POWER & WATER AUTHORITY

Submission to the Utilities Commission:

Proposed Ring Fencing Code

29 September 2000

PART A - GENERAL

1. INTRODUCTION

1. The Utilities Commission ("the Commission") has issued a discussion paper, including a draft replacement ring fencing code, and has invited submissions from interested parties.

2. As PAWA will be the entity most directly and substantially affected by the Code, PAWA considers it important to provide the Commission with a detailed submission in relation to the issues raised in the discussion paper and the proposed code.

2. SPEED OF RING FENCING PROCESS

3. PAWA considers that the timetable set by the Commission for implementing the replacement code is unreasonably short, given the complex issues involved. An illustration of this is that most of the other jurisdictions are still considering appropriate ring fencing obligations and have not implemented binding ring fencing regimes, notwithstanding the fact that competition in interstate markets has been in place for considerably longer than in the Territory[1].

4. PAWA will be the entity most directly and substantially affected by the replacement code. PAWA has had just under two months to consider the Commission's draft discussion paper and replacement code, consult within the organisation as to the likely effect of the proposed provisions, and any appropriate alternatives, seek appropriate advice and prepare and finalise its submission to the Commission. It is unreasonable for any business to be expected to do this within the time frame imposed by the Commission.

5. PAWA is also in the throes of change. PAWA has recently undergone considerable structural reform. An independent board has been appointed, and its business divisions have been restructured. With the implementation of the new competition regime, PAWA faces substantial and demanding challenges.

6. In addition, PAWA is in the process of implementing a comprehensive compliance regime and a new ledger system. These measures all place large time and resources demands on PAWA's management.

7. It is also important for the Commission to take heed of the clearly stated intention of the Territory government in implementing the recent electricity industry reforms that:

   (a) *"The Government had to ensure it had got* [the process of implementing

[1] Other jurisdictions are still working through their ring fencing principles and issues and have allowed considerably more time for the imposition of ring fencing guidelines. ORG and the SAIIR have yet to release their draft guidelines. IPART only just released its draft guidelines and discussion paper.

competition into the electricity industry] *right, because the ramifications of failing to properly implement them is immense";* and

(b) *"This is by no means a small job in regulatory terms. Millions of dollars of taxpayers' investments in existing Government infrastructure, and a similar potential investment by new entrants, require a stable and transparent regulatory regime"*[2].

It is clear that the Territory government did not wish to rush the introduction of the regulatory regime, either then or now, because of the risk of error, and the consequent diminution in the value and operational effectiveness of the Territory's publicly owned assets.

8. In these circumstances, it is unreasonable for the Commission to impose such a tight timeframe for the ring fencing process.

9. Further, this submission raises a number of issues which will require substantial and detailed consideration by the Commission. PAWA encourages this. Given the matters raised in this submission, the Commission should release a further draft code, backed up by detailed reasoning, for consideration and submission by PAWA and other interested parties. Given the importance of the obligations imposed by the proposed code, and the tight timeframe, PAWA sees this further consultation as essential. It will also help to ensure that the most appropriate ring fencing regime possible is implemented, thereby maximising the public benefit obtained.

3. PAWA'S APPROACH

10. PAWA sees the introduction of appropriate ring fencing arrangements as a positive tool to encourage PAWA to act competitively, and to encourage competition generally.

11. PAWA's culture of compliance is very good. This culture is fostered and encouraged by PAWA's management and by the board. Recently, PAWA has taken significant steps to regularise its compliance framework. In particular, PAWA is currently implementing a comprehensive compliance regime, spanning all of PAWA's operations. This regime will ensure that appropriate tools are in place for compliance with PAWA's ring fencing obligations.

12. In its discussion paper, the Commission is critical of PAWA's letter of 5 July 2000, which set out PAWA's proposed policies, practices and procedures in relation to ring fencing. PAWA considers that the Commission's criticism is unjustified, given the circumstances facing PAWA at the time:-

(a) PAWA was not made aware that its response was to be used by the Commission

[2] Ministerial statement by the Hon Mike Reed MLA, Treasurer, "Reforms to the supply of electricity in the Northern Territory", 20 October 1999, at p 1-2.

to assess the level of regulation which ought to be imposed in the replacement code;

(b) PAWA was not made aware of the Commission's minimum requirements for a ring fencing undertaking as set out at paragraph 3.6 of the discussion paper;

(c) the letter was written at a time when all parties were aware that the ring fencing code then in place was to be replaced in the near future, following consideration by the Commission and consultation with relevant parties. Quite simply, PAWA did not have an adequate opportunity to prepare detailed policies, practices and procedures, and, to a large extent, it would have been a wasted exercise to do so, given that the Code was to be replaced in the near future; and

(d) at the time the letter was written (and at the present time), PAWA is in a process of change. It is in the process of adapting to a new operating environment, appointing its general managers, and implementing compliance systems, including an education program for all PAWA staff. In addition, the constitution of PAWA has recently changed, with the appointment of a new Board.

13. The Commission also states that PAWA's letter of 5 July *"reflects the belief of management that the arrangements already put in place by and large should be sufficient in the circumstances."* [3] PAWA does not have the belief attributed to it by the Commission. This is reflected in the contents of PAWA's letter, and the comprehensive measures PAWA is putting in place to ensure compliance with an appropriate ring fencing regime.

14. PAWA's detailed response to the Commission's assessment of it is at paragraphs 47-52 below. The Commission appears to consider that a more "heavy handed" approach to regulation is justified given the matters referred to in the preceding paragraphs. PAWA considers that such an approach is unwarranted and requests that the Commission review the conclusions it has reached regarding PAWA's attitude to compliance, the steps it has taken to date, and ultimately the need for heavy handed regulation.

15. Given the tight timeframe imposed by the Commission on submissions, it has not been possible for PAWA to consult within the organisation as extensively as it might. Reflecting the importance of an appropriate ring fence regime being imposed, PAWA has nonetheless devoted considerable resources to consideration of the Commission's discussion paper and draft replacement code. In addition to general staff time spent considering the discussion paper and managing PAWA's submission, this has included:

(a) engaging outside consultants to assist it in the preparation of this submission; and

(b) holding an all day workshop with PAWA senior management and external advisors to work through some of the major issues arising from the discussion

[3] At paragraph 3.4.

paper, and PAWA's response to them.

16. While PAWA has consulted with its staff as widely as possible, given the short time frame, it has been impossible to fully assess the impact of the proposed code on PAWA's operations, and PAWA's costs . The effect on PAWA's costs will ultimately translate into an effect on charges to customers. Accordingly, although PAWA has endeavoured to ensure that this submission sets out all the potential effects of the proposed obligations, there are no doubt impacts on PAWA which are yet to emerge.

4. MAJOR ISSUES

17. The major issues arising out of the discussion paper and draft replacement code, and discussed in this submission are summarised below:

(a) the Commission's intention to extend ring fencing beyond what was contemplated by the Territory government in implementing the reforms to the electricity industry, particularly by the inclusion of PAWA Generation;

(b) the Commission's proposal to fit the code to PAWA's operating environment by use of the waiver provisions; given that it is likely that the code will apply to PAWA alone, the obligations imposed by the code should suit the environment in which it operates. The use of the waiver provisions to do this are inappropriate.

(c) the "heavy handed" approach proposed by the Commission, involving the provision of a detailed and prescriptive undertaking by PAWA, and the development of detailed cost allocation and accounting guidelines. There are many reasons why PAWA considers such a heavy handed approach to be unjustified;

(d) PAWA considers that it is necessary for the Commission to apply a "public benefits test" when considering whether or not to impose a particular obligation on a prescribed business. The Commission must provide the prescribed business with an opportunity to respond to the Commission's estimation of costs and benefits and then consider any response prior to an obligation being imposed;

(e) the continued focus by the Commission on restricting access to, rather than use of, information;

(f) given the comprehensive decision making guidelines already imposed on PAWA's business divisions, whether a separate obligation under the code to independently make decisions is justified.

18. Each of these issues is dealt with in detail in Part B of this submission. Part C of the Submission addresses issues arising from the drafting of the proposed code at Attachment D to the discussion paper.

PART B - DISCUSSION PAPER

1. CHAPTER 1 - INTRODUCTION

19. In paragraph 1.2, the reference to:

    (a) section 27(1)(a) of the *Electricity Reform Act* ("ERA") should be to section 28(1)(a); and

    (b) section 29(1)(a) of the ERA should be to section 31(1)(a).

Application of ring fencing to PAWA Generation

20. The proposed ring fencing code continues to include PAWA Generation as a prescribed business.

21. The ring fencing of PAWA's generation business was not contemplated by the Territory Government when implementing the new regime. This is apparent from:

    (a) the fact that section 25 of the ERA, dealing with generation licence conditions, does not include a provision allowing ring fencing such as appears in the equivalent sections in relation to networks, system control and retail;

    (b) the Treasurer's statement of 20 October 1999, which states that:-

    > *"PAWA's Network business will also be separated for (or "ring-fenced") from its retail and generation functions to ensure that PAWA's contestable activities gain no advantage - or cross subsidies - from its ongoing monopoly activities".*[4]

    (c) the second reading speech for the electricity legislative reforms:-

    > *"All licences issued will require industry participants to "ring-fence" their monopoly from their contestable activities, requiring them to have separate accounting and information systems and precluding them from cross-subsidising between monopoly and contestable activities".*[5]

22. In PAWA's opinion, the ring fencing of generation proposed in the replacement code is unnecessary and inappropriate. It is not appropriate for the Commission to push into the boundaries of PAWA's contestable businesses and determine how each business should

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[4] Ministerial statement by Hon Mike Reed MLA, Treasurer, "Reforms to the supply of electricity in the Northern Territory", 20 October 1999, at p 13.

[5] At page 8.

act in the contestable market. This is dealt with in more detail at paragraphs 66-92 below.

2. CHAPTER 2 - OBJECTIVES & PRINCIPLES

PAWA's attitude to ring fencing

23. PAWA considers that an appropriate ring fencing code is a positive factor leading to greater encouragement of PAWA's business divisions to be competitive. By definition, an appropriate ring fencing code will not be inappropriately onerous.

24. PAWA staff generally have a good culture of compliance, which is fostered and encouraged by management and the board.

Public benefits test

25. In imposing any ring fencing code, it is essential that the Commission consider and apply a public benefits test. The public benefits said to arise from imposition of a ring fencing obligation must be weighed up against:-

    (a) the cost of PAWA complying with the obligation;

    (b) the cost of the Commission monitoring compliance with the obligation; and

    (c) any reduced customer benefits caused by eliminating or reducing existing economic efficiencies[6].

    If the public benefits of imposing any particular obligation do not outweigh the costs of compliance, the obligation is unjustified and should not be imposed.

26. In particular, in considering the cost of compliance, the Commission must take into account:

    (a) the fact that the compliance costs are borne by the monopoly parts of PAWA's business ie the franchise customers; and

    (b) the small size of the Territory market, which may result in compliance costs which are reasonable in other markets being unreasonable in the Territory.

27. PAWA endorses the view of IPART, which has recently stated that[7]:-

    "The costs of ring fencing include:-

[6] IPART, "Ring Fencing of NSW Electricity Distribution Network Service Providers - Discussion Paper and Draft Ring Fencing Guidelines", September 2000 at p.1.

