such as electricity and gas. The treatment of these joint and common costs is relevant to the measurement of cross subsidies.

There are various ways of measuring cross subsidies. Each reflects an opinion ie which costs comprise the relevant cost of supply. While there is no universally accepted method, three indicators of a cross subsidy are commonly employed and discussed:

- revenues under recover incremental costs
- revenues over recover stand alone costs

⁵ IPART, Pricing for Electricity Networks and Retail Supply, Volume 2, pp 18-19.

⁶ Australian and New Zealand Minerals and Energy Council (1995) *Subsidies, Cross Subsidies and Community Service Obligations in the Public Electricity and Gas Utilities – Methods for Identifying and Measuring the Costs*, Report No. 95.04, Canberra., p 13.

- revenues either over or under recover fully distributed costs. ...

This view leads to the concept of a range of prices which are subsidy free. A set of prices is said to be 'subsidy free' if the price for each service lies above average incremental costs and below the average stand alone cost, as identified by EnergyAustralia:

There is a large gap between the extremes of avoidable and stand-alone costs for any customer class. Economic theory generally leaves the allocation of the gap or common costs to equity considerations. In distribution businesses a large proportion of the network costs relate to fixed or sunk costs and so is a major consideration in the setting of prices.⁷

The avoidable cost definition of cross subsidy may be appropriate from an economic perspective. However, from an equity and competitive neutrality perspective, this definition can lead to the potential for significant distortion of pricing signals.

For example, PAWA could allocate its corporate overhead costs to the contestable retail business at a level just above the avoidable costs, and the remainder to the franchise network and retail businesses. This would 'under load' the contestable business relative to other market participants who do not have regulated monopoly businesses to carry the bulk of the corporate overheads.

NT Power believes that the cross subsidy definition is very important, as it allows wide scope for the monopoly to allocate costs in a manner which can disadvantage its competitors. NT Power believes that there are a number of aspects and avenues by which this can and may be done. Monopoly providers can maximise their competitive advantage by using some simple cost allocation strategies:

- maximise the allocation of costs to regulated businesses so that the return of those costs is guaranteed by the revenue cap process. This will also ensure that competitors will be required to pay maximum costs for access to that service.
- Similarly, allocate costs away from the contestable portion or use a marginal pricing structure in that contestable portion of the market. This will allow the business to reduce prices in the contestable market without regard to covering the other costs. This can be done by a monopoly because the non contestable portion of the business underwrites all of the other costs. This is a very effective method of keeping competitors out of the market as new entrants do not have this ability.

For this reason, the definition of 'cross subsidy' should be based on a fully distributed cost allocation methodology.

⁷ EnergyAustralia, Economics of Network Pricing, January 1999. Submission to IPART electricity pricing review.

However, this in itself is insufficient, as may be best demonstrated by a hypothetical example. Using the Moomba-Sydney gas pipeline and the different fully distributed cost allocation methodologies, much different results that can arise:

- Starting from a proposition that the Sydney domestic market would not consume sufficient gas quantities to justify construction of a 1300 km pipeline, it is reasonable to argue that the stand alone cost of that pipeline should be borne by the industrial load, and domestic load should bear the marginal cost of additional capacity required to serve it. Consistent with many infrastructure projects, the marginal cost of additional capacity is considerably less than the average cost. This methodology would allocate the lion's share of the pipeline costs (say, 95%) to the industrial market, and a very small proportion (about 5%) of those costs to the domestic market.
- It could also be argued that customers should contribute to the costs of the pipeline in proportion to their usage. Allocating the costs of this pipeline across volumes would allocate approximately 75% of the costs to the industrial load and about 25% of the costs to the domestic market.
- However, infrastructure projects are generally constructed to meet peak requirements, and it could be reasonably argued that customers should contribute to the costs according to their peak demand. The domestic market having a peakier load, this would result in approximately 65% of the costs being allocated to the industrial market and 35% of the total costs being assigned to the domestic market.
- One could also argue (although perhaps less reasonably) that each customer should contribute an equal amount. With the pipeline serving about 400 industrial customers and over 700,000 domestic customers, virtually all the costs would be allocated to the domestic market. Considering the first point that the domestic customers would not consume enough gas to underwrite such a pipeline, this allocation methodology would be unsustainable.

