

POSSIBLE REVIEW OF CERTAIN REGULATORY INSTRUMENTS

ISSUES PAPER

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Level 9, 38 Cavenagh Street Darwin NT 0800

GPO Box 915, Darwin NT 0801

utilities.commission@nt.gov.au

www.utilicom.nt.gov.au

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Inquiries

Any submissions, comments or inquiries regarding this paper should be directed in the first instance to the Executive Officer, Utilities Commission at any of the following:

Postal address:
Utilities Commission
GPO Box 915
DARWIN NT 0801

Telephone:
08 8999 5480

Fax:
08 8999 6262

Email:
utilities.commission@nt.gov.au

FOREWORD

The Commission has taken an *in-principle* decision to – over the next year or so – revamp the NT electricity ring-fencing code and develop some contestable pricing guidelines, notwithstanding regulatory policy developments that may impact on the NT’s electricity market over the same period.

This Paper sets out the Commission’s reasoning for this preferred course of action, in order to obtain stakeholder feedback *prior to* the Commission following up on this decision. The Commission will take views received into account before deciding whether or how to proceed.

Submissions are invited from interested parties concerning the issues raised in this Paper and related matters.

The closing date for submissions is **Friday, 19 October 2007**.

In the interests of transparency and to promote informed discussion, submissions will be made available for public inspection at the office of the Commission or on its website unless the person making a submission claims confidentiality in respect of the submission (or any part of the submission). Claims for confidentiality should be clearly noted on the front page of the submission and the relevant sections of the submission should be marked as confidential

The focus of this Paper is on regulatory issues *excluding* network access regulation. Regulation of third-party access to the Territory’s electricity network, and of associated network pricing, are matters that the Commission is either comfortable dealing with separately under the 2009 network pricing reset process and/or unequivocally accepts is best left to policy developments and the national regulatory regime.

CHAPTER

1

CURRENT REGULATORY DEFICIENCIES**Deficiencies in current arrangements**

1.1 As a consequence of legislative changes that came into effect on 1 April 2000, the Territory's electricity supply industry currently operates within a policy framework that strives to deliver economic benefits through the operation of competitive product markets (where this is possible) or the simulation of competitive market outcomes (where competition is not possible).

1.2 Within this framework, the regulatory arrangements take *generation* and *retailing* of electricity to be activities that are capable of being provided through a competitive market, in which price and output are determined by the interaction of competing buyers and sellers. As such, generation and retailing are not subject to economic regulation. Only *network* services are subject to pricing and other controls that are typically applied to natural monopolies to simulate competitive market outcomes.

1.3 The market is activated by providing certain end-use customers with the freedom to choose their retailer. Currently, only medium to large customers in the NT system are contestable. They face no regulatory restrictions on their choice of retailer/generator or on the terms and conditions under which they agree to take supply.

1.4 However, experience has shown that these current regulatory arrangements fall short of the ideal in a number of respects.

System planning and control

1.5 A number of important system control and market administration functions remain within the sole supplier (Power and Water), and formal procedures for managing the level of reserve capacity (including the critical issue of how investment in new capacity is determined) are absent. Indeed, the current arrangements in the Territory are distinctive in that:

- the responsibilities, accountabilities and powers of the main participants with regard to system planning and reliability – the system controller, Power and Water Generation, Power and Water Networks and the Commission itself – are largely undefined; and
- there is limited recognition regarding the desirability of separating public interest responsibilities from commercial interests.

1.6 The way power system planning and reliability are managed in the NT electricity market gives rise to concerns regarding the operation, planning and reliability of the Territory power system. It may also directly discourage competition.

Retail market and customer protections

1.7 Because competition has failed to develop, customers are exposed to Power and Water's market power. Power and Water is the NT's only generator and retailer. In practice, it remains a vertically-integrated monopoly utility.

1.8 The realities of the commercial environment experienced by contestable customers are therefore far removed from the vision of the competitive market referred to in regulatory policy. These customers only have two options – either accept the terms offered by Power and Water or bypass the supply system. This raises particular regulatory issues. By restricting output, a firm with market power can price above efficient cost. If the firm is an efficient profit-maximiser it will convert the higher prices into monopoly profits, to the benefit of shareholders. If the firm is not efficient, some or all of the higher prices may be absorbed as increased costs, to the benefit of the providers of inputs to the firm. While the Commission is not asserting that this necessarily occurs in the case of Power and Water, customer perceptions can be as important as market realities.