[7] IPART, "Ring Fencing of NSW Electricity Distribution Network Service Providers - Discussion Paper and Draft Ring Fencing Guidelines", September 2000 at p.4.

- Initial set up costs. *For example, business reorganisation.*
- Ongoing operational costs. *This includes compliance and monitoring costs, and losses of economies of scale and scope.*
- Limits on business choice. *This refers to costs incurred by restricting the electricity businesses' ability to select their own business structure.*

Ideally, regulatory intervention should be highly effective, and capable of being implemented at low cost. In reality, trade-offs will be required, as the most effective measures may be more difficult or costly to implement."

28. The application of a public benefits test is the only justifiable means upon which the Commission can impose ring-fencing obligations on PAWA. This is reinforced by:-

(a) National Competition Policy, which stipulates that regulation should only be applied when clearly demonstrated to be in the public interest; and

(b) the approach taken by other regulators, including IPART and the QCA. The QCA has recently stated that:-

> *"In developing the.... ring fencing guidelines the Authority has been cognisant of the potential for upfront costs and disruption to the business, as well as the ongoing intrusiveness of compliance requirements and the need to weigh up these impacts in determining which ring fencing requirements should be adopted".*[8]

29. Further, the Commission has recognised the pre-eminence of the public benefits test, requiring it to be applied as the appropriate test when considering whether to amend the code, impose additional obligations, or waive current ring fencing obligations.[9]

30. As a result, in many cases, PAWA has been unable to adequately respond to conclusions reached in the discussion paper, as the application of the public benefits test by the Commission, if at all apparent, is vague and not in a form capable of being considered, evaluated or challenged by PAWA. Simply, the discussion paper does not, in the majority of cases, set out how the Commission applied the public benefits test, and what public benefits the Commission found to accrue from imposition of the relevant obligation. In order to avoid any implication that the Commission has denied natural justice, the process employed and matters considered in developing the code must be

[8] QCA, Final Determination, "Electricity Distribution: Ring Fencing Guidelines", September 2000 at p. 8.

[9] Paragraphs 6 & 22.

overtly demonstrable[10].

31. PAWA suggests that this situation can only be properly remedied by the Commission setting out its reasoning in more detail, and providing PAWA and others a reasonable opportunity to consider that reasoning and prepare a meaningful response.

32. PAWA acknowledges that the Commission must, in implementing ring-fencing obligations, limit PAWA's ability to extend monopoly powers into contestable parts of the electricity industry. However, the Commission must also attempt to facilitate competition outcomes. Ring fencing should not seek to restrict the PAWA's ability to achieve advantage over its competitors through fair competition.

33. The Queensland Competition Authority ("QCA"), in its final Electricity Distribution ring fencing guidelines[11] has a similar statement of objectives to that proposed by the Commission. The QCA then states that:

> *"This objective is supported by principles such as minimisation of the costs and intrusiveness of the exercise to the* [electricity] *entities, cost-benefit analysis with respect to each ring fencing requirement, evaluation of the potential for unintended consequences from ring-fencing requirements and ensuring the guidelines are simple, clear and easy to administer."* [12]

34. In considering whether or not a particular ring fencing obligation should be imposed, the Commission must apply a public benefits test. In PAWA's opinion, the Commission should refer to this test in its statement of objectives and principles as a guide as to whether or not any particular ring fencing obligation ought to be imposed.

35. PAWA's customers, and perhaps Government through increased CSO payments, will ultimately have to bear the cost to PAWA of implementing its ring fencing obligations. Ring fencing is imposed on the monopoly parts of PAWA's businesses, and thus the costs of ring fencing must be borne by the users of the services provided by those businesses (including franchise customers). By contrast, businesses becoming contestable will enjoy the benefits of competition. In this regard, the Commission should bear in mind that a very small number of sites (approximately 185) and a lesser number of customers[13] will reap the majority of the benefits arising from competition, once the 4 tranches of customers set out in the Regulations to the ERA become contestable.

36. In participating in the reforms to the electricity industry initiated by the NT Government

[10] PAWA suggests that the Commission adopt the approach taken by IPART in its recent Electricity Distribution ring fencing discussion paper and draft guidelines, September 2000, for example, at Table 5.2 (page 15) where benefits and costs are clearly stated.

[11] Dated September 2000.

[12] At p.2.

[13] A number of customers have more than one contestable site.

and supported by PAWA, and in seeking to impose ring fencing obligations in particular, it is important for the Commission to consider the unique position of the Territory, as reflected in the statements made by the Territory Government. The Territory government recognised the requirement for "*a stable and transparent regulatory regime*", which must take into account "*the Territory's unique physical and social circumstances.*" As a result, the Territory acknowledged that *"it was impossible just to pick up another jurisdiction's approach and use it for our purposes"*, and that a regulatory regime must be implemented which "*addressed the operating environment of the Power and Water Authority.*"[14]

37. The Territory government's intentions, in its reform of the electricity industry, must be understood by the Commission and reflected in its development of ring fencing obligations.

Statement of objectives

38. Whilst PAWA accepts that the intention behind the Commission's statement of objectives set out at paragraph 2.4 of the discussion paper is correct, it is inaccurate in one important respect. In implementing the reforms to the electricity industry, the Territory Government recognised that the separation of PAWA into competing companies would result in diseconomies that would be too great, given the small size of the market.[15] It is therefore acknowledged and taken for granted that the price of electricity sold will, to a certain extent, be biased because of PAWA's vertical integration ie PAWA continuing to operate as a vertically integrated business will result in economies of scale, the benefit of which will be passed on to consumers. This is the main benefit to consumers arising from PAWA remaining as a vertically integrated business and should be reflected in the Commission's statement of objectives.

39. The matters set out in the quote from the QCA extracted above at paragraph 33, together with the issues discussed at paragraph 38 above, should also be referred to in the Commission's statement of principles and objectives.

Issues for comment:

• Is this statement of objectives sufficient?
PAWA Response: The statement of objectives is not accurate in one important respect - the price of electricity sold will be biased as a result of PAWA's vertical integration - in favour of PAWA's customers, due to the economies of scale resulting from PAWA continuing to be a vertically integrated business.

[14] Ministerial statement by the Hon Mike Reed MLA, Treasurer, "Reforms to the supply of electricity in the Northern Territory", 20 October 1999, at p 2-3.

[15] Ministerial statement by the Hon Mike Reed MLA, Treasurer, "Reforms to the supply of electricity in the Northern Territory", 20 October 1999, at p 8.

Further, it is important that the Commission acknowledge in its statement of objectives the preeminence of the public benefits test in imposing any particular ring fencing obligation. It is widely accepted by regulators that if the public benefits test cannot be satisfied, there is no justification for imposing any particular obligation.

The public benefits said to arise from imposition of a ring fencing obligation must be weighed up against:

1. The cost of the electricity entity complying with the obligation;

2. The cost of the Commission monitoring compliance with the obligation; and

3. Any reduced customer benefits caused by eliminating or reducing existing economic efficiencies.

The costs set out above are referred by IPART in its recent ring fencing discussion paper and draft ring fencing guidelines dated September 2000.

PAWA refers to its detailed comments at paragraphs 25-39 above.

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

PAWA Response:

Similarly to the QCA's distribution ring fencing guidelines, the statement of objectives should refer to the public benefits test. The statement should also refer to the importance of the special circumstances of the Territory. PAWA refers to its comments in relation to the previous issue for comment and paragraphs 25-39 of its submission.

3. CHAPTER 3 - DRAFT REPLACEMENT CODE

Provision of a detailed ring fencing undertaking

40. The Utility Regulators' Forum has stated[16] that 2 possible ways in which ring fencing can be implemented are:

    (a) in a comprehensive manner, requiring a high level of intervention by the regulator in prescribing the processes and methods involved; or

    (b) a more light handed regulatory method, giving the entity discretion as to how it will comply with its ring fencing obligations.

[16] Utility Regulators Forum "Information gathering for ring fencing and other regulatory purposes", October 1999, at p 7-8.

41. One of the means by which a regulator can take a more interventionist role is, as is suggested by the Commission, to require the entity to provide a detailed ring fencing undertaking to it. The approach of providing an undertaking has not been widely used in other jurisdictions.

42. The Utility Regulators Forum suggests[17] that, as a more light handed alternative to provision of an undertaking, the entity could be obliged to regularly report to the regulator as to its compliance with the Code, citing the National Gas Code[18] as an example of this approach. Similar obligations to those contained in the National Gas Code are included in the Commission's draft replacement code[19].

43. It appears that the Commission now intends to adopt both approaches outlined by the Utility Regulators Forum, ie:-

    (a) requiring PAWA to provide a detailed and prescriptive undertaking to the Commission, which cannot be changed without the Commission's consent; and

    (b) imposing an obligation on PAWA to regularly report on its compliance with the ring fencing obligations.

44. In PAWA's opinion, this level of regulation is unjustified, excessive and would not pass any public benefits test. The approaches set out in the preceding paragraph are considered to be alternative, not cumulative, methods of regulating compliance.

45. The requirement that PAWA ought to provide an undertaking should be removed. It intrudes beyond the minimum measures necessary to satisfy the Commission's requirement for a base of information that is sufficient for it to conduct effective regulation. The costs involved with implementing and maintaining the undertaking (including requiring PAWA to seek the Commission's consent to its amendment) are not justified given the small size of the NT market and the alternative mechanisms to monitor compliance already contained in the draft replacement code.[20]

46. There is general consensus among economic regulators in Australia that regulation should be "light handed". For example:

    (a) National Competition Policy requires regulation to be "light handed", that is, only applied when clearly demonstrated to be in the public interest;

[17] Utility Regulators Forum, "Information gathering for ring fencing and other regulatory purposes", October 1999, at p 8-9.

[18] Paragraph 4.13.

[19] Paragraph 16.

[20] At paragraph 12.

(b) the National Electricity Code[21] lists its first objective as being to provide a regime of light-handed regulation of the market to achieve the market objectives;

(c) the Utility Regulators Forum has indicated that "light handed" regulation is desirable and consistent with removing inefficient regulation[22]; and

(d) the Office of the Regulator-General, Victoria, describes the regulatory framework provided for the Victorian electricity industry as "essentially light handed", which it describes as meaning that legislation and other relevant documents should avoid placing onerous restrictions or reporting requirements on market participants.[23]

47. The Commission appears to consider that its taking a more heavy handed approach is justified by:-

(a) its conclusion that the policies, practices and procedures set out in PAWA's letter to the Commission dated 5 July 2000 were too broad and fell short of meeting the minimum requirements of a ring fencing undertaking[24]; and

(b) its belief that PAWA management considers that the arrangements already put in place should be sufficient in the circumstances[25].

PAWA'S LETTER OF 5 JULY 2000

48. PAWA provided its letter of 5 July 2000 in response to the Commission's request that it outline its proposed policies, practices and procedures to comply with the code, and to provide comments on the current code.

49. As to the Commission's assessment that the policies, practices and procedures set out in PAWAs letter were *"closer to a broad statement of principles and intentions than a set of detailed policies, practices and procedures"*, PAWA finds this conclusion surprising and makes the following comments:-

(a) PAWA was not made aware that its response was to be used by the Commission to assess the level of regulation which ought to be imposed in the replacement code;

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[21] National Electricity Code, paragraph 1.4(b)(1).

