



REGULATORY CHALLENGES IN THE NT CONTEXT

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** Interim Commissioner until formalities associated with his appointment as the first Commissioner are completed.

Introduction

My intention is to cover the following topics:

1. What is the Utilities Commission's role?
2. What has the Commission done so far?
3. What is the Commission's regulatory charter?
4. What are the regulatory challenges facing the Commission?

The first two topics are essentially background to the last two, which set out my views on the tasks (and challenges)—and so directions—ahead.

What is the Utilities Commission's role?

Background

The Utilities Commission was established on 21 March 2000, on the commencement of the *Utilities Commission Act 2000*. The object of the Act is:

“to create an economic regulatory framework for regulated industries that promotes and safeguards competition and fair and efficient market conduct or, in the absence of a competitive market, that promotes the simulation of competitive market conduct and the prevention of the misuse of monopoly power”. (Section 2)

Under the Act, specific regulatory responsibilities can be assigned to the Commission in a particular industry in the Territory (eg the electricity supply industry) only in legislation dealing specifically with that industry (called “relevant industry regulation Acts” in the *Utilities Commission Act*). In the electricity industry's case, the relevant industry regulation Acts are the *Electricity Reform Act 2000* and the *Electricity Networks (Third Party Access) Act 2000*, both of which commence on 1 April 2000.

In particular, the Territory's electricity network industry is declared to be a regulated industry for the purposes of the Act (and the Commission assigned the role of regulator) by the Networks Act, and the Territory's electricity supply industry more generally is declared to be a regulated industry under the Reform Act.

The Commission is the equivalent of the jurisdictional regulators established in all the States and Territories during the 1990s, except Western Australia. The decision of the Territory Government not to follow Western Australia's example

of weak regulatory arrangements is significant because some other important features of the market design are based upon the WA case. Indeed, the *Utilities Commission Act* is modelled closely on South Australian legislation passed last year establishing that State's independent industry regulator.

The Territory Government has explained the establishment of the Utilities Commission in the following terms:

"The Utilities Commission is a cornerstone of the proposed reforms of the Territory's electricity supply industry. It is also required for the Territory to obtain certification of the proposed network access code through the National Competition Council." (Second Reading Speech, November 1999)

"The traditional 'regulatory' instrument available to the Government—monopoly provision by a government-owned utility—has not been fully effective. ...Going forward, rather than relying on a government monopoly, the Government plans to harness competition and, where this is not possible, to adopt more explicit and rigorous regulatory arrangements..." (Ministerial Statement, October 1999)

"Regulatory administration within government is to be strengthened by the creation of a Utilities Commission to administer certain economic regulation functions at arm's length from the Government..." (Overview Paper, October 1999)

"The Commission...will provide independent and authoritative advice on matters such as utility pricing, access to infrastructure, service quality and security of supply." (Second Reading Speech, November 1999)

"To engender the confidence of new and potential entrants into contestable sectors of the power market and of contestable customers themselves:

- regulatory *transparency* [and certainty] will be achieved principally by codifying the regulatory principles and framework ...; and
- regulatory *independence* will be achieved principally by ensuring that regulation of all prices affecting contestable sectors of the electricity industry is undertaken independently of PAWA and at arm's length from the Government..." (Overview Paper, October 1999)

Functions of the Commission

The Commission's functions can be divided into three main groups:

1. those aimed at making competition work;
2. those simulating competitive outcomes where competition is not possible/likely; and
3. those involving a policy-type role.

The main functions with regard to the competitive sectors of the Territory's electricity supply industry are:

- issuing licences to generators and to retailers selling electricity to contestable customers—including setting licence conditions and monitoring compliance with those conditions;
- settling disputes about the contestability status of end-use customers; and
- handling complaints from contestable customers against retailers, and from industry participants about the anti-competitive behaviour of other parties.

The main functions of the Commission with regard to the monopoly sectors of the industry are:

- issuing licences to network providers, to retailers selling electricity to non-contestable (franchise) customers, and to the power system controller—including the setting of licence conditions and monitoring compliance with licence conditions;
- regulating network prices;
- regulating out-of-balance energy prices;
- regulating system control charges;
- conciliating network access disputes and, where necessary, appointing an arbitrator to settle such disputes;
- approving network technical codes and protocols;
- approving dispatch and system security protocols; and
- setting service/performance standards for suppliers to non-contestable customers, and reporting on compliance with those standards.