Each of these options is an example of a fully distributed cost allocation methodology, although with sharply different results.

As long as the allocation methodology of the direct costs of a particular infrastructure system is consistent between customers served by the incumbent and customers served by competitors, the cost allocation methodology would not be anti competitive. However, often the monopoly system is a part of a larger corporate group and bears a proportion of joint and common corporate costs. Defining the cost allocation methodology will be important in ensuring that competitive costs are not loaded onto the monopoly infrastructure system to the benefit of the competitive parts of the business.

The matter of corporate overhead allocations is further complicated when some services are supplied by other agencies for which the incumbent's corporate group is not charged. For example, if the NT Government supplies services to PAWA, PAWA's 'corporate overheads'

will be 'under loaded' relative to other market participants. Such government-provided services might include:

- Legal - does PAWA use legal services for which it does not pay such as from the Attorney General Department;
- Treasury – does PAWA pay the proper amount under National Competition Policy for the benefits of funding and services provided by NT Treasury;
- Lands – does PAWA pay for the access to land for generation, stores, easements in the same way as competitors are required to pay.
- Planning – does PAWA benefit from overall planning provided by the various Government Departments, and at what price? Is this information shared equally with competitors in the industry?

The cost allocation guidelines should contain a 'completeness check' to ensure that all costs are captured and correctly allocated.

6.2 Support for incumbent proposals

Consistent with the above comments, NT Power is strongly opposed to giving the incumbent *carte blanche* to define its cost allocation methodologies. As demonstrated in the example above, it is possible for the incumbent to define 'reasonable' cost allocation methodologies that can act to seriously disadvantage new entrants or particular customer groups.

NT Power is of the view that this is a function that must be performed by an independent body (the Commission) to prevent the cost allocation methodology from constructing barriers to entry.

NT Power is of the view that the Commission could put forward draft cost allocation methodologies, outlining in detail the types of costs incurred, the basis for allocation, and the resulting costs by business segment and customer class. This demonstration could be performed using prior period data. This draft could then be subject to a public review process, including analysis of the effects of the cost allocation methodologies employed.

7 Limits on information flows

Issues for Comment:

Are the proposed clarifications to the type of information not to be shared sufficient?

Should the making of protocols for the sharing of information be mandatory?

Should the proposed requirement preventing the sharing of marketing staff between monopoly and contestable businesses be capable of waiving?

Access to and sharing of information

NT Power is concerned with the proposed shift from restriction on *access* to information to *use* of information. In NT Power's view, restrictions on access to information are important to prevent its abuse.

In a commercial environment, business decisions are often made without knowing all the details relevant to a proposed transaction. Analysts often use a 'mosaic theory' to form a picture from disparate pieces of information. It would be virtually impossible for a commercial analyst, having access to key information, to quarantine that information from the decision making process.

Control of, and access to, information is therefore very important to NT Power. As noted in the discussion paper, PAWA's network business has access to important information about NT Power, NT Power's customers, the electricity market and customers. Much of this information is important to our business. NT Power has no access to similar information about PAWA's business. The control of the flow of this sensitive information is thus very important to NT Power.

The types of sensitive information include:

- Information about the size, energy requirements and usage patterns of customers, both contestable and non contestable;
- Information about the growth in the market demand for energy which can influence the planning of development of new generation assets;
- Information about the contracts and price paid for certain input costs (such as gas fuel costs);
- Information concerning the terms offered by competitors to contestable customers.