[22] Utility Regulators Forum "Best Practice Utility Regulation - Discussion Paper", July 1999, at p 9.

[23] Office of the Regulator-General, Victoria "Electricity Industry Regulatory Statement" Issue 2, Part 2.1, 1 September 1995.

[24] See discussion paper paragraphs 3.3 & 3.9.

[25] See discussion paper paragraph 3.4.

(b) PAWA was not made aware of the Commission's minimum requirements for a ring fencing undertaking as set out at paragraph 3.6 of the discussion paper;

(c) the letter was written at a time when all parties were aware that the ring fencing code then in place was to be replaced in the near future, following consideration by the Commission and consultation with relevant parties. Quite simply, PAWA did not have an adequate opportunity to prepare detailed policies, practices and procedures, and, to a large extent, it would have been a wasted exercise to do so, given that the Code was to be replaced in the near future; and

(d) at the time the letter was written (and at the present time), PAWA is in a process of change. It is in the process of adapting to a new operating environment, appointing its general managers, and implementing compliance systems, including an education program for all PAWA staff. In addition, the constitution of PAWA has recently changed, with the appointment of a new Board.

THE BELIEF OF PAWA MANAGEMENT

50. The statement in paragraph 3.4 of the discussion paper that PAWA management believes that arrangements already in place would by and large be sufficient to ensure compliance with the Code is incorrect and not supported by the dealings between PAWA and the Commission in relation to ring fencing. In particular, the Commission is aware that:-

(a) far from PAWA considering adequate arrangements were already in place, PAWA had engaged outside consultants to assist it in the ring fencing process, including addressing compliance issues;

(b) PAWA has invested heavily in time and effort to rewrite its general ledger to capture costs and revenues for different parts of its businesses; and

(c) in its letter to the Commission dated 5 July 2000, PAWA stated that:

- the concept of ring fencing was being embraced across the organisation.
- the CEO had sent a memo on 29 March 2000 in relation to the ring fencing requirements.
- PAWA appreciated that, in order to work properly, PAWA staff must understand the concept of ring fencing and be trained in its requirements and implementation.
- PAWA proposed to implement an ongoing education program on the practicalities of ring fencing.
- the importance of compliance with the ring fencing requirements will be the subject of endorsement by PAWA's Board, to be distributed to all staff.

- more detailed policies, procedures and practices will evolve over time through the development of codes of conduct.

- responsibilities for meeting ring fencing requirements and implementing policies and procedures will be clearly stated, with an appropriate reporting regime.

- the training for PAWA staff will include the necessity for compliance with PAWA's proposed policies, procedures and codes of conduct and reporting of non-compliance.

- PAWA will develop, implement and train relevant staff on a code of conduct in relation to the no cross-subsidisation requirements.

- PAWA will prepare and implement a code of conduct (including staff training) in relation to the Chinese walls requirements.

- PAWA is in the process of engaging a Compliance Manager, whose duties will include reviewing compliance with ring fencing guidelines.

- PAWA will adopt a code of conduct in relation to the requirement for independent decision making.

51. Further, since PAWA's letter of 5 July, PAWA has:-

    (a) engaged Clayton Utz to assist it in developing a comprehensive compliance system across the organisation; and

    (b) engaged Clayton Utz and KPMG to assist in implementing appropriate mechanisms for compliance with appropriate ring fencing obligations.

52. It is clear from the above that PAWA's management did not (and does not) have the belief attributed to it by the Commission in paragraph 3.4 of the discussion paper.

PROVISION OF AN UNDERTAKING - CONCLUSION

53. Given the matters set out above, PAWA submits that there is no justification sufficient for the Commission to take the heavy handed approach proposed by the provision of a detailed undertaking.

54. In addition, there is currently nothing in the draft replacement code or the discussion paper which:

    (a) amounts to an obligation on PAWA to provide the undertaking;

    (b) sets out the consequences of provision of an undertaking (such as it is prima facie evidence of compliance with the code);

(c) stating the consequences of a failure to comply with the undertaking; or

(d) setting out the procedures for amending the undertaking.

If the Commission continues to insist that PAWA provide an undertaking, these matters need to be comprehensively addressed by the Commission in a further discussion paper, with PAWA being afforded sufficient time to formulate a response.

55. Finally, if the Commission continues to insist that PAWA provide an undertaking, the obligation to report in paragraph 16 of the draft replacement code should be removed, as it amounts to double regulation.

Draft replacement code

56. In formulating the draft replacement code, it is important that the Commission take into account the intent of the Territory government at the time the legislative reforms were implemented, that is:

(a) it is impossible to import another jurisdiction’s approach and use it for the Territory's purposes; and

(b) that a regulatory framework must be designed that addressed PAWA's operating framework.[26]

57. The Commission intends to adopt a ring fencing code based on the National Gas Code model. The National Gas Code regulates:

(a) entities in all jurisdictions across Australia; and

(b) many and varied entities.

58. Therefore, by necessity, the Gas Code sets out a number of general obligations, with procedures allowing the waiver of those obligations to suit individual entities.

59. By contrast, the ring fencing code is likely to apply to PAWA alone, and, in accordance with the Government's intentions, should be tailored to PAWA's operating environment. As such, it is more appropriate that the code be designed specifically to suit PAWA. The use of the Commission's waiver powers to fit the Code to PAWA (for example, by waiving compliance with the non-financial separation requirements of the code with respect to PAWA Retail) is not appropriate, given that PAWA is the only entity bound by the code.

60. Further, given that the code is likely only to apply to PAWA, it is not appropriate to apply

[26] Ministerial statement by the Hon Mike Reed MLA, Treasurer,"Reforms to the supply of electricity in the Northern Territory", 20 October 1999, at p 3.

the public benefits test at the time the Commission is considering whether or not any specific obligation ought to be waived; that test ought to be applied when considering whether the obligation should be imposed in the first place.

61. Finally, PAWA refers to the matters raised at paragraph 212 below in relation to the specific wording of the waiver provisions.

Procedures for adding to or amending ring fencing obligations

62. Pursuant to paragraph 23 of the proposed code, a prescribed business has the right to apply to the Commission seeking a waiver of a ring fencing obligation. The procedures in the proposed code with respect to adding to or amending the code, as set out in paragraphs 6 and 7 of the proposed code, allow only the Commission to start the amendment process.

63. In line with the waiver procedure, a prescribed business should also have the right to request the Commission to amend the code. A similar provision to that contained in paragraph 24(a) of the proposed code, allowing the Commission to reject frivolous applications, could be included to ensure that this right does not become overly burdensome.

Time for commencement of application of code

64. The imposition of final ring fencing obligations will require PAWA to continue to take substantial steps to ensure its compliance. In some cases, the draft replacement code mandates PAWA to develop and implement protocols. This will take some time. PAWA must be given an appropriate period from publication of the final ring fencing obligations to adapt to and prepare for the requirements of the Code.

65. PAWA suggests that in order to minimise the disruption to its business, the Commission should either:-

    (a) adopt the "phased in" approach to implementing the ring fencing obligations, as is being considered by IPART[27]. An appropriate timetable could be prepared by the Commission in consultation with PAWA; or

    (b) adopt the approach taken by the QCA, and stipulate that the ring fencing obligations apply after a certain period of time has elapsed from publication of the final guidelines, or Code[28].

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[27] IPART "Ring Fencing of NSW Electricity Distribution Network Service Providers - Discussion Paper and Draft Ring Fencing Guidelines", September 2000 at page 29.

[28] In September 2000, the QCA published its final Electricity Distribution Ring Fencing Guidelines, to apply from 1 December 2000.

Issues for comment:

• Do PAWA's proposed ring-fencing policies, practices and procedures justify the Commission taking a more prescriptive approach in a replacement code?
PAWA Response: No. Heavy handed regulation is unwarranted and does not pass any public benefits test. PAWA believes there is no justification sufficient for the Commission to take a more prescriptive or heavy handed approach in a replacement code. There is general consensus among economic regulators in Australia that regulation should be light handed. Examples are provided at paragraph 46 of this submission. Further, paragraphs 48 to 52 of this submission set out the dealings between PAWA and the Commission in relation to ring fencing which demonstrate PAWA's clear commitment to compliance with ring fencing principles. Given the consensus amongst regulators for light handed regulation, the small and unique electricity market in the Territory and PAWA's demonstrated commitment to ring fencing, the Commission is not in any way justified in taking a more prescriptive approach in the replacement code. A heavy handed approach would not pass any public benefits test. PAWA refers to its detailed comments at paragraphs 40 to 55 above.
• Does the National Gas Code model represent an appropriate model for the replacement code?
PAWA Response: To some extent, the National Gas Code represents an appropriate mode for the replacement code, however, the Commission must apply a public benefits test before deciding to impose any particular obligation on PAWA. Given that PAWA is likely to be the only entity bound by the code, it is important that the code be tailored to suit PAWA. The National Gas Code regulates entities in all jurisdictions across Australia and many and varied entities. The National Gas Code therefore, by necessity, sets out a number of general obligations, with procedures allowing the waiver of those obligations to suit individual entities. By contrast, the ring fencing code is likely to apply to PAWA alone, and, in accordance with the Government's intentions, should be tailored to suit PAWA's operating environment. As such, it is more appropriate that the code be designed specifically to suit PAWA. The use of the Commission's waiver powers to fit the Code to PAWA (for example, by waiving compliance with the non-financial separation requirements of the code with

respect to PAWA Retail), is not appropriate, given that PAWA is likely to be the only entity bound by the code. Further, given that the code is likely only to apply to PAWA, it is not appropriate to apply the public benefits test at the time the Commission is considering whether or not any specific obligation ought to be waived; that test ought to be applied when considering whether the obligation should be imposed in the first place. PAWA refers to paragraphs 56 - 60 above.
• 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?
PAWA Response: Yes. However, in line with the waiver provisions in the proposed code, a prescribed business ought also to have the right to request the Commission to amend the Code. PAWA considers that the use of waiver powers to fit the code to PAWA's operating environment is not appropriate, given that PAWA is likely to be the only entity bound by the code. For the same reasons, it is not appropriate to apply the public benefits test at the time the Commission is considering whether or not compliance with any specific obligation ought to be waived; that test ought to be applied when considering whether the obligation should be imposed in the first place. Pursuant to paragraph 23 of the proposed code, a prescribed business has the right to apply to the Commission seeking a waiver of a ring fencing obligation. The procedures in the proposed code with respect to adding to or amending the code, as set out in paragraphs 6 and 7 of the proposed code, only allow the Commission to start the amendment process. However, a prescribed business should also have the right to request the Commission to amend the code. A similar provision to that contained in paragraph 24(a) of the proposed code, allowing the Commission to reject frivolous applications, could be included to ensure that this right does not become overly burdensome.

4. CHAPTER 4 - NOTABLE FEATURES OF THE CURRENT CODE

Ring fencing of generation

66. PAWA refers to its comments at paragraphs 20 - 22 above. The Commission should only seek to implement ring fencing by applying it to truly monopoly businesses and by avoiding any unnecessary intervention in competitive market segments.