The main policy-type functions of the Commission are:

- monitoring industry/market developments in the Territory—annual reporting of developments over the previous year and reporting on medium-term generation ‘supply’ versus ‘demand’ prospects; and
- general advice to the Regulatory Minister on the emerging issues in regulated industries, notably where arrangements may not be working as effectively as planned in achieving the outcomes targeted by the Government.

The Commission is not the only regulatory authority under the new electricity arrangements. Other regulatory players in the Territory’s electricity supply industry are:

- the “Regulatory Minister”, who is the Minister having responsibility for Part 3 of the *Electricity Reform Act*;
- the Safety Regulator—now located in the Department of Industries and Business—who has responsibility under the *Electricity Reform Act* to

monitor and enforce safety standards, and to establish and enforce safety-related standards for electrical equipment;

- the Power System Controller, who is licensed under the *Electricity Reform Act* to control the day-to-day dispatch of generators and associated ancillary services and for the maintenance of system security; and
- the NT Ombudsman, who has responsibility for investigating complaints against PAWA from non-contestable customers.

The *Utilities Commission Act* also establishes the basis for the regulatory processes to be adopted by the Commission.

- Decisions of the Commission (other than price regulation decisions) are reviewable by the Commission itself at the request of an affected party, and are then appealable to the Territory's Supreme Court on grounds of bias or the misrepresentation of facts.
- Subject to strict confidentiality provisions, information gained by the Commission that:
 - could affect the competitive position of a licensed entity or other person; or
 - is commercially sensitive for some other reason;

is classified as confidential information and subject to disclosure only in very limited circumstances.

- The transparency of regulatory processes is achieved by required consultation processes (although not yet on licensing), with all decisions by the Commission required to include a summary of the information on which the determination is based and a statement of the reasons for making the determination.

Finally, the Commission has certain powers of enforcement, being able to impose penalties up to \$250,000 for breaches of the *Electricity Reform Act* and up to \$100,000 for breaches of the Code.

What has the Utilities Commission done so far?

The Utilities Commission has a history longer than its 21 March commencement date would suggest.

In fact, I was appointed Interim Utilities Commissioner by the Treasurer on 20 October 1999, to undertake—prior to formal establishment of the Commission—the duties envisaged for the independent industry regulator. This appointment recognised the fact that certain regulatory decisions were necessary in advance of passage of the legislation if third-party access to PAWA's networks was to be up and running on 1 April 2000.

Underpinning this ‘interim’ role is Section 45 of the *Utilities Commission Act* which:

- deems any action taken by the Interim Commissioner to have been undertaken by the Commission—provided it is subsequently ratified by the Commission; and
- deems as valid any action taken by the Commission prior to a provision coming into force—provided it is undertaken so far as reasonably practicable in accordance with the provision.

Against this background, quite a lot has been achieved by the Commission (and its predecessor) to date:¹

With regard to potential contestable customers:

- two information circulars have been issued;
- briefing sessions have been conducted; and
- certain end-use customers have been advised on their contestability status.

With regard to potential new suppliers in the industry:

- expressions of interest (to participate in regulatory processes) have been obtained from potential new suppliers;
- (provisional) *Licensing Guidelines* have been issued;
- initial licence applications have been accepted;
- draft *Ring-fencing Guidelines* have been issued;
- third-party licence applicants have been notified of the identity of first tranche contestable customers; and
- generation, network, retail and system control licences (specifying a range of licence conditions) have been issued.

With regard to network price regulation:

- a *Determining PAWA’s Network Revenue Caps* discussion paper has been issued;
- an approval strategy for network prices has been agreed with PAWA;
- an interim determination of the WACC for PAWA Networks has been issued—allowing a 7.95% real-terms pre-tax annual rate of return on capital;
- criteria for assessing PAWA’s Network Pricing Principles Statement have been issued;

¹ See the Commission’s website for further details of the activities summarised:
<http://www.utilicom.nt.gov.au>

- an initial determination of PAWA Network’s revenue caps for the period 1 April to 30 June 2000 has been made—\$45.9 million for Darwin for example (excluding payments to other network operators);
- PAWA’s Network Pricing Principles Statement has received interim approval, and an open and transparent process for approving that Statement in time to apply to network tariffs from 1 July 2000 has been initiated;
- PAWA’s initial network tariffs have been approved—averaging 4.2 cents per kWh for high voltage contestable customers for the use of PAWA’s Darwin network;
- initial system control charges have been approved; and
- initial out-of-balance energy prices have been approved.