Generation barriers to entry

1.9 Recent developments mean that competition in the NT generation sector is unlikely to emerge in the medium term.

1.10 A new long-term gas contract is in place, with every indication that Power and Water in effect has exclusive rights to the available gas. A new power station has been committed by Power and Water that will add 35MW of capacity to the Darwin-Katherine system in 2007-08 and again in 2010-11. The Commission's 2006 *Power System Review* projected that, as a result, there will be sufficient capacity to maintain reserves in excess of N-1 through to 2015-16. Until then, any new competitor will face the prospect of entering a market with a single incumbent supplier holding excess capacity (recognising that the emergence of new unanticipated load is always possible).

1.11 From a potential generator-entrant's perspective, additional challenges include:

- the nature of the load-following requirements and the out-of-balance settlement arrangements associated with the NT's bilateral contracting framework, as well as the market for ancillary services and the requirements for adequate reserves or standby generation; and
- whether the power system control function would be exercised by Power and Water on a transparent and fair basis to all generators.

Retail barrier to entry

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

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

- trying to understand the exact nature of the bilateral contracting framework currently in place and the equality of regulatory treatment afforded a new retailer (or customer) compared to Power and Water Retail; and
- having sufficient comfort that the ring-fencing processes in place are effective enough to ensure they obtain access to wholesale energy on competitively-neutral commercial terms from Power and Water Generation.

Implications for the Commission

1.14 In certain respects, these deficiencies are outside the Commission's control. Where the best or only solution to any of these deficiencies is policy change, such a solution is a matter for the Government and not the Commission.

1.15 However, the Commission can play a role where either:

- the source of any particular deficiency is inadequate use of existing regulatory powers; or
- the symptoms (or impacts) of these deficiencies can be moderated by the exercise of existing regulatory powers.

1.16 To varying degrees, many of the above-mentioned deficiencies could be ameliorated by action currently within the Commission's power. Overall, the Commission acknowledges that it has generally taken a 'light-handed' approach to regulation. In retrospect, therefore, the Commission accepts that some of the deficiencies in the present market and regulatory environment in the NT identified by contestable customers and potential entrants may be put down to Commission's preference to date to not exploit the full extent of its available powers.

1.17 However, before exploring the options available to the Commission to improve the efficacy of its regulatory oversight, it is necessary to first consider where – and to what extent – the prospects for change in the NT regulatory regime constrain the options available to the Commission. This is the subject of Chapter 2.

Issue:

- (1) Is there any disagreement with the Commission's views regarding the nature and extent of current regulatory deficiencies and their implications for the Commission? If so, why?**

CHAPTER

2

PROSPECTIVE POLICY DEVELOPMENTS**Prospects for regulatory change**

2.1 Over the last two years, the NT Government has been reviewing the effectiveness of the existing electricity market regulatory regime, and in doing so has identified a number of structural and regulatory barriers to private investment and competition in the Territory electricity supply industry.

2.2 Recognising that the existing framework will continue to impose substantial costs on market participants, the Government is considering the merits of joining the national energy regime established by the Australian Energy Market Agreement.

2.3 NT Treasury has advised that it is in the process of:

- developing a Policy Paper setting out the terms and conditions for transitioning to the national regime;
- undertaking targeted consultation with national energy market bodies (the Australian Energy Regulator (AER), the Australian Energy Markets Commission (AEMC) and the National Electricity Market Management Company (NEMMCO)); and
- planning consultation with NT users (in the 4th quarter of 2007)

with a view to the Government making a final decision in the first half of 2008.

2.4 As a result, there is a very real possibility that regulatory jurisdiction for the NT electricity market will migrate to national arrangements any time after mid-2008. The Commission has advised the Government that it sees considerable merit in this possibility from a regulatory administration point of view.

2.5 In investigating the move to the national energy regime, all parties recognise that some modifications to the national regime are likely to be required to accommodate Territory-specific circumstances (notably its non-interconnectivity with the national grid and its small scale), at least until such time as market conditions in the NT support full transition.

2.6 It is understood that NT Treasury is currently undertaking negotiations that seek to:

- determine the need for regime exemptions; and
- agree on exemptions and associated review mechanisms.

