



**ELECTRICITY  
RING-FENCING CODE**

**Revised Draft Replacement Code**

**December 2000**

## **Table of Contents**

Foreword.....	1
Revised Draft Replacement Code .....	2
Appendix A: Explanatory Notes on Revisions .....	23
Appendix B: Ring-Fencing of PAWA Generation.....	36
Appendix C: Ring-Fencing Accounting Requirements.....	49
Appendix D: Cross Subsidy Definition and Cost Allocation Principles.....	53
Appendix E: Regulation Drafting Instructions.....	58

## FOREWORD

An Interim Ring-Fencing Code ("Interim Code") is currently in effect in the Territory's electricity supply industry. This Code formally commenced with effect from 1 April 2000.

In July 2000, the Commission issued a Ring-Fencing Code Discussion Paper which included a draft replacement Code for public comment ("initial draft"). In response, submissions were received from the Power and Water Authority ("PAWA"), the NT Power Group ("NT Power") and the NT Treasury. These submission can be viewed on the Commission's website.

As a consequence of issues raised in these submissions, the Commission has decided to release a further draft replacement code ("revised draft") for comment. The revised draft follows immediately after this foreword.

Appendix A provides a general explanation for the changes from the initial draft proposed in the July 2000 Discussion Paper.

Appendix B discusses in more detail the Commission's view on the ring-fencing of PAWA Generation, including an analysis of the net public benefits of this provision of the proposed code.

Appendix C explains the Commission's approach to the accounting and cost allocation provisions of the proposed code.

Appendix D examines the definition of cross subsidies and its relationship with the proposed cost allocation principles.

Appendix E contains proposed drafting instructions for a regulation authorising the Commission to make the replacement ring-fencing code under section 24 of the *Utilities Commission Act 2000*.

Submissions, comments or inquiries regarding this revised draft and the supporting material should be directed to:

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The **closing date** for submissions is **28 February 2001**.

The Commission now plans to issue the final text of a replacement Code by 31 March 2001, to have effect no later than 1 July 2001. The Interim Code will continue to have effect until that time.

# REVISED DRAFT CODE

## Notice for Gazette

This Ring-Fencing Code ("**Code**") is published by the **Commission** pursuant to section 24 of the *Utilities Commission Act 2000* and will take effect on the date on which this notice appears in the *Gazette*. This Code replaces the Interim Ring-Fencing Code which commenced with effect on 1 April 2000.

## NORTHERN TERRITORY ELECTRICITY RING-FENCING CODE

### 1. Authority

- (a) This **Code** is made by the **Commission** under section 24 of the **Act** and in accordance with the authority granted to the **Commission** by [*insert relevant regulation*<sup>1</sup>].
- (b) In making this **Code**, the **Commission** has had regard to the matters listed in section 6(2) of the **Act**.

### 2. Application

This **Code** will apply to all **Electricity Entities** who carry on a **Prescribed Business** in the Northern Territory as and from the **Commencement Date**.

### 3. Ring-Fencing Minimum Obligations

An **Electricity Entity** that carries on a **Prescribed Business** in the Northern Territory must:

- (a) establish and maintain a separate set of financial accounts in respect of each **Prescribed Business** which have been prepared in accordance with the **Accounting Procedures** approved by the **Commission** from time to time under clause 4;
- (b) allocate any costs that are shared between a **Prescribed Business** and a **Related Business** in a manner that:

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<sup>1</sup> See Appendix E.

- (i) complies with the **Cost Allocation Procedures** approved by the **Commission** from time to time under clause 4; and
  - (ii) is otherwise fair and reasonable;
- (c) ensure that **Confidential Information** provided by a **Customer** to a **Prescribed Business** is:
  - (i) used only for the purpose for which that information was provided;
  - (ii) only disclosed to a **Related Business** if the disclosure of that information is not prohibited under the **Information Procedures** approved by the **Commission** under clause 4 from time to time; and
  - (iii) otherwise dealt with in accordance with the **Information Procedures** approved by the **Commission** under clause 4 from time to time;
- (d) ensure that all information obtained by the **Electricity Entity** or by its employees, consultants, contractors or agents in the course of conducting a **Prescribed Business** which might reasonably be expected to materially affect the commercial interests of a competitor of a **Related Business** (including **Confidential Information**) is:
  - (i) used only for the purpose for which that information was provided or obtained;
  - (ii) only disclosed to a **Related Business** if the disclosure of that information is not prohibited by the **Commission** under clause 4 from time to time; and
  - (iii) otherwise dealt with in accordance with the **Information Procedures** approved by the **Commission** under clause 4 from time to time;
- (e) ensure that goods or services provided by a **Prescribed Business** are provided on a non-discriminatory arm's length basis to all **Customers**;
- (f) ensure that goods or services provided to a **Prescribed Business** by a **Related Business** are provided on a non-discriminatory arm's length basis; and