It should be noted that decisions to date have involved:

- some allowance for the higher business risks associated with investment in the networks industry in the Territory;
- PAWA being allowed some time to phase in its targeted efficiency improvements (rather than expecting fully efficient practices from day 1);
- PAWA (and its customers) continuing to pay for the full cost of use of the Darwin-Katherine transmission line—while the nature of the rights and obligations associated with the existing (but out-of-scope) access agreement to that line are clarified;
- transitional price adjustments aimed at minimising the scope for price shocks;
- setting in train some further open and transparent review processes; and
- nudging the arrangements in a direction that should improve the scope for competition and economic efficiency.

What is the Utilities Commission’s regulatory charter?

Legislative requirements

In undertaking its role in any regulated industry, the *Utilities Commission Act* requires the Commission to have regard to the need:

- “(a) to promote competitive and fair market conduct;
- (b) to prevent misuse of monopoly or market power;
- (c) to facilitate entry into relevant markets;
- (d) to promote economic efficiency;
- (e) to ensure consumers benefit from competition and efficiency;

- (f) to protect the interests of consumers with respect to reliability and quality of services and supply in regulated industries;
- (g) to facilitate maintenance of the financial viability of regulated industries; and
- (h) to ensure an appropriate rate of return on regulated infrastructure assets.” (section 6(2))

Under the Network Access Code² (hereafter “the Code”), the regulation of network pricing is to be administered by the Commission to achieve the following outcomes:

- “(a) an efficient and cost-effective regulatory environment;
- (b) prevention of monopoly rent extraction by [regulated entities];
- (c) promotion of competition in upstream and downstream markets and promotion of competition in the provision of network services where economically feasible;
- (d) regulatory accountability through transparency and public disclosure of regulatory processes and the basis of regulatory decisions;
- (e) reasonable certainty and consistency over time of the outcomes of regulatory processes; and
- (f) an acceptable balancing of the interests of [producers, consumers] and the public interest.” (clause 63)

Finally, the Code also identifies some specific objectives for network pricing, requiring such prices:

- “(a) in principle to be cost reflective, to facilitate contestability in the Territory electricity supply industry, to provide equitable user prices and to ensure that appropriate investment in the network takes place in the longer term;
- (b) to involve a common approach for all network users ...;
- (c) to be transparent and published in order to provide pricing signals to network users;
- (d) to promote price stability; and
- (e) to reflect a balancing of the quest for detail against the administrative costs of doing so which would be passed through to end-use customers.” (clause 74)

I’d distill these into various objectives into four main streams: three dealing with the Commission’s role as a ‘monopoly authority’ and one dealing with its role as a ‘competition authority’.

Regulate service standards as well as prices/profits

² Schedule to the *Electricity Networks (Third Party Access) Act 2000*.

The first duty of the Commission as a 'monopoly authority' is to ensure that regulated utilities that supply the public do so safely and adequately and at reasonable prices. All economic regulation proceeds from the premise that citizens deserve adequate services at reasonable prices.

To be sure, not all attempts at modern regulation (or modern de-regulation) have kept this goal in mind. A particular example of a regulatory lapse was signaled in New Zealand in 1998, when the central business district of Auckland was without power for weeks. In this case, the regulatory lapse involved was not one by a regulator, but arose because of the lack of a disinterested, expert regulatory body.

The experience in 1998 in New Zealand highlights the basic duty of regulators like the Commission—and regulated utility businesses. That duty is to render adequate service to consumers. A widespread misperception is that the economic regulation concerns, foremost, prices and profits. On the contrary, the prime duty of economic regulation must be safety and adequacy of service to the public. It is true that profits, tariffs and revenue caps consume much of the efforts of economic regulators and evade easy scrutiny by most consumers. But citizens and businesses need no complex analyses to tell them they are suffering from a power failure.

Reconcile the long-term interests of consumers and utilities, rather than just eliminate economic rents *per se*

The second duty of the Commission is to ensure that application of the regulatory arrangements do not jeopardise the financial viability of the regulated utilities (or diminish the property rights of utilities providing regulated services). Without an assurance that regulators will not deny regulated utilities the ability to recoup legitimate and expected profits, the utility cannot maintain sufficient financial integrity to be able to engage in the ongoing capital commitments necessary to provide uninterrupted service.