Implications for the Commission

2.7 Given the prospects of regulatory regime change, the Commission sees merit in distinguishing between the current regulatory deficiencies *not only* on the grounds

of whether or not they could be ameliorated by action currently within the Commission's power *but also* according to whether they are:

- not NT-specific and so can await national developments and regulation; or
- unique to the NT circumstances and so require NT-specific regulation.

2.8 The Commission therefore acknowledges that it should consider exercising the powers that it currently has only with respect to those current regulatory deficiencies that need to be addressed by NT-specific regulatory instruments. Such matters deserve to be addressed regardless of the regulatory reform in prospect.

2.9 Of the actions/initiatives that could be undertaken by the Commission to address current regulatory deficiencies in the NT electricity market, the Commission concedes that those addressing deficiencies in the following areas seem most likely to be overtaken by the NT Government's reforms (including the NT's migration to the national energy regime):

- third-party access to networks and associated access price regulation (outside the scope of this Paper);
- Power and Water's *de facto* responsibility for power system planning and reliability; and
- system control issues.

2.10 However, there are some actions/initiatives that could be undertaken by the Commission to address current deficiencies in the NT electricity market that, by their nature, seem unlikely – at least in the short term – to be overtaken by the NT's migration to the national electricity regime. These include:

- barriers to entry directly associated with Power and Water's vertical integration in general, and the lack of legal separation between Power and Water's networks, generation and retail businesses and between its franchise and contestable retail businesses in particular; and
- the lack of regulatory oversight in the 'contestable' market segments in the absence of any alternative supplier to Power and Water.

2.11 Hence the Commission is of the view that there may be some significant NT-specific issues of regulatory administration that are unlikely to be dealt with (or overtaken) by likely changes in the regulatory policy environment – at least for the foreseeable future.

2.12 In particular, should the Government choose to join the national energy regime, some existing regulatory instruments may continue in place for a time as the NT transitions. Moreover, the national regulatory bodies are unlikely to devote time and resources to NT-specific issues in the short to medium term if existing instruments exist that can be 'grandfathered'.

2.13 In these circumstances, the Commission could be remiss if it continues to defer the exercise of its existing powers in such areas on the grounds that the NT will soon be joining the national regulatory regime.

Issue:

(2) Is there any disagreement with the Commission's views regarding the nature and extent of prospective policy developments and their implications for the Commission? If so, why?

CHAPTER

3

COMMISSION'S PREFERRED APPROACH

The Commission's functions and powers

3.1 Whether the Commission has the capacity to address these NT-specific regulatory deficiencies depends very much on its existing powers and functions.

3.2 The Commission has a number of such powers and functions with which it could:

- maximise the likelihood of competition eventually emerging in the NT; and
- provide safeguards for customers that have no option but to take supply on terms dictated by Power and Water.

Ring-fencing powers

3.3 Section 24 of the *Utilities Commission Act* authorises the Commission to make codes or rules relating to the conduct or operations of a regulated industry or licenced entities only when authorised to do so by the relevant industry regulation Act or by regulations under the *Utilities Commission Act*.

3.4 Specifically, regulation 2 authorises the Commission to make a code relating to ring fencing in a regulated industry, where subregulation 2(2) defines ring fencing to mean "the separate operation of related or associated businesses" (emphasis added).

3.5 The NT Ring-fencing Code – developed and published by the Commission – essentially replicates codes in place in other jurisdictions. As a result, the extent of "separate operation" required in the NT circumstances – particularly in the absence of legal separation – has not been fully explored.

Guideline-making powers

3.6 Section 7 of the *Utilities Commission Act* authorises the Commission to publish guidelines (and statements and reports) relating to the performance of its functions.

3.7 Guidelines promulgated by the Commission can be particularly important in providing guidance to market participants regarding the Commission's likely interpretation of the powers and responsibilities that are specifically given to the Commission by relevant industry regulation Acts or by regulations under the *Utilities Commission Act*.