- (g) ensure that the **marketing staff** of its **Prescribed Businesses** are not also used as **marketing staff** for its **Related Businesses** and, in the event that the **marketing staff** of its **Prescribed Businesses** do become or are found to become involved in a **Related Business**, ensure that that involvement immediately ceases.

#### 4. Compliance with Approved Procedures

4.1 In this clause 4, a reference to “**Procedures**” includes in each case the **Accounting Procedures**, **Cost Allocation Procedures** and **Information Procedures**.

4.2 An **Electricity Entity** who carries on a **Prescribed Business** must within:

- (a) 3 months (in the case of the **Accounting Procedures** and the **Cost Allocation Procedures**); and
- (b) 6 months (in the case of the **Information Procedures**)

of the **Commencement Date** submit to the **Commission** for approval draft **Procedures** for its **Prescribed Businesses**.

4.3 The draft **Procedures** submitted by an **Electricity Entity** under clause 4.2 must be:

- (a) designed to ensure compliance with the **Electricity Entity’s** obligations under clause 3; and
- (b) otherwise consistent with the general principles set out in Schedule 2 to this **Code** for each type of **Procedure**.

4.4 In considering whether to approve any draft **Procedures** submitted by an **Electricity Entity** under clause 4.2, the **Commission** will have regard to (among other things):

- (a) the matters set out in section 6(2) of the **Act**; and
- (b) whether the draft **Procedures** give effect to the principles set out in Schedule 2 to this **Code** for those type of **Procedures**.

4.5 The **Commission** may grant its approval to draft **Procedures** submitted by an **Electricity Entity** under clause 4.2 subject to such conditions as the **Commission** considers are appropriate in the circumstances including conditions requiring that:

- (a) the **Procedures** are approved for a fixed term;

- (b) the **Procedures** must be resubmitted for approval following any change to the **Code** effecting the **Procedures** or when otherwise requested by the **Commission**; and
  - (c) the **Electricity Entity** report to the **Commission** concerning the implementation, application and/or compliance with the **Procedures** when requested by the **Commission**.
- 4.6 An **Electricity Entity** must comply with any **Procedures** approved by the **Commission** from time to time under clause 4.2 and any conditions attaching to the **Commission's** approval of those **Procedures**.
- 4.7 An **Electricity Entity** may at any time apply to the **Commission** to approve a variation to any existing **Procedures** approved by the **Commission**. An application to vary any existing **Procedures** will be dealt with by the **Commission** in accordance with the procedure set out in this clause 4.
- 4.8 The **Commission** must notify an **Electricity Entity** within 30 days after receiving an application from the **Electricity Entity** to approve any **Procedures** (or any variation to the existing **Procedures**) whether the **Commission** approves those **Procedures** (or the proposed variation to the existing **Procedures**). The **Electricity Entity** must implement any **Procedures** within 30 days after the date upon which they are approved by the **Commission**.
- 4.9 If an **Electricity Entity** fails to submit any draft **Procedures** to the **Commission** within the time period specified in clause 4.2 for the submission of those **Procedures**, the **Commission** may issue its own procedures which will be deemed for the purposes of this **Code** to be the **Procedures** applying to that **Electricity Entity** until such time as draft **Procedures** are submitted to the **Commission** and approved.
- 4.10 An **Electricity Entity** who carries on a **Prescribed Business** must provide to any person upon request copies of the accounts provided to the **Commission** under clause 3(a) for the most recent annual reporting period upon payment by that person of the fee approved for that purpose by the **Commission**.
- 5. **Adding to or Amending this Code**
  - 5.1 The **Commission** may vary or revoke this **Code** (or any part of this **Code**) in accordance with section 24 of the **Act**.
  - 5.2 An **Electricity Entity** may request the **Commission** to vary or revoke any part of this **Code**.