67. There appears to be some inconsistency between the discussion in chapter 4 in relation to the ring fencing of generation and the definition of "prescribed business" as it relates to generation in paragraph 32 of the proposed code.

68. The discussion paper envisages that the whole of PAWA Generation will be ring fenced. Paragraph 32 of the proposed code requires the generation functions of out of balance energy and standby power to be ring fenced.

69. Since the release of the discussion paper, and in response to a request by PAWA, the Commission has confirmed that its intention is that the whole of PAWA Generation should be ring fenced[29].

70. As is stated at paragraphs 20 - 22 above, PAWA does not accept that it is appropriate, reasonable, or in the best interests of consumers to ring fence generation.

71. In the Territory market, a requirement to ring fence generation is not suitable. There is no pooled wholesale electricity market. As stated by the Treasurer in implementing the electricity reforms[30]:

> *"A wholesale electricity market...will not be established - it would be too costly in our circumstances and of limited benefit given our lack of inter-connection with other state power systems."*

72. This was also noted by the Commission[31]:

> *"The small size of the Territory's electricity market has meant that it has not been feasible to establish a wholesale electricity pool in the Territory such as now operates in the national electricity market in south-eastern Australia."*

73. The NT market operates by a system of bilateral contracting, involving matching of demand and coordination between the generator and retailer for day to day and longer term requirements. This results in retailers meeting their customers' supply needs and generators having comfort in their investment decisions.

74. In addition, the ring fencing of the contestable business of generation, placing an additional cost on that business, will put PAWA Generation at a disadvantage to its competitors. The other prescribed businesses that are subject to the Code, are truly monopoly in nature and thus the costs of ring fencing are borne by all market participants. The generation business, on the other hand, is fully contestable and competes in the market place. There is no justification for the imposition of the burden of ring fencing on the generation business.

75. Franchise generation is already effectively regulated by PAWA's CSO obligations,

[29] Letter Utilities Commission to Clayton Utz, 31 August 2000.

[30] Ministerial statement by the Hon Mike Reed MLA, Treasurer, "Reforms to the supply of electricity in the Northern Territory", 20 October 1999, at p 8.

[31] Tregilgas, "An update on the NT's electricity reform program", September 2000 at p 3.

overseen by NT Treasury. These obligations already prohibit PAWA Generation from subsidising the contestable market.

76. At paragraph 4.5 of the discussion paper, the Commission states that:

(a) PAWA Generation is the dominant participant in the NT generation market;

(b) it exhibits many of the characteristics of a monopoly in some sub-markets;

(c) PAWA dominates the market for standby power to third party generators; and

(d) PAWA dominates the market for the sale of wholesale electricity to third party retailers.

77. Further, the current (to be amended) definition of "prescribed business" in respect of generation, refers to the residual generation business of the supply of "out of balance energy".

78. Taking each of those matters separately, PAWA's response is set out below.

PAWA GENERATION AS THE DOMINANT PARTICIPANT IN THE NT GENERATION MARKET

79. Although this may be the case at the present time, approximately 45% of the market will be successively opened up to competition over the next 18 months or so.

PAWA DOMINATES THE MARKET FOR STANDBY POWER TO THIRD PARTY GENERATORS

80. This statement presupposes that generators will always look to PAWA for additional generation capacity. This is not the case. There are no barriers to entry to any part of the generation market. Although currently PAWA is the only entity with sufficient capacity to supply standby power to other generators, this could well change as a result of:

(a) another market participant determining that it should invest in its own standby generation infrastructure, for example, if PAWA overprices. Such a decision by another market participant is a commercial decision freely reached by that participant;

(b) as a result of the gradual opening up of the retail market, another market participant may determine that it will be necessary to purchase additional generating capacity in any event which could serve as a source of standby power; or

(c) a third market participant enters the generation market, thus providing an alternative source of standby power.

81. Further, the nature of the standby generation market means that the market is effectively

self-regulating. The price charged must be above what it costs PAWA to produce the power, but below the third party generator's replacement cost for the power. If PAWA overprices, the third party will invest in its own generating capacity.

PAWA DOMINATES THE MARKET FOR THE SALE OF WHOLESALE ELECTRICITY TO THIRD PARTY RETAILERS

82. As stated above, and acknowledged by both the Territory and the Commission, there is no existing market for the sale of wholesale electricity to third party retailers for PAWA to dominate. PAWA Generation supplies electricity to one retailer, PAWA Retail. NT Power Generation supplies electricity to its retailing arm. Neither generator supplies wholesale electricity to third party retailers, and, in any case, dealings with third parties would be the subject of unregulated commercial arrangements.

OUT OF BALANCE ENERGY

83. The prices charged by PAWA for the supply of out of balance energy are already heavily regulated by the *Electricity Networks (Third Party Access) Act* and Chapter 9 of the *Electricity Networks (Third Party Access) Code*. The *Electricity Networks (Third Party Access) Act* prescribes the basis of out of balance pricing. The Code also provides that the Commission is obliged to oversee PAWA's prices charged for out of balance energy.

84. In these circumstances, if a generator considers that the cost of being out of balance is excessive, that is not as a result of PAWA's monopoly of this market, but rather is a result of the generator not matching his customer's demands as required by the bi-lateral contracting arrangements. PAWA is merely the supplier of this out of balance facility, if it occurs.

85. Compliance with the third party access code is a condition of PAWA's Generation, System Control, Networks and Retail licences. The ultimate sanction of terminating or suspending any or all of these licences is available to the Commission if PAWA fails to comply with the access code.

RING FENCING OF GENERATION - CONCLUSION

86. In PAWA's submission, from the issues raised by the Commission in its discussion paper, and discussed above, there is no reasonable justification for the Commission to ring fence PAWA Generation.

87. In the absence of detailed discussion, it is difficult to understand the Commission's reasoning for requiring that PAWA Generation should be ring fenced. The Commission has not stated how PAWA Generation could exploit its market dominance to the detriment of competitors to PAWA Retail, nor how the public benefits test has been applied.

88. In any event:

(a) any attempt by PAWA to exploit its purported dominance is likely to amount to a breach of section 46 of the *Trade Practices Act*, dealing with misuse of market power; and

(b) the scrutiny involved in PAWA's CSO obligations should be sufficient to ensure that PAWA produces and prices electricity efficiently. PAWA's compliance with its CSOs is closely supervised by the Territory, which bears the cost of the CSOs and declares them in its Budget papers. The CSO regime represents an efficient mechanism already in place to ensure that PAWA does not subsidise its contestable activities from its franchise activities.

89. The matters set out above should alleviate any reasonable concerns the Commission may have.

90. On the material presently contained in the discussion paper, PAWA submits that there is no apparent justification to ring fence PAWA Generation. Given the fact that any misuse by PAWA of any market dominance it does have is addressed by the requirements of the *Trade Practices Act*, the ring fencing of generation would amount to a level of regulatory intrusion which is unnecessary to obtain the outcomes the Commission purports to deliver.

91. If the Commission still intends to ring fence PAWA Generation, PAWA considers it to be vital that the Commission set out its reasoning, including how the public benefits test was applied, and give PAWA and other interested parties the opportunity, and the time, to provide further submissions in relation to the issue.

92. Finally, PAWA notes that there are no regulatory precedents in any other jurisdictions for this requirement.

Public availability of contracts between PAWA Generation and PAWA Franchise Retail

93. It is settled law that a person cannot enter into an agreement, contract, covenant or deed with himself. As a result, PAWA Generation does not possess the legal capacity to contract to sell electricity to PAWA Retail. Any purported agreement between PAWA Generation and PAWA Retail has no effect in law.

94. Whilst PAWA accepts that the arrangement will be unenforceable at law, PAWA is in the process of implementing a service level arrangement between PAWA Generation and PAWA Franchise Retail. PAWA expects this arrangement to be finalised in the next 4 weeks or so.

95. There are no regulatory precedents for this requirement. It is not the Commission's role to determine whether or not these contracts should be made publicly available. Whilst PAWA accepts the Commission's statement that these contracts ought to be transparent, it is not the Commission's role to implement de facto freedom of information.

96. Further, the Territory government has a clear role and interest in this issue. It is difficult to comprehend why further intervention is required by the Commission, or what public benefit would be gained by making these contracts publicly available, particularly as NT

Treasury already oversees PAWA's compliance with its CSOs. The CSO obligations constitute a mechanism by which the public interest is already protected. In the absence of any discernible benefit, PAWA suggests that the Commission should not impose this requirement.

Financial separation only of monopoly and contestable retail activities

97. PAWA agrees that the ring fencing of PAWA's monopoly and contestable retail activities should be limited to financial matters. In addition to the matters set out at paragraph 4.10 of the discussion paper, PAWA presently has one customer information system which contains information in relation to both the contestable and franchise customers.

98. Finally, PAWA notes that the Commission has not included the waiver in respect of the ring fencing requirements for PAWA Franchise Retail proposed at paragraph 4.12 of the discussion paper in the draft replacement code.

Public availability of separate financial reports

99. PAWA agrees that the provision of its financial statements for PAWA Generation (assuming the Commission continues to include PAWA Generation as a prescribed business) and PAWA Franchise Retail would provide commercially sensitive information to its competitors, and accordingly agrees with the Commission's view that these statements ought not to be made publicly available. Particularly, were these reports to be made public, in combination with the overall PAWA reports required to be provided, it would be possible for anyone to derive the financial statements for the contestable part of PAWA Retail's businesses. There is no justification for requiring PAWA Generation to make its financial statements publicly available, given that Generation is a fully contestable activity.

Coverage

100. In the second reading speech for the ERA, the Treasurer stated that:

> *"All licences issued will require industry participants.... to 'ring fence' their monopoly from their contestable activities..."*[32]

101. The application of the ring fencing code to all market participants in the regulated business is consistent with the approach adopted by:

(a) the ACCC - it proposes to apply its transmission ring fencing guidelines to all Transmission Network Service Providers under the National Electricity Code[33]; and

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[32] At page 8.

[33] ACCC, Draft statement of Principles for the Regulation of Transmission Revenues, 25 May 1999, at paragraph 13.1, page 133.

(b) the QCA's distribution ring fencing guidelines - which apply to all Distribution Network Service Providers in Queensland.[34]

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?
PAWA Response: No. There is no sufficient public interest to impose this requirement. It is beyond what was contemplated by the Territory Government in implementing the reforms. PAWA Generation should not be subject to the same ring-fencing obligations as PAWA Networks and Franchise Retail. The Commission should only seek to implement ring fencing by applying it to truly monopoly businesses and by avoiding any unnecessary intervention in competitive market segments. The inconsistency between the Commission's discussion paper and the draft replacement code is noted at paragraphs 67 and 68 of the submission above. Notwithstanding this inconsistency, PAWA does not accept that it is appropriate, reasonable or in the best interests of consumers to ring fence generation. Some of the reasons for this are as follows: 1. A requirement to ring fence generation is not suitable in the Territory. There is no pooled wholesale electricity market. The Territory market operates by a system of bilateral contracting, involving matching of demand and coordination between the generator and retailer for their customers' supply needs and generators having comfort in their investment decisions. 2. Any ring fencing of PAWA Generation would place an additional cost on the business and would put PAWA Generation at a disadvantage to its competitors. 3. The other prescribed businesses that are subject to the code are truly monopoly in nature and thus the costs of ring fencing are borne by all market participants. The generation business, on the other hand, is fully contestable and competes in the market place. 4. There is no justification for the imposition of the burden of ring fencing on the generation business. Presently, generation sales to the franchise market are already effectively regulated by PAWA's CSO obligations, overseen by NT Treasury. These

[34] QCA, "Electricity Distribution: Ring-fencing Guidelines", dated September 2000 at page 20.

obligations already prohibit PAWA Generation from subsidising the contestable market.