3.8 To date, guidelines have been issued in relation to:

- *Contestable Pricing* (issued September 2001; withdrawn April 2007), which dealt with the types of pricing conduct that could give rise to a finding of 'anti-competitive' and/or 'discriminatory' conduct by the Commission under either

the Ring-Fencing Code or the complaints provisions of the *Electricity Reform Act 2000*;

- *Framework for Negotiation of Discounted Network Tariffs* (issued May 2002), which provides that network tariffs may be negotiated below the approved reference tariffs (and thus effectively recouped from other network users) where there is a genuine threat of network “by-pass” by a particular end-use customer – either in whole or in part;
- *Negotiating Power Prices With A Large New Load* (issued December 2004), which clarifies that, in situations where one of Power and Water’s contestable businesses is not in fact in competition with any third-party generator or retailer, any limits placed on the pricing activity of Power and Water’s contestable businesses is an exercise of Power and Water’s discretion (including in light of its broader legal obligations) and not a requirement under the Contestable Pricing Guidelines or Network Tariff Discounting Guidelines; and
- *Standards of Service Code Procedural Guidelines* (issued March 2006), which sets out the procedures the Commission will adopt when administering certain aspects of the NT Electricity Standards of Service Code.

3.9 Section 48(1)(b) of the *Electricity Reform Act* authorises the Commission to conduct investigations into conduct that may be contrary to the competition and efficiency objects of both the *Electricity Reform Act* and the *Utilities Commission Act*. This grants the Commission certain investigatory powers when a complaint is made.

3.10 Hence, guidelines promulgated by the Commission can provide guidance to market participants regarding the Commission’s likely interpretation of conduct that may be contrary to the competition and efficiency objects of both the *Electricity Reform Act* and the *Utilities Commission Act*. Developing and publishing such guidelines can also provide a platform for certain issues to be debated among market participants before complaints arise, possibly even forestalling such complaints.

Implications for the Commission

3.11 Where any current regulatory deficiencies relate to market conduct discouraging entry by other service providers, the main instrument available to the Commission is its ring-fencing code making powers. On the other hand, where any current regulatory deficiencies relate to market conduct towards end-users in ‘contestable’ sectors, the main instrument available to the Commission is its guideline making powers in conjunction with its investigatory powers.

3.12 Hence:

- deficiencies arising because of inadequate operational separation between Power and Water’s monopoly and contestable business units could be addressed by strengthening and fine-tuning the ring-fencing code; and
- deficiencies arising because the activities of Power and Water’s deregulated ‘contestable’ businesses still operate with considerable market power could be addressed by exercise of the Commission’s guideline-making powers in conjunction with its investigatory powers.

Revamp of the NT electricity ring-fencing code

3.13 In particular, the Commission sees the need to address certain market barriers to entry confronting potential entrants because of Power and Water’s vertical integration by undertaking a comprehensive revamp of the NT Ring-fencing Code. This could see the Code incorporating – particularly in the absence of legal separation between Power and Water’s various businesses – the requirement for (the equivalent of):

- purchase agreements between Power and Water's generation and retail businesses;
- access agreements between Power and Water's network and retail businesses;
- operational protocols between Power and Water's system control and generation businesses;
- coordination agreements between Power and Water's franchise and contestable retail businesses; and
- standing offers/reference prices/proforma contract structure between Power and Water and third-party retailers and generators.

3.14 The Commission has received legal advice that it already possesses the powers necessary to address many of the current deficiencies it sees in the existing NT ring-fencing, accounting separation and cost allocation arrangements.

3.15 The Commission also notes that the AER is on record as stating that:

"... legal separation of networks infrastructure operators from related businesses and maintenance of separate accounts by service providers are minimum requirement for an effective ring fencing regime." (AER submission to the MCE on the exposure draft of the National Electricity Amendment Bill, February 2007, p.3.)

Development of contestable pricing guidelines

3.16 The Commission also sees the need to develop and publish certain guidelines to complement use of its investigatory powers when addressing concerns arising for contestable customers because of the lack of any alternative supplier to Power and Water. This could see the development and publication of contestable retail pricing guidelines applicable in the absence of competition, including the direct pass-through of network and generation prices.

These matters are unlikely to be addressed initially by the national regulator

3.17 Finally, it is the Commission's view that ring-fencing and contestable pricing guidance are unlikely to receive particular attention from the AER or the AEMC in the short to medium term, and certainly not in a way that addresses NT-specific circumstances and needs.

3.18 The Commission considers itself well placed to progress consideration of these issues while policy-makers are focused on issues surrounding application of national laws and rules in the NT context. By doing so, the Commission could contribute to ensuring that effective NT-specific regulatory instruments are in place that are capable of application by national regulatory bodies during the NT's transition to the national regulatory regime.

Issue:

(3) Is there any disagreement with the Commission's proposal to undertake a major review of the NT electricity ring-fencing code and to develop certain contestable pricing guidelines? If so, why?