The main threat to the financial viability of regulated utilities arising on account of regulation is where such regulation involves uncertainty and ambiguity. The following are potential problems:

- uncertainty or ambiguity in the link between investments/expenses and the level of permissible revenues under a regulated tariff regime;
- uncertainty or ambiguity in the link between permissible revenues and the charges that are collected from customers through the provision of regulated services; and
- uncertainty or ambiguity in the link between tariffs today and those applicable in subsequent periods (or years).

In all of these respects, without clear and transparent rules for moving from costs to permissible revenues, from permissible revenues to tariffs, and from

tariffs now to tariffs next year, the whole process of creating a regulated tariff regime is unlikely to ensure that regulated utilities have the opportunity to get the returns they deserve and that consumers are comparatively free from the danger of being abused by their monopoly provider.

Where the process of setting utility prices bows to subjectivity and opaqueness, utilities either can be prevented from earning their just return or customers can be gouged. One of the principal methods for ensuring regulatory predictability (upon which the ability to raise capital on reasonable terms depends) is for regulatory decisions to comply with strict procedural rules. The goal is to ensure that regulatory decisions possess a high degree of legitimacy and predictability. Such a goal is achieved by making the regulatory decision-making process highly transparent and open to the viewpoints of potentially opposing interest groups.

Also, where a regulator takes away immediately any above-normal profits earned by a regulated utility due to cost reductions—or improvements in productive efficiency—that are in excess of benchmarks set previously by the regulator, the incentive for that regulated utility to pursue efficiency improvements (which is in the consumer's interest also) will be eliminated.

The arrangements linking tariffs today and those applicable in subsequent periods (or years) must not involve removing the incentives for managers and owners to undertake the activities that create efficiencies.

Predictable, transparent and incentive-compatible processes are therefore required if the investment necessary in essential infrastructure (such as electricity, gas and telecommunications networks) is to be sustained at appropriate levels.

Recognise that competition (where possible) is more efficient and effective than regulation

The third duty of the Commission is to recognise that the market rather than a regulator is more likely to cost-effectively achieve the lower prices and quality service standards targeted by Government. Where competition is introduced, regulation must therefore focus on providing the structure of the market and ensuring that positions of excessive market power do not develop or, if pre-existing, are not abused.

Changes in technology and industry practice have led to a world-wide trend away from the supply of electricity by integrated monopolies, towards competition in those elements of the industry where it is technically feasible and costs can be reduced.

Hence, for economic regulation to co-exist effectively with competition and allow competition to evolve where feasible, the following principles should apply:

- where competitive forces are adequate and effective, the regulator should not intervene; and
- where regulation is required, the regulator should impose behaviour on the regulated utility that, to the extent possible, mirrors the likely behaviour of unregulated firms if competitive forces were to prevail.

Foster actual (not just potential) competition

The Treasurer, in his second Reading Speech, suggested that:

“It is as much the threat of competition, as actual competition, that is being targeted by the Government.

Success must therefore eventually be measured not by the number of actual new entrants into the industry but by the extent to which the conduct and performance of existing (and any new) industry players approach competitive-like outcomes”.

This give rise to questions like: Is the threat of competition alone good enough? Is a level playing field enough? Should actual competition be encouraged?

My view is that the Commission’s role must be pro-active with regard to competition, by developing regulatory arrangements in such a way as to achieve actual competition and foster the emergence of multiple entrants.

While the Commission is primarily a ‘monopoly authority’, I see its charter as going beyond ensuring efficient monopoly industry sectors or taking a passive attitude towards emerging competition. This is not to say that the Commission can of itself foster or ensure competition. Rather, its regulation of the monopoly (dominance) sectors needs to be sufficiently diligent to ensure that actual competition in the contestable sectors has the best chance of evolving efficiently and effectively.

What are the regulatory challenges in the circumstances?

Against the background provided by previous sections of this paper, finally I wish to suggest some of the directions that economic regulation can be expected to take here in the Territory—in response to particular circumstances found in the Territory’s electricity supply industry and aimed at actively pursuing the objectives set out in the last section.