NT Power believes that it is important that the rules relating to access and sharing of information be very, very clear. This will stop misinterpretation or vagueness being used as excuses for breach of the information sharing guidelines.

Consistent with our comments on a more prescriptive approach to ring fencing, the focus of the rules should be on prevention rather than penalisation. It will always be much better to control the flow of sensitive information in the first place. Considerable damage can result from a single breach of the rules. In the future, where there may be an apparent breach of confidentiality, it will be difficult to prove improper use of the information.

NT Power and other market participants need to be confident that procedures are in place to respect the confidentiality of its information, and information relating to its customers and potential customers.

The focus on prevention should not be construed as absolving the information control procedures of enforcement provisions. A monitoring process will be important to ensure compliance with the information control protocols. NT Power believes that PAWA's performance under ring fencing should be independently audited each year by the NT Auditor General, and reported in detail to the Commission. NT Power also believes it is important to implement a system by which proven breaches are penalised in some manner.

In summary, NT Power is of the view that protocols on access to information and sharing of information be spelled out in some considerable detail, require mandatory application, be subject to an ongoing audit and review monitoring process, and be subject to a penalty system for proven breaches.

Staff sharing

NT Power is conscious that the Northern Territory does not have a large population from which to draw adequately skilled staff. Accordingly NT Power recognises that staff sharing arrangements that may be appropriate in other jurisdictions may not be appropriate in the Northern Territory. However, overlap of functions which advantage the incumbent vs new entrants is, in the view of NT Power, inconsistent with the spirit of the National Competition Policy. This is the case with sharing of marketing staff.

Sharing of Staff can create a significant issue where the overlap of job functions give rise to an automatic breach of ring fencing requirements, particularly where a single staff person has access to restricted information that is incompatible with their range of duties. For example, it would not be acceptable for a retail marketer to be aware of network load information requests from customers, or have access to network load information without the customer's approval.

Sharing of staff is related to separation of duties and decision-making, and is discussed in more detail in the following section.

8 Separation of decision-making

Issues for comment:

Can legal separation be distinguished in practice from structural separation in PAWA's case, and would its application to PAWA Generation, PAWA Networks and PAWA Retail entail administrative costs that exceeded any benefit to the public?

How should the general manager of each of PAWA's monopoly businesses be held accountable for the performance of that business, and absolved from responsibility for any possible detrimental impact of business decisions upon related businesses?

Should there be any common management between PAWA's monopoly and contestable businesses below the level of the Chief Executive Officer?

8.1 Purpose of Part D requirement of current Code

NT Power agrees with PAWA on one critical issue: the effectiveness of the ring fencing procedures will be maximised if the desired outcomes of those procedures are expressed simply and clearly, without resorting to legalese. Here PAWA and NT Power diverge.

PAWA's current proposal is for PAWA to be given the responsibility to design its own Codes of Conduct. NT Power is of the view that, considering PAWA's dominant place in the Northern Territory market, it would not be appropriate to leave the definition of ring fencing procedures to PAWA. In NT Power's view, it is important for the Commission and other market participants to take a role in defining the appropriate items for inclusion in the Codes of Conduct.

8.2 Legal separation or functional separation?

NT Power believes that legal separation is of little consequence where there is no fundamental difference in the operation of the monopoly. Separation is only meaningful where it is implemented in practice. In this regard, NT Power has attached a copy of its comments to the NCC on the NT Access Code. These comments are equally appropriate here.

Public benefit derives from the introduction of competition and efficiency developed from it. Separation of PAWA divisions would be a preferred outcome from a competition perspective. Net public benefit is that amount of competition benefit retained after deducting the costs associated with the structures to promote those competitive benefits. Indeed, NT Power agrees with the Commission that legal separation would impart additional costs on PAWA (and ultimately PAWA's customers), and may not provide a net public benefit.

NT Power believes that the absence of a break up of PAWA, then a Code (or Codes) of Conduct is required to be implemented establishing an ethical benchmark for the operation of the PAWA businesses.