In any event, any attempt by PAWA to exploit its purported dominance is likely to amount to a breach of section 46 of the *Trade Practices Act*, prohibiting a misuse of market power by an entity having substantial power in a market.

PAWA also notes that there are no regulatory precedents in any other jurisdiction for this requirement.

PAWA's detailed response is set out at paragraphs 66 - 92 of this submission.

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

PAWA Response:

Yes. PAWA agrees that the provision of its financial statements for PAWA Generation (assuming the Commission continues to include PAWA Generation as a prescribed business) and PAWA Franchise Retail would provide commercially sensitive information to its competitors in respect of its contestable activities, and accordingly agrees with the Commission's view that these statements ought not to be made publicly available. Particularly, were these reports to be made public, in combination with the overall PAWA reports required to be provided, it would be possible for anyone to derive the financial statements for the contestable part of PAWA Retail's businesses. There is no justification for requiring PAWA Generation to make its financial statements publicly available, given that Generation is a fully contestable activity.

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

PAWA Response:

Yes. PAWA considers that any requirement that its franchise retail business should not operate the related contestable business of contestable retail is unworkable and does not pass any public benefits test. PAWA agrees with the Commission's assessment set out in paragraph 4.10 of the discussion paper.

In addition to the matters set out in paragraph 4.10 of the discussion paper, PAWA presently has one customer information system which contains information in relation to both the contestable and franchise customers.

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

contestable retail business?
PAWA Response:Yes. See paragraphs 97 - 98 above and PAWA's response to the preceding issue.
• 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?
PAWA Response: Yes. PAWA believes that the ring fencing code should apply to all licensed businesses. This approach is in line with that adopted in other jurisdictions. The ACCC proposes to apply its transmission ring fencing guidelines to all transmission network service providers under the National Electricity Code. IPART's proposed distribution ring fencing guidelines apply to all distribution network service providers in NSW. The QCA's recently released distribution ring fencing guidelines apply to all distribution network service providers in Queensland. See paragraphs 100 - 101 above.

5. CHAPTER 5 - ACCOUNTING SEPARATION

102. PAWA accepts the objective of accounting separation, given that it ensures that, at a financial level, there is transparency of costs between businesses, so that costs incurred by the contestable businesses are not passed on to the non-contestable or monopoly businesses.

103. Regulatory precedents in this area have set out clear accounting separation guidelines.

104. As an "on budget" Northern Territory government agency, PAWA already operates an expensive and complex government accounting system. PAWA's financial services section already devotes a significant amount of time and resources to responding to NT Treasury's queries.

105. As a government agency, PAWA is required to report annually on a cash basis. The government accounting system currently used by PAWA imposes a number of restrictions. The Commission has acknowledged this challenge in its statement that "*as a budget agency, PAWA is not subject to accounting rules consistent with a commercial accounting approach."* [35]

106. A new ledger structure for PAWA's accounting system was put in place as from 1 July 2000. PAWA's Board has decided on a new accounting system to be put in place to assist with financial reporting. These initiatives involve substantial staff resourcing and significant additional costs to PAWA.

[35] Utilities Commission, "Regulatory Challenges in the NT context", 30 March 2000, p 19.

107. Potentially, PAWA could incur significant further costs in complying with any future accounting guidelines issued by the Commission, particularly if these guidelines prescribe something different to the processes PAWA is putting in place with its new ledger and new accounting systems.

108. For the following reasons, PAWA suggests that it is inappropriate and unwarranted regulation for any specific accounting guidelines to be imposed as part of the accounting separation requirements of the replacement code:

(a) as a Territory government agency, PAWA is already bound by transparent, prescriptive and detailed accounting guidelines[36];

(b) given the guidelines already in place in relation to the preparation by PAWA's accounts, PAWA should be left with some discretion as to how it complies with the accounting separation requirements; this is consistent with light handed regulation;

(c) the imposition of further guidelines, whether prepared by the Commission or PAWA, would add little if any public benefit;

(d) by contrast, the cost of compliance with any guidelines is likely to be substantial, and will ultimately be borne by PAWA's customers; and

(e) the small size of the Territory market, and thus the relatively onerous and costly obligation of implementing any further guidelines.

109. In this regard, it is important that the Commission bear in mind the small size of the Territory market and thus the relatively onerous and costly obligation of implementing any further guidelines not consistent with the systems PAWA already has in place. Reliance upon the significant measures already in place to ensure adequate and appropriate accounting separation is also consistent with:

(a) the Treasurer's statement that the regulatory regime implemented in the Territory must address PAWA's operating environment[37];

(b) a "light handed" regulatory approach; and

(c) maximising any public benefits arising from the accounting separation obligation.

110. Furthermore, the imposition of any further accounting guidelines at some time in the future, to apply retrospectively from the beginning of the 2000-2001 financial year, is likely to result in significant additional costs to PAWA.

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[36] Pursuant to the *Financial Management Act* and the series of Treasurers' Directions issued under that Act.

[37] Ministerial statement by the Hon Mike Reed MLA, Treasurer, "Reforms to the supply of electricity in the Northern Territory", 20 October 1999, at p 3.

111. If the Commission does not accept that the measures already in place are sufficient, it is PAWA's preference to develop its own guidelines, to be submitted to the Commission for review.

112. If the Commission nevertheless intends to develop its own guidelines, it is essential that PAWA be consulted. The consultation process should be mandatory and set out in the replacement code.

113. If the Commission elects to develop its own guidelines:

(a) PAWA suggests that any guidelines published by the Commission ought not to be prescriptive, but rather take a general, light handed approach, leaving PAWA some latitude as to how it complies.

(b) Any general accounting guidelines published by the Commission under paragraph 2(a) of the proposed code should be consistent with PAWA's current obligations as a Northern Territory government agency reporting to Treasury on a cash basis, so as to minimise the additional cost to PAWA of compliance.

(c) For these reasons, it is important that PAWA be involved in the formulation of these guidelines. PAWA suggests that a provision be inserted into the replacement code requiring the Commission to consult with PAWA in formulating any guidelines.

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?

PAWA Response:

The requirement for regulatory accounting guidelines to be prepared as part of the overall obligation in respect of accounting separation is unjustified and does not pass any cost benefit analysis. PAWA has set out in paragraphs 102 to 110 above the reasons why it would be inappropriate and unwarranted regulation for any specific accounting guidelines to be imposed as part of the accounting separation requirements of the replacement code. These include the fact that PAWA is an "on budget" NT government agency already bound by transparent, prescriptive and detailed accounting guidelines. The imposition of further accounting guidelines would not be consistent with light handed regulation and would add little if any public benefit. By contrast, the cost of compliance with any guidelines is likely to be substantial, and will ultimately be borne by PAWA's customers. If the Commission nonetheless requires such guidelines, PAWA's preference is for it to develop its own guidelines and provide them to the Commission for review.

6. CHAPTER 6 - CROSS SUBSIDIES

114. PAWA acknowledges that a requirement not to cross-subsidise between monopoly and contestable businesses is an essential feature of effective ring fencing.

115. It is important, however, to acknowledge the distinction between taking appropriate advantage of economies arising from synergies between PAWA's different businesses and inappropriate cost shifting.

Implementation of cross-subsidisation requirements

116. PAWA confirms that it does not intend to cross-subsidise between its monopoly and contestable business. PAWA has already taken substantial steps to ensure this does not take place.

117. From 1 July 2000, PAWA has implemented a new general ledger structure which separates out PAWA's prescribed businesses from its other businesses. The general ledger ensures accountability and transparency of the separate businesses.

118. PAWA is also in the process of developing service level arrangements between its separate businesses, including the setting out of transfer pricing principles and a cost allocation methodology. This is used to apportion costs to each business in the general ledger.

119. It is apparent from the above that PAWA has been aware for some time of the requirement not to cross-subsidise and has taken substantial steps to meet it. PAWA has made significant progress in this area to date.

Definition of cross-subsidy

120. PAWA agrees with the Commission's proposed definition of "cross subsidy" as set out at paragraph 6.5 of the discussion paper and paragraph 32 of the draft replacement code. The long term avoidable cost of supply is the accepted definition in other jurisdictions.

Basis for cost allocation

121. PAWA notes the Commission's proposed costs categories set out in paragraph 6.13 of the discussion paper. Paragraph 6.13 of the discussion paper also refers to revenue allocation. Revenue allocation is irrelevant to cost allocation and accordingly, PAWA does not make any further comments in relation to the categories of costs set out in paragraph 6.13 as they may apply to revenue.

122. Whilst the Commission does not propose including the specific costs categories to be provided for when applying the cost allocation methodology, the proposed categories are set out in paragraph 6.13 of the discussion paper. PAWA has some difficulty in applying a working capital figure. As a government agency, PAWA effectively does not have "working capital"; it is simply obliged to operate within its allocated budget.

Cost allocation guidelines

123. Similarly to the submissions made above with respect to the provision of a ring fencing undertaking to the Commission and the preparation of accounting guidelines, PAWA asserts that the development of cost allocation guidelines, whether by PAWA or the Commission, is unjustified, unwarranted and does not pass any public benefit test. Specifically:

(a) there is no need for any specific cost allocation guidelines, given PAWA's CSO obligations, overseen by Treasury. The Territory will not allow PAWA to prop up the contestable market by unfairly allocating costs to the monopoly markets;

(b) the imposition of prescriptive guidelines is not necessary to ensure effective regulation, and goes beyond the minimum measures necessary to satisfy the obligation. It therefore does not pass the public benefits test;

(c) the imposition of guidelines is inconsistent with light handed regulation; and

(d) the general obligation not to cross subsidise and to allocate costs on the basis of the definition of cross-subsidy contained in the proposed code will maximise the public benefits arising from compliance with the obligation.

124. The primary obligation should be that the methodology adopted by PAWA to allocate costs should be fair and reasonable and, in accordance with the long term avoidable cost of supply definition of cross subsidy.

125. The obligation to allocate costs fairly and reasonably can be found in other jurisdictions [38]. PAWA suggests that, in line with other jurisdictions, the words "and is otherwise fair and reasonable" be inserted into the end of paragraph 1(e) of the proposed code.

126. If the Commission nonetheless decides that it is necessary to develop cost allocation guidelines, PAWA's preference is for it to prepare the guidelines and submit them to the Commissioner. Such an approach is also more consistent with "light handed" regulation and will minimise PAWA's additional costs of compliance and is similar to that adopted by the QCA in its recently published Distribution Ring Fencing Guidelines[39].

127. In particular, if the Commission is to impose its own cost allocation guidelines, it is essential that:

(a) they are consistent with PAWA's existing arrangements and PAWA's operating environment; and

(b) the Commission consult with PAWA in relation to the development of those guidelines.