Regulatory hurdles and pitfalls are not hard to find. For example, at the same time as the first regulatory decisions are being made:

- the enabling legislation had yet to be passed or commenced, and the National Competition Council review of the ‘effectiveness’ of the new regime (for the purposes of certification of the regime under Part IIIA of the

Commonwealth's *Trade Practices Act 1974*) is still in progress—meaning that the ground rules could still change;

- a court case has been in progress between the major industry participants, in part covering some of the same regulatory and pricing issues as required of the Commission; and
- very tight deadlines have had to be observed in making the initial regulatory decisions to ensure a 1 April commencement of third-party access to the Territory's electricity market—limiting the scope for full consultation and perhaps jeopardising appropriate levels of consideration and transparency.

Today, however, I wish to go beyond these short-term inconveniences. Nor do I want to dwell unduly on complexities arising on account of the small size of the Territory's electricity market³—or its isolation and distance from other power systems—which mean that the approaches to market access and economic regulation adopted in the larger jurisdictions may need to be modified in some respects for application to the Territory.

Instead, I want to identify the main *medium-term* challenges facing effective regulation under the new electricity regime in the Territory.

In doing so, however, I don't want just to identify the problems that I see emerging. Rather, my approach will be to:

- identify the main challenges, and
- with respect to each such challenge, to propose the course of action I envisage to take as independent regulator to ensure these challenges are met in ways which are consistent with the broad objectives set out in the last section.

Challenge #1: Achieving, and maintaining, regulatory independence

To engender the confidence of new and potential entrants into contestable sectors of the power market and of contestable customers themselves, regulatory independence must be achieved—and be seen to be achieved.

The Government has accepted the importance of an independent regulator, as evidenced in the second reading speech made when the legislative package was introduced into the Territory parliament.

“It is important for the Utilities Commission to be independent from the Government with regard to those regulatory determinations that directly affect network users or individual contestable customers.

³ The Darwin-Katherine interconnected system is limited to some 250 MW, in contrast with loads of 10,000 MW in NSW, 7,000 MW in Victoria and 2,000 MW in South Australia.

...New industry participants require an independent Utilities Commission to ensure that any regulation which may impact upon their competitive position is not subject to day to day political considerations.”

Any constraints on the Commission’s independence are most likely to (be seen to) derive from:

- the Commission’s on-going *administrative* relationship with Treasury;
- the capacity of the Regulatory Minister to appoint Associate Utilities Commissioners (with voting rights); and
- the varying degrees of independence envisaged for the Commission—with most independence given regarding networks (and contestable customers) and least regarding non-contestable customers—which could make it difficult for the Regulatory Minister to approach the Commission’s independence consistently.

Commission’s approach

For my part, I do not see any of the above factors as being a cause for concern. Moreover, the required independence will be reinforced on the Commission’s part:

- given that the first Utilities Commissioner is being appointed from outside the NT Public Service;
- in view of the Government’s agreement to my appointment on a part-time basis—which I expect will enhance the independence of the office given I my reputation is important to my separate career (and I am not beholden to the Government for on-going employment);
- by the engagement by the Commission of expert and experienced advisers (often with interstate reputations to consider); and
- through active pursuit by the Commission of dialogue with third parties and contestable customers, thereby ensuring the close participation of those who stand to benefit most from ongoing and effective regulatory independence.

Challenge #2: Dealing with the myriad of issues associated with the Commission’s wide role (for such a small organisation)

Besides being a pricing regulator (like IPART, for example), the Commission has also been assigned the roles of:

- a licensing body (like Victoria’s Office of the Regulator-General (ORG));
- a technical regulator (only safety matters are excluded from the Commission’s mandate);
- an ‘ombudsman’ for contestable customers (the Government Ombudsman retains the role for all non-contestable customers); and

- a generation capacity monitoring role (with no Office of Energy dedicated to such tasks in the Territory).

In these circumstances, there is a risk that the Commission could be overwhelmed by these various functions, and not achieve the require expertise and effectiveness in any of them.

Commission’s approach

This risk will be managed by:

- careful prioritisation of the Commission’s agenda, with the Commission striving to ‘do first things first’; and
- the use of expert assistance on particular tasks.

For example, the Commission has already appointed a team from the New South Wales Independent Pricing and Regulatory Tribunal (IPART) as its pricing advisers.

Challenge #3: Minimising the scope for price shocks (including in the form of CSO payments funded by Territory taxpayers)

Cross-subsidies have played a large role in the Territory’s electricity industry to date.