Importantly, PAWA's Codes of Conduct should clearly state that an officer of PAWA should not be penalised for abiding by the terms of the Code.

NT Power believes that PAWA should be required to appoint a Compliance Officer, who would report directly to the Board of Directors. The Compliance Officer would be responsible for investigating possible breaches of the Codes of Conduct. The Compliance Officer should be required to prepare a quarterly report to the Commission, outlining PAWA's compliance with the Codes, any complaint activity, etc.

NT Power agrees with the Commission's comments on overlap of functions in relation to senior management. Specifically NT Power believes that is inappropriate that:

- the General Manager Retail is also the General Manager Generation and that these positions report to a single Executive Director. Alarming, these GM positions are currently both filled by that Executive Director. These functions are clearly incompatible.⁸
- there appears to be no management separation of franchise and contestable retail operations. This separation will be important to ensure fair play during the phasing in of contestable customers, and avoid 'early bird discounts' being provided to customers approaching contestability.
- the System Control General Manager and Executive Director is also the General Manager and Executive Director of the Network Management. This could result in PAWA's generation being dispatched in favour of new entrant generation.
- the functions of Strategic Planning and System Control are undertaken by the same executive director. Information from the system control function could be used in the process of strategic planning to install technical barriers to new entrants.⁹

Without these changes, PAWA may make decisions which are inconsistent with the spirit of the National Competition Policy.

⁸ NT Power notes PAWA's commitment to create a separate general manager responsible for at least one of the retail or generation businesses reporting directly to the CEO. In NT Power's view, this is an important and necessary step.

⁹ NT Power has previously had opportunity to comment on the separation of the system control function from PAWA. Considering the difficulties of separating the system control function, NT Power continues to believe that separating the system control function would likely not provide net public benefits. However, this function should still be segregated from the strategic planning function to the extent possible.

NT Power believes that it is unreasonable to expect senior management, on becoming aware of strategic information relating to new entrants or competitors, to make decisions that have not been coloured by that knowledge.

For example, where a new entrant approaches PAWA Generation wishing to purchase energy for sale to contestable customers, PAWA Retail may become aware of that discussion and take preventive measures to secure the customer to a longer term contract. Further, it would be impossible for the Executive Director with responsibility for both generation and retail to negotiate a sale of electricity to a new entrant without being aware of the loss of margins in the retail business. In such a case, the interests of PAWA Retail may impede such a transaction.

NT Power is of the view that, for the market to function correctly, genuine ring fencing must be in place. Importantly, market participants must have confidence in the ring fencing arrangements, and in this respect the *perception* of genuine ring fencing is equally as important. In view of the potential for abuse (or perception of abuse) of decision and information ring fencing, NT Power believes that it is imperative that PAWA have a significant degree of division of duties of senior staff.

Consistent with its previous comments, NT Power acknowledges that the limited talent pool in the territory may make this degree of division impracticable. Therefore, it is imperative that the Codes of Conduct are sufficiently rigorous to compensate for the realities of the Northern Territory environment.

Consistent with these comments, NT Power is of the view that, ideally, there should be no common management between PAWA's monopoly and contestable businesses below the level of the Chief Executive Officer. This is the only way, in NT Power's view, by which the general manager of each of PAWA's monopoly businesses can be held accountable for the performance of that business, and absolved from responsibility for any possible detrimental impact of business decisions upon related businesses. Again, the Territory will need to rely on rigour of the Codes of Conduct.