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[38] QCA Ring fencing guidelines, December 1999, paragraph 1(e); National Gas Code, paragraph 4.1(e).

[39] QCA Ring fencing guidelines, September 2000, at page 12.

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?

PAWA Response:

PAWA accepts that the Commission's proposed definition of "cross subsidy" as set out at paragraph 6.5 of the discussion paper and paragraph 32 of the draft replacement code. The long term avoidable cost of supply is the accepted definition in other jurisdictions.

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

PAWA response:

For the following reasons, PAWA considers that the development of cost allocation guidelines, whether by PAWA or the Commission, is unjustified, unwarranted and does not pass any public benefits test:

1. There is no need for any specific cost allocation guidelines, given PAWA's CSO obligations, which are overseen by NT Treasury. The Territory will not allow PAWA to prop up the contestable market by unfairly allocating costs to the monopoly markets.

2. The imposition of prescriptive guidelines is not necessary to ensure effective regulation, and goes beyond the minimum necessary to satisfy the cost allocation obligation. It therefore cannot pass the public benefits test.

3. The imposition of guidelines is inconsistent with light handed regulation.

4. The general obligation not to cross subsidise and to allocate costs on the basis of the definition of cross subsidy contained in the proposed code will maximise the public benefits arising from compliance with the obligation.

The primary obligation should be that the methodology adopted by PAWA to allocate costs should be fair and reasonable and in accordance with the long term avoidable cost of supply definition of cross subsidy.

If the Commission nonetheless decides that it is necessary to develop cost allocation guidelines, PAWA's preference is for it to prepare the guidelines and submit them to the Commission. Such an approach is more consistent with light handed regulation and will minimise PAWA's additional costs of compliance. It is also in line with the approach adopted by the QCA in its recently published Distribution Ring Fencing Guidelines.

7. CHAPTER 7 - LIMITS ON INFORMATION FLOWS

PAWA's approach

128. PAWA acknowledges that the information flows between monopoly and contestable businesses can have anti-competitive consequences.

129. As PAWA stated in its letter to the Commission of 5 July 2000, PAWA has taken a number of steps to comply with the ring fencing provisions limiting information flows. The process is expected to be ongoing for some time. PAWA's response to the Commission's requests demonstrates its commitment to addressing the requirement that the use of information be restricted.

130. In addition, PAWA recognises the fact that, as is stated at paragraph 7.8 of the discussion paper, ring fencing with respect to information flows can be very difficult to implement and monitor in an organisation such as PAWA.

131. As has been already stated, PAWA is in the process of implementing an organisation wide compliance system, which includes the development and implementation of processes designed to ensure that there is no inappropriate use of information, together with monitoring and reporting functions. PAWA has engaged Clayton Utz to assist with the development of its compliance framework. PAWA's Board and management are committed to this process. In its letter of 5 July, PAWA indicated to the Commission that it would develop a code of conduct to be adhered to by all staff.

132. Whilst PAWA agrees with the Commission's comment at paragraph 7.6 of the discussion paper that PAWA's "*policies...to contain certain information and activities need to be fleshed out in a good deal more detail*", it could not be said that PAWA had failed to take appropriate steps to address the requirements of the new regime, particularly given the extremely tight timeframe the Commission has imposed for the ring fencing process.[40]

Disclosure/use of information

133. The Commission has stated in its discussion paper that the Code should aim at controlling the use of information, rather than access to it[41]. As PAWA stated in its letter to the Commission of 5 July 2000, this is the only approach consistent with:-

[40] Other jurisdictions are still working through their ring fencing principles and issues and have allowed considerably more time for the imposition of ring fencing guidelines. ORG and the SAIIR have yet to release their draft guidelines. IPART has only just released its draft guidelines and discussion paper.

[41] At paragraph 7.4

(a) PAWA's currently vertically integrated structure, with a number of services (such as economic services and contract management) being used by all of PAWA's businesses; and

(b) achieving the economics of scale contemplated by the Territory in implementing the current reforms.

134. Notwithstanding this, paragraphs 1(f) and (g) of the Proposed Code prohibit access to information. While the Commission has proposed that PAWA will be exempt from these requirements provided that approved information protocols are in place, PAWA suggests that the primary prohibition in the code ought to be on the inappropriate use of the information.

135. As the proposed code currently restricts access to, rather than use of, information, PAWA would be in breach of the information disclosure requirements while the process of development and approval of PAWA's protocols was taking place, even though no inappropriate use of the information was being made.

136. The Commission should tailor the Code to fit PAWA's operating environment. PAWA is one legal entity operating as a vertically and horizontally integrated business. It would be extremely costly to PAWA to implement physical and information controls to ensure that access to information was restricted to comply with the code. The high costs involved do not justify any public benefits test arising from prohibiting access to, rather than use of information.

137. PAWA suggests that the appropriate provision is to the following effect:

(a) a prescribed business can only use confidential information for the purpose for which it was provided; and

(b) a related business cannot use confidential information held by a prescribed business unless authorised to do so.

Sharing of marketing staff

138. PAWA is concerned that the ring fencing requirement in relation to separate marketing staff will result in higher cost, which is not justified by the public benefit of imposing the obligation.

139. For the following reasons, the imposition of a requirement not to share marketing staff is not justified:

(a) the restrictions proposed in relation to the use of information and the protocols to be put in place already effectively deal with this issue;

(b) reliance on the general restrictions and the protocols is more consistent with light handed regulation;

(c) the requirement is not consistent with the Territory government's intention to retain the economies of scale resulting from PAWA remaining as a vertically integrated business; and

(d) as a result, the imposition of this requirement does not pass the public benefits test.

140. If the Commission nevertheless intends to impose this requirement, the discussion paper states that it will be capable of waiver, but that PAWA will need "*to demonstrate no net public benefit from continuing application of this prohibition."* PAWA suggests that the appropriate test to apply is the accepted test that the public benefit outweighs the cost of compliance. Further, the requirement that PAWA needs to demonstrate that the test is satisfied is unwarranted. If it is apparent to the Commission, whether through the facts presented to it, its own inquiries, or submissions by other parties, that the public benefit does not outweigh the cost of compliance, the waiver should be granted.

141. Particularly, were PAWA to seek a waiver of this obligation, as this would require an amendment to the code, the Commission would need to consult with interested parties prior to making its decision. Accordingly, the Commission should be free to rely on all information made available to it, rather than requiring PAWA to demonstrate that the cost does not outweigh the public benefit.

142. The Commission should also ensure that the replacement code provides for the waiver of this requirement where approved protocols are in place. As is stated at paragraph 197 below, the proposed code attached to the discussion paper does not provide for this waiver.

Implementation of Chinese walls protocols

143. PAWA agrees with the Commission's proposed clause 5 dealing with the development by PAWA of Chinese Walls protocols.

144. The proposed code does not mandate the development of these protocols, but rather sets out the consequences to PAWA if the protocols are in place. PAWA considers this to be the correct approach.

Definition of confidential information

145. PAWA refers to its comments at paragraphs 212 - 213 below in relation to the definition of “confidential information” in paragraph 32 of the proposed code.

Issues for comment:

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

PAWA Response:

PAWA suggests that the definition of "confidential information" proposed by the Commission should be amended to read as follows:

> *"Confidential information" means information which is or has been provided to a prescribed business or an associate taking part in a related business and which is confidential or commercially sensitive, including information which is derived from any such information.*

If the Commission adopts this change, then PAWA considers the clarifications to the type of information not to be shared to be sufficient and appropriate.

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

PAWA response:

The obligation to prepare protocols should not be mandatory, and is not contained in the proposed code, although it is appropriate that the Code provide for the consequences to the prescribed business of having such protocols are in place, as is proposed in paragraph 5 of the proposed code.

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

PAWA response:

Any obligation imposed by the code should be capable of being waived pursuant to the waiver procedure set out in the proposed code. The requirement preventing the sharing of marketing staff between monopoly and contestable businesses presents an issue for PAWA; PAWA's detailed comments are set out at paragraphs 138 to 142 above.

Primarily, PAWA is concerned that this requirement will result in higher costs which are not justified by the public benefit of imposing the obligation.

The imposition of a requirement not to share marketing staff is not justified for the following reasons:

1. The restrictions proposed in relation to the use of information and the protocols to be put in place already effectively deal with this issue.

2. Reliance on the general restrictions and the protocols is more consistent with light handed

regulation.

3. The requirement is not consistent with the Territory government's intention to retain the economies of scale resulting from PAWA remaining as a vertically integrated business.

As a result, the imposition of this requirement does not pass the public benefits test.

If the Commission nevertheless intends to impose this requirement, the discussion paper states that it will be capable of being waived, but that PAWA will need to demonstrate "no net public benefit from continuing application of this prohibition." PAWA suggests that the appropriate test to apply is the accepted test that the public benefit outweighs the cost of compliance.

Further, the requirement that PAWA must demonstrate that the test is satisfied is unwarranted. If it is apparent to the Commission, whether through the fact presented to it, its own inquiries, or submissions by other parties, that the public benefit does not outweigh the cost of compliance, the waiver should be granted.

8. CHAPTER 8 - SEPARATION OF DECISION MAKING

PAWA's approach

146. The Commission is critical of PAWA's proposals to ensure compliance with the independent decision making requirements. This criticism is unjustified. PAWA's response, its participation in the development of regulatory processes, and the steps it has taken and resources devoted to compliance issues clearly demonstrate PAWA's commitment to addressing the separation of decision making requirement.

147. The Commission has suggested that consideration should also be given to legal separation of PAWA's businesses and further management separation. As will become apparent from PAWA's discussion of those issues below, PAWA cannot be criticised for its failure to address those issues in its earlier response to the Commission.

Legal separation

148. The Territory government's policy is clear – “*PAWA will not be separated into competing companies”*.[42] PAWA does not accept the Commission's misconstruction of the Territory's intentions as set out at paragraph 8.8 of the discussion paper. There is no basis for this misconstruction.

149. It is inappropriate for PAWA to comment upon this decision; as a Territory government agency, PAWA's role is to implement government policy, not comment upon it, unless it is asked to do so by its owner.

[42] Ministerial statement by the Hon Mike Reed MLA, Treasurer, "Reforms to the supply of electricity in the Northern Territory", 20 October 1999, at p 8.

150. In any event:

(a) the Commission has no power to implement legal separation of PAWA's businesses. This would require amendment to legislation, including the *Power and Water Authority Act*;

(b) the experience of other jurisdictions (particularly Queensland) indicates that legal separation would not result in any costs savings; rather, it is likely to impose significant additional increased costs which, as the Territory government noted, would be unjustified given the small size of the market;

(c) as the Commission notes in paragraph 8.11 of the discussion paper, where common ownership of the separated businesses remains, incentives or opportunities to favour related businesses will continue to exist; accordingly, it is likely that little, if any, public benefit would be gained by legal separation.

151. Furthermore, the consideration of industry structure is beyond the Commission's role in implementing appropriate ring fencing obligations.