While funding of the Government’s policy of residential and small business customers in rural areas paying no more than the prices paid by their Darwin counterparts now comes from the Government’s budget, the same is not true of community service obligations (CSOs) arising on account of the Government’s overall cap on prices. The latter type of CSOs continue to be funded via cross-subsidies between customer classes. However, over time, competition and regulation will both reduce the capacity for such CSOs to be funded internally by PAWA (through cross subsidies).

Moreover, the price rises possible through freeing up one sector of the industry (networks) mean that—within an overall price cap—the effective prices received by other sectors will be reduced. This could see pressure for *either* higher CSO payments to PAWA from the Territory budget *or* ‘price shocks’ for certain groups of consumers.

Commission’s approach

The Commission will manage the emergence of such pricing pressures by giving appropriate weight to the objective of price stability (included as an objective of price regulation under clause 74(d) of the Code). Concerns for price stability relate:

- not just to the period following establishment of the first set of network tariffs—with possible adverse price effects arising from the movement from existing tariffs also being a matter of concern; and
- not just to the prices paid by end-use customers—but to the ‘prices’ paid by the Government for its ‘purchases’ under its CSO policy where the Government is effectively a co-purchaser of energy services.

Transparency requires that the Government, like other customers, should be well-informed on the consequence of the proposal for their ‘purchases’. It is appropriate that the implications for Government as purchaser be assessed and, like other users, for the Government to have an opportunity to express its views on the outcomes.

With regard to the network component of electricity prices, the Commission will take a cautious approach to adjusting prices (given the price stability objective), with transitional arrangements—and perhaps ultimately ‘side constraints’—relied upon to avoid giving rise to price shocks.

Challenge #4: Dealing with the rigidities of ‘bilateral contracting’

Instead of buying from or selling into a wholesale electricity market or pool, new entrants into the market (whether they be third-party generators and/or retailers) are expected to follow a ‘bilateral contracting’ model involving them:

- arranging supply directly between an independent generator and contestable end-use customers;
- supplying all the power needs of individual contracted customers under normal circumstances;
- matching their transfers of energy into the network to the demand profile of their customers as a group (with mismatches attracting a regulated charge); and
- making adequate standby power arrangements (mainly involving contracting standby with other generators).

It is not always practical or appropriate to achieve the perfect ‘load following’ that these arrangements imply.

In fact, PAWA Generation—because it is the only party that can do this at present—has been nominated to act as the residual generator in the power system, absorbing any excesses and making up any shortfalls that arise from the operation of bilateral contracting. This is known as the supply of ‘out of balance’ energy.

The Code sets a tolerance limit to separate relatively minor out-of-balance occurrences from more significant occurrences, and provides for a settlement process to occur between generators on this basis.

There may be a concern that rigid application of the load following principle—and the discouragement of out-of-balance occurrences—runs the risk that:

- contestable customers may be actively discouraged from switching to third-party generators, as they bear the risk of interruptions (when load following is not achieved (and the system is out of balance));
- the reserve plant margin required across the entire power system may be higher than possible (either presently, or under a pool-like arrangement)—and this is clearly economically inefficient;
- generators may in effect be dispatched irrespective of the underlying ‘merit order’;
- if the power system controller is not involved in reviewing the adequacy of standby arrangements or the contracted energy balances within access agreements, the full weight of fostering zero out-of-balance energy will fall on the price signal associated with out-of-balance energy charges; and
- if out-of-balance energy is, for regulatory purposes, priced at a significant margin over costs, PAWA Generation could have both the incentive and the means to operate in a manner that is in conflict with the regulatory objective of minimising imbalances.

Also, as the related out-of-balance energy pricing arrangements currently stand, there is a risk that commercially (and competitively) sensitive information on the incremental costs of either (or both) PAWA Generation and independent generators could be revealed.

Commission’s approach

The Commission intends to approach this complex set of issues in a considered and transparent way, and in full consultation with the parties involved. In particular, the Commission will:

- ensure that the roles and responsibilities of the power system controller are clarified, and that the ring-fencing arrangements are such that this function is undertaken truly independently from the incumbent generator; and
- explore the scope in time for introduction of a ‘single buyer’ model, with the power system controller—with its system security responsibilities—possibly purchasing energy balancing services from PAWA Generation.