Appendix 1: Excerpt from NT Power's submission to the NCC

In its submission to the NCC on the authorisation of the Northern Territory Access Code, NT Power made the following comments on ring fencing issues:

Adequacy of ring fencing arrangements in NT Network Access Code

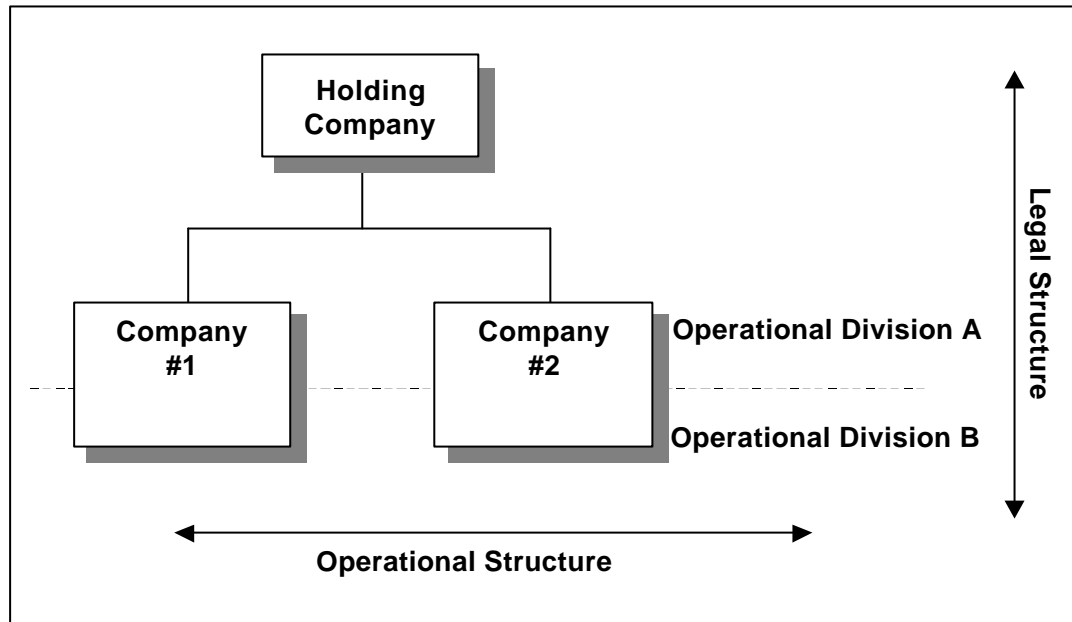
D1 Definition of ring fencing

In any discussion on ring-fencing, it is important to draw distinctions between operational ring-fencing, accounting separation, and legal separation. These different forms of ring-fencing can be distinguished as follows:

- **Ring Fencing (operational separation):** Operational separation requires separation of the management of the different parts of the business, that is, to impose operational separation of a ring fenced business from other business activities. This involves “arms length” dealings between these different arms and possibly separate staffing in areas which may foster anti-competitive behaviour (for example, marketing). Operational separation is likely to be achieved by behavioural rules.
- **Accounting separation:** This might normally involve activity based accounting, implementing regulatory accounting systems that separate regulated and non-regulated activities and adopting specific cost allocation rules between regulated and non-regulated activities.
- **Legal separation of the different functions:** This involves using different corporate entities to separate the regulated business from the non-regulated business. It still allows the same parent company to continue to undertake different activities on a joint but separate basis. It involves different governance and management arrangements. In particular, there are separate boards of directors for the different businesses. Where legal separation is adopted, accounting separation is required under the Corporations Law.

There may be a unique one-to-one relationship between a legal entity and a business activity. However, this does not provide operational ring-fencing as the separation is not physical. For example, it is common business practice to disperse assets and resources across different legal entities within a group of companies, but for the different operations or lines of business of the group to cut across, and be organised without regard to, the legal entities or vehicles that hold the assets and resources. This concept is illustrated simplistically below.

Figure 1: Illustration of legal versus operational boundaries



As Figure 1 illustrates, legal and operational structures are not necessarily congruent because:

- a one-to-one relationship between licensed or price-regulated activities and particular legal entities cannot be assumed. For example, other activities may exist (eg. prescribed services not regulated by price or revenue cap) within a legal entity;
- new unregulated activities may be introduced into a legal entity; and
- in the interests of efficiency, certain services (administrative or call centre services for example) may be shared between different legal entities of businesses, not all of which may even operate in the electricity supply industry.