152. This has been recognised by the QCA, which recently stated that[43]:-

> *"Over time, evidence may emerge as to the benefits and costs of different industry structures, and the effectiveness of the current structure of the electricity industry will then be able to be more clearly determined. In the meantime, such structural options, along with alternatives such as transferring retail subsidiaries to generating entities, are matters for consideration by Government. At the present time, the Authority will regard industry structure as a given and has developed it Distribution Ring-Fencing Guidelines accordingly."*

153. At paragraph 8.12 of the discussion paper, the Commission states that the proposed code requires that PAWA's businesses operate as if they were subsidiaries as defined under the Corporations Law, and that PAWA's Board and management need to consider the implications of this requirement.

154. The proposed code does not say this; it merely provides (in paragraph 1(a)) that a prescribed business must be a separate business division of a statutory authority that would be a subsidiary within the meaning of the *Corporations Law*, if the *Corporations Law* applied to it. The incorporation of the *Corporations Law* definition of "subsidiary" into the definition of "prescribed business" does not also incorporate the duties and obligations imposed on subsidiaries under the *Corporations Law*. Even if they did, recent amendments to the *Corporations Law* are to the effect that a subsidiary can act in the best interests of its owner.

155. In any event, the purported imposition by the Commission of any general requirement that

[43] QCA, Final Determination, "Electricity Distribution: ring fencing guidelines", September 2000, at p.9.

PAWA's businesses act as if they were subsidiaries under the Corporations Law is beyond the Commission's power to implement in the confines of a ring fencing code.

Further management separation & management structure

156. The requirements of the current code in relation to independent decision making are clear and have been embraced by PAWA management. PAWA's staff generally have a good compliance culture, which will continue to be reinforced by management and through the comprehensive compliance systems currently being put in place.

157. As an NT government agency, PAWA is bound to set public service conditions of employment, including requirements to adhere to the NTPS Code of Conduct, which apply to the majority of its staff. These conditions now provide a mechanism by which individual incentives or financial rewards can be linked to business performance, and for the standard conditions to be varied, with the agreement of the Commissioner for Public Employment and PAWA's CEO.

158. However, PAWA's Executive Contracts provide for regular performance reviews, which include relevant criteria such as business performance. Senior management are employed on standard NT public service contracts, ie employment is on a temporary basis and is performance based.

159. PAWA confirms that it is taking the steps outlined in paragraph 8.16 of the discussion paper in relation to the multiple responsibilities of some of its senior management. Particularly:-

(a) PAWA's General Manager positions are currently being advertised; and

(b) PAWA is, for operational reasons, changing the current situation by which its Executive Director - Commercial is also filling the roles of General Manager - Retail and General Manager - Generation.

Necessity for independent decision making

160. In PAWA's submission, the imposition of this obligation on its prescribed businesses is unreasonable and unnecessary.

161. The prescribed businesses of PAWA Networks and System Control are already bound by prescriptive decision making and operational criteria, which already effectively regulate their decision making and ensure that decisions are made independently and without regard to any potential competition impact.

162. These criteria are contained in:

(a) the Network Technical Code (required under the Third Party Access Code and approved by the Commission) - this sets out required service and performance standards. Compliance with this code is required by PAWA Network's licence;

(b) the Network Access Code, which fully sets out PAWA Networks' obligations in relation to the provision of access to the Network. Again, PAWA is obliged to comply with this code under the terms of its licence;

(c) the Network Planning Criteria, which set out the criteria to be applied for augmentation of the network to provide better than minimum standards of service;

(d) PAWA's Network Licence, which obliges PAWA to develop and comply with customer related standards and procedures;

(e) the System Control Technical Code, which is in the process of being implemented and is a requirement of PAWA's System Control Licence - this sets out measures for the reliable, safe, secure and efficient operation of the power system, including operational protocols and arrangements for system security and dispatch. Under its licence, PAWA System Control is obliged to comply with this code; and

(f) the requirements of PAWA's System Control Licence, which include an obligation to develop and comply with customer related standards and procedures.

163. Given these measures, the imposition of any additional obligation on the prescribed businesses of Networks and System Control to independently make decisions is unwarranted, and does not provide any additional public benefit. PAWA suggests that this obligation not be imposed in respect of these businesses.

164. Further, PAWA considers that this obligation should not be imposed on the prescribed business of PAWA Franchise Retail. Given that the prices which it charges for electricity are determined by government instrument and overseen by NT Treasury, it is difficult to understand what decisions it could make which may have an anti-competitive effect. If the Commission considers that there is potential for Retail to make such decisions, PAWA asks that the Commission explain this, and give interested parties an opportunity to respond, prior to imposing this obligation on PAWA Franchise Retail.

165. As to the imposition of this requirement upon PAWA Generation, as stated above, PAWA contends that PAWA Generation should not be a prescribed business under the Code. In any event, any decisions made by Generation are related to pure market issues, and are not issues which are appropriate to be dealt with in any ring fencing code. Any misuse of PAWA Generation's market power is already prohibited by section 46 of the *Trade Practices Act*.

Protocols

166. There is no provision in the proposed code to the effect of that set out in paragraph 8.17 of the discussion paper. The protocols referred to in paragraph 5 of the proposed code have no application to the obligations in respect of decision making independence. There is nothing in the proposed code which provides that any approved protocols or

undertakings are prima facie evidence of compliance with ring fencing obligations.

167. If the Commission does impose independence of decision making obligations, notwithstanding PAWA's submission above, PAWA suggests that a provision requiring it to prepare and submit for approval a detailed undertaking in relation to the decision making requirements is overly prescriptive, unwarranted, does not pass any cost benefit analysis, is demonstrably not for the public benefit and should not be included in any replacement code.

168. The arguments set out above in relation to the Commission's proposal that PAWA provide to it a detailed undertaking in relation to its compliance with the code generally apply equally here.

169. If the Commission nonetheless determines that such a provision ought to be included in the Code, PAWA should be given a reasonable opportunity, and reasonable time, to comment on the draft provision.

170. PAWA also refers to its comments in relation to paragraph 4 of the proposed code, at paragraphs 191 - 196 below.

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?

PAWA response:

The government policy in relation to this issue is clear. PAWA's primary position is that consideration of these issues is beyond the scope of the Commission's power in imposing a ring fencing code, and is a matter for government policy. As a Territory government agency, it is inappropriate for PAWA to comment on this issue. PAWA's role is to implement government policy, not comment upon it, unless it is asked to do so by its owner.

In any event, the Commission has no power to implement legal separation of PAWA's businesses. This would require amendment to legislation, including the *Power and Water Authority Act.*

In addition, the experience of other jurisdictions (particularly Queensland) indicates that legal separation would not result in any costs savings; rather, it is likely to impose significant additional costs which, as the Territory government has noted, would not be justified given the small size of the market.

PAWA also notes that the Commission states in paragraph 8.11 of the discussion paper, that where common ownership of the separated businesses remains, incentives or opportunities to favour related businesses will continue to exist; accordingly, it is likely that little public benefit would be gained by legal separation.

The consideration of industry structure is beyond the Commission's role in implementing appropriate ring fencing obligations. The QCA recently addressed this issue in its final determination on it distribution ring fencing guidelines as follows:

> *"Over time, evidence may emerge as to the benefits and costs of different industry structures, and the effectiveness of the current structure of the electricity industry will then be able to be more clearly determined. In the meantime, such structural options, along with alternatives such as transferring retail subsidiaries to generating entities, are matters for consideration by government. At the present time, the Authority will regard industry structure as a given and has developed its Distribution Ring-Fencing Guidelines accordingly."*

A more detailed discussion of these issues appears at paragraphs 148 to 159 of this submission.

- 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?

PAWA response:

PAWA considers it inappropriate for the Commission to ask external parties to comment on how the general managers of each of PAWA's monopoly businesses should be held accountable for the performance of that business and absolved from responsibility for any possible detrimental impact of business decisions on related businesses. This is beyond the scope of the issues at hand.

As an NT government agency, PAWA is bound by public service conditions of employment, including requirements to adhere to the NTPS Code of Conduct, which apply to the majority of its staff. These conditions now provide a mechanism by which individual incentives or financial rewards can be linked to business performance, and for the standard conditions to be varied, with the agreement of the Commissioner for Public Employment and PAWA's CEO.

PAWA's Executive contracts provide for regular performance reviews, which include relevant criteria such as business performance. Senior management are employed on standard NT public service contracts, ie employment is on a temporary basis and is performance based.

The Commission has no power over PAWA management responsibilities and Performance obligations.

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

PAWA response:

This is an internal matter for PAWA. It is not the role of the Commission to facilitate debate on these issues, in the context of ring fencing. PAWA will implement a management structure in accordance with its legal obligations, including any ring fencing code.

PART C - DRAFT REPLACEMENT CODE

Paragraph 1(a)

171. The requirement that a prescribed business be "*...a separate business division of [PAWA] that would be a subsidiary within the meaning of the* Corporations Law *if [PAWA] were a body corporate to which the* Corporations Law *applies"* suffers from a fundamental flaw, discussed below.

172. If PAWA was a corporation under the *Corporations Law*, would PAWA's business divisions be subsidiaries under the *Corporations Law*?

173. Section 46 of the *Corporations Law* defines "subsidiary". Applying the definition to PAWA, a business division of PAWA will be a subsidiary of PAWA only if:

    (a) PAWA controls the composition of the board of the business division;

    (b) PAWA is in a position to cast, or control the casting of, more than half of the maximum number of votes that might be cast at a general meeting of the business division;

    (c) PAWA holds more than half of the issued share capital of the business division; or

    (d) the business division is a subsidiary of a subsidiary of PAWA.

174. In PAWA's opinion, the business divisions of PAWA are not "subsidiaries" of PAWA within the definition set out above. This is because PAWA's business divisions:

    (a) are not bodies corporate;

    (b) do not have boards of directors;

    (c) do not conduct general meetings at which votes are cast; and

    (d) do not have share capital.

175. Given the definition of "related body corporate" contained in the ERA and set out above, if PAWA's business divisions are not "subsidiaries" of PAWA, then they cannot be related bodies corporate to each other, nor are they related bodies corporate to PAWA.

176. Accordingly, this requirement fails as a matter of law.

Paragraph 1(d)

177. There is no real need for the Code to require that the prescribed business must prepare separate accounts for contestable services provided by it. PAWA suggests that, rather

than the Code imposing this obligation, the Code simply require that the separate consolidated set of accounts required to be prepared set out the contestable business information within those accounts.

Paragraph 1(e)

178. In line with the approach taken in other jurisdictions[44], and as discussed above, PAWA suggests that inclusion of the words "and is otherwise fair and reasonable" at the end of the paragraph.

Paragraph 1(f) and (g)

179. In line with the existing Code, the words "take reasonable steps to" should be included at the beginning of the clause.

180. PAWA refers to the discussion at paragraphs 133 - 137 above in relation to the proposed information restriction obligations.

Paragraph 1(h)

181. Whilst PAWA understands the Commission's intention in inserting this requirement, the clause as presently drafted is unworkable. For example, it would prohibit a prescribed business from taking into account legitimate commercial considerations when negotiating terms for the provision of services such as:

(a) reduced prices for larger customers, or those with better load profiles;

(b) costs considerations - the actual cost of providing the service must be reflected fairly - for example, provision of services to a competitor of an associate may require investment in additional infrastructure, the costs of which the prescribed business may be justified in passing on to future users;

(c) provision of discounts for longer service agreements;

(d) credit risk; and

(e) other business benefits which may arise from the agreement.