Challenge #5: Overcoming remaining structural biases against competition

The main structural impediments to competition emerging in the Territory’s power industry have been addressed by the Government’s decisions to:

- allow certain customers to become contestable—and so free to choose their power supplier;

- allow new suppliers to enter the market in competition with PAWA; and
- facilitate access to PAWA's networks which of necessity are to remain a monopoly function.

Some structural impediments remain, however, including:

- the single source of fuel (gas) for power generation in the Territory, compared with the multiple sources in southern markets;
- the lack of constraints on the capacity of PAWA Generation to dominate future generation expansions (with contestability not yet effective in the market for generation increments);
- existing independent power producers (IPPs) are tied up in long-term supply arrangements with PAWA Generation, and not able to participate in the competitive market;
- some contestable customers are also tied up in long-term supply agreements with PAWA that effectively preclude those customers from choosing an independent supplier on their eligibility date;
- PAWA's ease of access to information about the identity, eligibility dates and load profiles of soon-to-be contestable customers—in contrast to all other market players; and
- the limit placed at present on the extent of the rollout of contestability (750MWh per annum).

Commission's approach

The Commission will explore these issues as it is confirmed that they present real, not imaginary, impediments to competition—and will do what it can within its mandate to ensure that particular parties do not use these remaining arrangements to disadvantage end-use customers or competitors.

- With regard to issues such as gas availability, future generation expansions and existing IPPs, the Commission will monitor behaviour and use moral suasion where appropriate.
- With regard to the advantages that PAWA possesses because of its control of information concerning potential contestable customer, the Commission has processes in train designed to ensure that PAWA does *not*:
 - contract with contestable customers before the customer receives a formal notification of the contestability (and third-party suppliers receive information not only on the identity of such customers but on their load profile), or
 - negotiate contracts with larger non-contestable customers that would see those customers 'cashing in' early on upcoming contestability, in exchange for pre-committing to PAWA.

- With respect to the pace and extent of contestability, the Commission will assist the Government in the earliest possible assessment of experience with extending contestability to lower load levels in other States and in the bedding down of contestability arrangements in the Territory.

Challenge #6: Offsetting the advantages accruing to PAWA on account of its continuing vertical integration

A major structural impediment I have yet to mention is the ongoing vertical integration of the Power and Water Authority.

In view of the Territory's small electricity market, the Government has decided:

- “
- to maintain PAWA as a single business under common management to achieve available economies of scope, albeit operating in future as ring-fenced generation, networks and retail business units; and
 - to maintain PAWA Generation as a single business unit, not divesting or separating any of the existing generating units.

The diseconomies that would result from separating PAWA into competing companies are too great given the small size of the Territory market.”

This situation puts considerable emphasis upon the need for effective ring-fencing arrangements, with structural separation being ruled out by the Government.

Compounding this problem is that, while PAWA will be reporting on a line-of-business basis, it appears that it will still be managed on a common services (functional) basis—which makes implementation of 'chinese walls' difficult.

Commission's approach

The Commission has issued a 'statement of principles' that effectively identify the outcomes to be achieved by the ring-fencing of PAWA.

This statement of principles requires PAWA to use all reasonable endeavours to ensure that:

- only officers and employees engaged in the relevant business have access to, or possession of, any information in relation to that business;
- any goods or services it provides to, or receives from, any other business operated by PAWA when conducting the relevant business are provided or received on a 'commercial basis'—with no cross-subsidisation, in whatever form, between the ring-fenced business and the related contestable businesses; and
- any goods or services it provides to, or receives from, any third-party operating in competition with another business operated by PAWA are provided or received on a basis that takes no account of the competitive or

financial impact of that transaction upon that other business operated by PAWA.

The licence conditions that have been set require PAWA to comply with a ring-fencing code to be approved by the Commission, aimed at giving effect to the ring-fencing principles.

Rather than prescribing what management and process/system steps are necessary within an organisation like PAWA to achieve the *outcomes* targeted by the statement of principles, the Commission is progressing on the basis that—aside from specifying the segregation of accounts and records—the most cost-effective means of achieving the stated *outcomes* be left to PAWA management in the first instance.

To this end, within 3 months of issue of the licences, PAWA will be required to develop procedures to implement the ring-fencing principles and must submit those procedures to the Commission for review and approval in the form of a ring-fencing code.