It is also important to emphasise that accounting separation guidelines will provide a mechanism to enable licensees to report on their licensed or regulated activities. The act of reporting on accounting separation does not of itself provide any mechanism to define or enforce the boundaries of licensed or regulated activities from other business activities. Therefore, notwithstanding that in general terms accounting separation and ring-fencing are often referred to synonymously, it would be reasonable to expect that there needs to be a clear distinction between accounting separation, and operational ring-fencing.

D2 Ring-fencing and the National Electricity Code

The NT Government is not a participant in the National Electricity Market and has no obligations or commitments under the COAG Electricity Agreements. Nevertheless, the

provisions of the National Electricity Code covering ring fencing illustrate how ring fencing is being handled by other jurisdictions that are introducing competition to their electricity supply industries.

Clause 6.20 of the National Electricity Code states that Transmission Ring Fencing guidelines shall be developed and published by the Australian Competition and Consumer Commission (“ACCC”) and that Distribution Ring Fencing guidelines shall be developed and published by each jurisdictional regulator.

Ring fencing guidelines must be developed by the ACCC in consultation with the jurisdictional regulator and each participating jurisdiction for the accounting and functional separation of the provision of prescribed services by Transmission Network Service Providers from the provision of other services by such Transmission Network Service Providers (Transmission Ring Fencing Guidelines).

Ring fencing guidelines must be developed by each jurisdictional regulator in consultation with the ACCC and each jurisdictional regulator for the accounting and functional separation of the provision of prescribed distribution services by Distribution Network Service Providers located in that Jurisdictional Regulator’s participating jurisdiction from the provision of other services by such Distribution Network Service Providers (Distribution Ring Fencing Guidelines).

Clause 6.20.2(c) of the National Electricity Code states that transmission and distribution ring-fencing may include, but not be limited to:

(1) *provisions defining the need for and extent of:*

(A) *legal separation of the entity through which a Network Service Provider provides network services from any other entity through which it conducts business;*

(B) *the establishment and maintenance of:*

(i) *consolidated and separate accounts for prescribed services and other services provided by the Transmission Network Service Provider; and*

(ii) *consolidated and separate accounts for prescribed services and other services provided by the Distribution Licensee*

(C) *allocation of costs:*

(i) *between prescribed services and other services provided by the Transmission Network Service Provider; and*

- (ii) *between prescribed distribution services and other services provided by the Distribution Licensee*
- (D) *limitations on the flow of information between the Network Service Provider and any other person; and*
- (E) *limitations on the flow of information where there is the potential for a competitive advantage:*
 - (i) *between those parts of the Network Service Provider's business which provide prescribed services and parts of the Network Service Provider's business which provide any other services; and*
 - (ii) *between those parts of the Network Service Provider's business which provide prescribed distribution services and parts of the Network Service provider's business which provide any other services; and*
- (2) *provisions allowing the ACCC or Jurisdictional Regulator to add or to waive a Network Service Provider's obligations under the Transmission Ring Fencing Guidelines or the Distribution Ring Fencing Guidelines.*

These provisions provide a benchmark for assessing the adequacy of the ring fencing arrangements incorporated in the NT network access regime — the subject of the next section.

D3 Adequacy of ring-fencing requirements in the NT network access regime

Whilst the NT network access regime adequately covers the issue of accounting separation, it does not adequately address the issue of operational ring-fencing. Operational ring-fencing would consider issues which include, but are not limited to:

- whether the sharing of services, such as marketing, between the network provider and related parties should be excluded;
- the issues of branding of the network provider and other businesses conducted by a related party;
- limitations that should be placed on the flow of information between the network provider and other related parties; and
- the physical separation of staff between the network provider and other parties.

These issues are not covered in the NT network access regime.