These considerations are an every-day part of commercial dealings.

182. PAWA suggests that the issue sought to be dealt with by paragraph 1(h) is adequately dealt with in paragraph 1(i).

183. Further, the obligations in both 1(h) and (i) in relation to the provision or purchase of

[44] See QCA, "Electricity Distribution Ring-Fencing Guidelines", September 2000; National Gas Code.

goods or services should be limited to "prescribed" goods or services, ie goods or services produced or provided pursuant to the prescribed business - some of PAWA's businesses conduct other businesses outside of the prescribed businesses carried on - the provision of those goods or services should be outside the obligations contained at 1(h) and (i).

Paragraph 1(i)

184. PAWA agrees that a provision to the effect of paragraph 1(i) is required, however, considers that the inclusion of the words "financial impact" is unjustifiable on any competition or fair playing field grounds.

Paragraph 1(j)

185. In line with the submissions made at chapter 7 of Part B above, PAWA suggests that this obligation be deleted.

186. At paragraph 7.10 of the discussion paper, the Commission states that the replacement code makes provision for a waiver of this requirement where approved information sharing protocols are in place. This waiver is not included in paragraph 5 of the replacement code, and should be included.

Paragraphs 2(a) & (c) - accounting guidelines

187. PAWA refers to the submissions it has already made at paragraphs 102 - 113 above in relation to the development of separate accounting guidelines.

Paragraphs 2(b) & (c) - cost allocation guidelines

188. PAWA refers to the submissions it has already made at paragraphs 123 - 127 above in relation to the development of cost allocation guidelines.

Paragraph 3(b) - provision of accounts to the public

189. Paragraph 3(b) as it is currently drafted is ambiguous. Presumably, the Commission's intention is that the obligation to make accounts publicly available is only to apply to those accounts prepared in respect of the prescribed businesses[45], and not to the accounts required to be prepared in respect of the contestable business.

190. This ought to be made clear. There is no reason why the accounts in respect of contestable activities should be made public.

Paragraph 4

191. If the Commission accepts PAWA's submission at paragraphs 181 - 183 above, sub-

[45] With the exception of generation and franchise retail, for which there is a waiver of this obligation.

paragraph 4(a) can be deleted.

192. There is no regulatory precedent for paragraph 4. Stipulating that the Commission decides whether goods or services are received or provided in breach of sub-paragraphs 1(h) or (i) begs the question of how it will be determined whether PAWA has breached any other requirement of the code (such as not to cross subsidise).

193. Ultimately, if the Commission determines that PAWA has not complied with either 1(h) or (i), and PAWA disagrees, it will be a matter for the court to determine. As paragraph 4 currently reads, it is arguable that the court would be unable to look behind the Commission's opinion to decide for itself whether PAWA has failed to comply with the relevant obligation; in effect, once the court finds that the Commission's opinion was that PAWA was in breach, the court could not consider the issue further.

194. PAWA submits that such a state of affairs is undesirable and inconsistent with open and accountable regulation.

195. The statement that the issue will be determined in this manner "*until agreement can be reached on alternative mechanisms*" begs the question of:

(a) who the parties to such an agreement will be; and

(b) the mechanism for reaching such an agreement.

196. For the reasons set out above, PAWA suggests that paragraph 4 has potentially undesirable consequences, is unnecessary and ought not to appear in the replacement code.

Paragraph 5

197. At paragraph 7.10 of the discussion paper, the Commission states that the replacement code makes provision for a waiver of the requirement for separate marketing staff where approved information sharing protocols are in place. This waiver is not included in paragraph 5 of the replacement code.

198. In addition, PAWA assumes that the reference in paragraph 5 to 1(g) and (i) is intended to be to 1(f) and (g).

199. Assuming this to be the case, PAWA suggests that sub-clause (b) be amended to include the words "*or provided by a customer or prospective customer or*" before the word "*obtained*". This will ensure that the Chinese walls protocols cover information falling under paragraph 1(f).

Paragraph 6

200. PAWA generally has no problems with this paragraph, but suggests the following changes:

(a) As stated at paragraphs 62 - 63 above, and similarly to the waiver provisions, a prescribed business should have the right to request the Commission to amend the code. This could be coupled with a provision similar to paragraph 24(a) dealing with frivolous applications.

(b) The addition of the words "*require the prescribed business to comply with additional obligations*" after the opening words in the second sentence "*the Commission may.*" The clause as it currently reads does not specify any criteria which must be satisfied before the Commission can impose additional obligations.

(c) Deleting the words *"the prescribed business cannot demonstrate that"* in the second sentence. These words are unnecessary and do not appear in the equivalent provision in the ACCC's draft transmission ring fencing guidelines[46]. The imposition of additional obligations would require the Commission to follow the procedures set out in paragraphs 8 to 14 of the proposed code, which oblige it to seek and consider submissions from interested parties. The Commission will then decide whether or not additional obligations are warranted, on the basis of all the material available to it, not just material provided by the prescribed business. In these circumstances, it is inappropriate to require the prescribed business to *demonstrate* that the costs outweigh the public benefit.

Paragraph 15

201. PAWA submits that it is appropriate that it be given a reasonable time from the commencement of the replacement code to establish the required procedures (PAWA suggests 6 months). This allowance should be included in the Code. Of course, while these procedures are in the process of being established, PAWA is still bound by the substantive ring fencing requirements set out in paragraph 1 of the proposed code.

Paragraph 16

202. PAWA does not see any reason why the ring fencing report should be publicly available. The equivalent provisions in the National Gas Code[47] and the ACCC's draft transmission ring fencing guidelines[48] do not contain this requirement.

203. If the Commission nonetheless determines that the code should provide for the report to be made public, PAWA suggests that there are no circumstances or public benefit sufficient to justify the public disclosure of confidential information. At the very least,

[46] At paragraph 4. The guidelines are contained in the ACCC's Draft Statement of Principles for the Regulation of Transmission Revenues. The equivalent provision in the National Gas Code is worded differently.

[47] Paragraph 4.12.

[48] Paragraph 8.

the Commission should be bound to apply a public benefits test before allowing this confidential information to be published. Further, given that confidential information could well be commercially sensitive to a customer, PAWA suggests that the words *"or the customer or prospective customer which provided the information"* be inserted at the end of the last sentence in paragraph 16.

Paragraph 17

204. Given:

(a) The size of the market in the Northern Territory;

(b) The high cost of any independent audit; and

(c) The obligation currently contained in each of PAWA's licences to undertake an annual independent audit of its compliance with the Code[49],

PAWA submits that the Commission's power to require an audit is unwarranted, amounts to excessive regulation and is not justified by any perceived benefit. No similar requirement is contained in the National Gas Code.

205. PAWA has previously advised the Commission[50] that it considers the obligation in its licences to annually undertake an independent audit of its compliance with regulatory instruments, including the ring fencing code, to be costly and unjustified. PAWA's preferred position is that paragraph 17 of the proposed code remain, with the obligation to independently audit in the licences being removed.

Paragraph 20

206. PAWA suggests the words "*as soon as reasonably practicable*" replace the words "*immediately*".

207. The final sentence of paragraph 20 states that "*any breach of* [the requirement to report a breach of the Code] *may be subject to civil penalties prescribed for breaches of this Code where a breach is determined to occur*".

208. PAWA suggests that this statement is unnecessary, and begs the question of what liability attaches to a breach of other provisions in the Code.

Paragraph 21 & Schedule

209. The Schedule does not include the waiver referred to at paragraph 4.12 of the Commission's discussion paper in respect of the non-financial separation requirements

[49] Generation, Networks, and Retail licences paragraph 11.1(b); System Control licence paragraph 12.1(b).

[50] See PAWA's letter to the Commission dated 5 July 2000.

with respect to PAWA Retail's contestable and franchise businesses.

Paragraph 22

210. PAWA makes the following comments with respect to paragraph 22:

(a) The word "may" in the first line should be "must". The only sustainable grounds upon which ring fencing obligations can be imposed on a market participant is if the public benefit arising outweighs the cost. If the Commission is satisfied of this, compliance with the obligation should be waived. If the Commission considers that further criteria should be satisfied before a waiver can be granted, these criteria should be set out in paragraph 22.

(b) For the reasons set out at paragraph 200(c) above, the words "*the prescribed business can demonstrate that*" should be removed.

Paragraph 32 - Interpretation

ASSOCIATE

211. This definition suffers from the flaws identified above arising from the incorporation of the *Corporations Law* definition of "subsidiary".

CONFIDENTIAL INFORMATION

214. PAWA suggests that this definition be amended to read as follows:

> *"Confidential information means information which is or has been provided to a prescribed business or an Associate taking part in a related business and which is confidential or commercially sensitive, including information which is derived from any such information."*

215. The proposed amendments give clearer guidance to the definition.

CROSS SUBSIDY

216. As stated at paragraph 120 above, PAWA agrees with the Commission's proposed definition of cross subsidy.

CUSTOMER

217. The definition of customer in the proposed code is taken directly from the QCA's distribution ring fencing guidelines; as such, it defines a customer as a person who engages in the activity of purchasing electricity.

218. This definition is clearly too narrow for our code, which, in addition to distribution businesses, applies to other monopoly businesses such as system control and network access. As it is currently drafted, for example, it would not include generators who

provide information to the prescribed business of system control or network access.

219. PAWA suggests that the definition be widened to fit the Territory conditions.

MARKETING STAFF

220. PAWA agrees with the Commission's definition of marketing staff.

ELECTRICITY BUSINESS

221. This definition also suffers from the flaws identified above arising from the incorporation of the corporations law definition of "subsidiary".

PRESCRIBED BUSINESS

222. As to the inclusion of generation in this definition, PAWA refers to paragraphs 20 - 22 and 66 - 92 above.

223. In PAWA's opinion, the definition as it currently stands provides the Commission with inappropriate discretion in determining other businesses which it considers to be non-contestable or dominated by a single supplier. Were the Commission to determine that another business should be a prescribed business, as this does not involve any amendment to the Code, it is not obliged to go through the procedures for amending the code set out in the Code, and therefore is not obliged to consult with PAWA or any other interested parties[51]. Indeed, there is no obligation on the Commission to publish its determination or make it known to PAWA.

224. Even if the reference in the definition to the Commissioner making determinations is deleted, the definition still suffers from a further defect. As the definition is inclusive rather than exhaustive, it is possible that PAWA could be in breach of the Code in respect of the activities of a business not specifically mentioned in the Code, but which has developed the characteristics of a monopoly.

225. The issues discussed above clearly indicate that the current definition of "prescribed business" is inconsistent with open and accountable regulation. To overcome this, PAWA suggests that the introductory words in the definition be deleted and simply replaced with "*prescribed business means the following electricity businesses:*". This amendment will provide certainty to PAWA and ensure that, if the Commission considers

[51]Although, of course, the Commission is bound by the rules of natural justice in making any determination.

that a further business ought to be a prescribed business, it must amend the Code and therefore consult with interested parties.

POWER & WATER AUTHORITY

Submission to the Utilities Commission:

Proposed Ring Fencing Code

September 2000

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