In judging whether management's proposals are likely to be effective in achieving the above ring-fencing *outcomes*, the Commission will be influenced by a number of considerations, including:

- the extent to which the processes proposed are transparent, not only to the Commission but to affected third parties; and
- the extent to which there are clear accountabilities within the organisation for the effectiveness of ring-fencing, with clear responsibilities in this area being delegated to nominated senior officers.

Unless agreement can be reached on alternative mechanisms for determining whether particular goods or services have been provided or received by a monopoly-like business unit of PAWA on a commercial basis or on a basis that takes no account of the competitive or financial impact of that transaction upon another related business, such questions will be decided by the Commission on the basis of the Commission's opinion of the matter.

Challenge #7: dealing with the impacts of continuing Government ownership of PAWA

After considering the matter in 1998, the Government opted to keep PAWA within government ownership for the time being. Understandably, the Government prefers to rely on competition in the first instance to force performance improvements in PAWA rather than the riskier route of transferring a monopoly utility to private ownership or management.

Continuing government ownership does, however, give rise to issues that need to be dealt with by the regulator:

- some misinformation is possible—I've heard a story that one large contestable customer is not prepared to shift away from PAWA because the Government might retaliate by withdrawing government business and/or increasing government licence fees or charges;
- many eligible contestable customers are Territory Government agencies, which may prevent them from exercising the same degree of choice as other contestable customers;
- where the 'market power' of the incumbent (government-owned) business is an issue, the Government is confronted with having to make a trade-off between its ownership, regulatory and market facilitation interests;
- because the corporatisation of PAWA has not proceeded to the same degree as its interstate counterparts, PAWA is not as commercially focussed as it should be; and
- the information imperatives on PAWA because of its continuing status as a budget agency in the Territory (like any other Government Department) result in an inadequate information base from a regulatory perspective—as a budget agency, PAWA is not subject to accounting rules consistent with a commercial accounting approach (but the annual, cash focus of government).

Commission's approach

The Commission will be dealing with such issues by:

- reiterating the Government's own reasoning for wanting competition;
- monitoring the extent to which contestable government agencies make decisions about their supplier of choice based upon the true costs and benefits to them (not any outside (whole-of-government) considerations); and
- with regard to PAWA's poor information base, making clear to all within government the type of information the Commission—as well as management—needs going forward.

Challenge #8: Dealing with the pre-existing (and out-of-scope) access agreement applying to the Darwin-Katherine transmission line (DKTL) and a pre-existing generating and retail licence held by the operators of that line

The contractual arrangements associated with the DKTL are outside the scope of the Access Regime covered by the Code, although provision has been made for that line to come within scope once:

- a review of the Code has been undertaken to account for the circumstances applicable to that line; and

- the NCC has affirmed that the (revised) Code is effective from a national competition principles perspective.

In the meantime, some uncertainty will remain about the interaction between the regulated and unregulated parts of the integrated Darwin-Katherine power system, heightened by uncertainty about the timeframe within which it may be intended to bring the DKTL within scope.

In addition, so as not to tamper with the property rights conferred by a licence issued in 1998 to the DKTL's operators granting them the right to operate also as a generator and retailer of electricity in the Territory, the *Electricity Reform Act* provides that:

“(2) If immediately before the commencement of [the Act] a person held a licence granted under the repealed [Electricity] Act, the Utilities Commission must on that commencement grant the person a licence under Part 3 to carry on operations in the electricity supply industry that the person was permitted to carry on under the licence granted under the repealed Act.

(3) A licence granted in accordance with subsection (2) –

- (a) is subject to the same terms and conditions that applied to the licence granted under the repealed Act; and
- (b) remains in force for the remainder of the period for which it was granted under the repealed Act.” (Section 113)

While appropriate in the circumstances, this arrangement does give rise to industry players being subject to different conditions, possibly to the detriment of end-use consumers who cannot rely on the possession of a licence as having a particular meaning (including that certain technical licence conditions have been, or are being, met).

Commission's approach

The Commission will deal with these sensitive matters by:

- applying commonsense and moderation, including recognising the different circumstances facing regulated and unregulated network providers in the Territory—and the history involved—and by not taking sides in disputes about the rights and obligations conferred on parties by either the pre-existing contract or the pre-existing licence;
- working towards early extension of coverage of the Code to include the DKTL, including by proactively exploring with the parties the sort of regulatory arrangements which might best apply in the circumstances; and
- recognising the role that different regulatory approaches can play in different circumstances (and so 'horses for courses').

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