- 5.3 Without limiting the powers of the **Commission** under section 24 of the **Act** to vary or revoke the **Code**, the **Commission** may vary the **Code** to require that an **Electricity Entity** comply with an obligation in relation to the conduct of a **Prescribed Business** which differs from or is in addition to the minimum obligations set out in clauses 3 and 4.
- 5.4 In deciding whether to vary or revoke this **Code** (or any part of this **Code**) under clauses 5.1 or 5.2 or impose any additional or varied obligation on an **Electricity Entity** under clause 5.3, the **Commission** will have regard to:
- (a) the matters listed in section 6(2) of the **Act**; and
  - (b) in the case of a variation to the **Code** which imposes an additional or varied obligation on a particular **Electricity Entity**, the general principle that the administrative cost to that **Electricity Entity** of complying with the additional or varied obligation should not, or should not be likely to, outweigh the benefits to the public from compliance with that additional or varied obligation.
- 5.5 Before varying or revoking this **Code** under this clause 5, the **Commission** will consult with each **Electricity Entity** in accordance with the procedure set out in clause 6 and otherwise comply with the other requirements of the **Act** and clause 6.
- 5.6 An **Electricity Entity** must comply with any additional or varied obligation imposed upon that **Electricity Entity** under clause 5 once that obligation has taken effect in accordance with section 24 of the **Act**.

## **6. Procedures for Adding To or Amending Ring-Fencing Obligations**

- 6.1 The **Commission** must, before varying or revoking this **Code** (or any part of this **Code**) or imposing an additional or varied obligation on an **Electricity Entity**, inform each person known to the **Commission** who the **Commission** believes has a sufficient interest in the matter that the **Commission** is considering varying or revoking this **Code** (or any part of this **Code**) or imposing an additional or varied obligation on an **Electricity Entity** by publishing a written notice which at least:
- (a) states the nature of the proposed variation, revocation or additional or varied obligation; and

- (b) requests submissions by a date specified in the notice (not being a date earlier than 30 days after the date of the notice).
- 6.2 The **Commission** will also give a copy of any notice published in accordance with this clause 6 to each **Electricity Entity** to which the notice relates.
- 6.3 The **Commission** must consider any submissions received by the date specified in the notice published under clause 6.1(b) and may (but is not obliged to) consider any submissions received after that date.
- 6.4 Within 30 days (or such longer period as the **Commission** notifies) after the last day for submissions specified in the notice published under clause 6.1(b), the **Commission** must issue a draft decision stating whether or not it intends to proceed with the proposed variation, revocation or additional or varied obligation.
- 6.5 The **Commission** must:
- (a) provide a copy of its draft decision to each **Electricity Entity**, any person who made a submission on the matter and any other person who requests a copy; and
- (b) request submissions from persons to whom it provides the draft decision by a specified date (not being a date earlier than 30 days after the date the draft decision was issued).
- 6.6 The **Commission** must consider any submissions it receives by the date specified by the **Commission** under clause 6.5(b) and it may (but is not obliged to) consider any submissions received after that date.
- 6.7 Within 30 days (or such longer period as the **Commission** notifies) after the last day for submissions on the draft decision specified by the **Commission**, the **Commission** must issue a final decision stating whether or not it will proceed with the proposed variation, revocation or additional or varied obligation.
- 6.8 A notice in relation to a variation, revocation or additional or varied obligation will have effect 30 days after the notice is given to each **Electricity Entity** and published in the *Gazette* (or such later date as the **Commission** specifies in the notice).

## 7. Compliance Procedures and Compliance Reporting

- 7.1 An **Electricity Entity** who carries on a **Prescribed Business** must within 6 months of the **Commencement Date** establish and maintain appropriate internal procedures to ensure that it complies with its

obligations under this **Code**. The **Commission** may require the **Electricity Entity** to demonstrate the adequacy of, and level of, compliance with these procedures upon reasonable notice. However, any statement made or assurance given by the **Commission** concerning the adequacy of an **Electricity Entity's** compliance procedures will not affect the **Electricity Entity's** obligations under this **Code**.

- 7.2 An **Electricity Entity** must provide a report to the **Commission**, at reasonable intervals determined by the **Commission**, describing the measures taken by the **Electricity Entity** to ensure compliance with its obligations under this **Code**. This report, along with the **Commission's** assessment of compliance, will be made publicly available by the **Commission** subject to the **Commission** first complying with its obligations under section 26 of the **Act**.
- 7.3 The **Commission** may, upon reasonable notice to an **Electricity Entity**, appoint an independent reviewer to undertake an audit of the **Electricity Entity's** compliance with any of its obligations under this **Code**.
- 7.4 If the **Commission** nominates standards or requirements to apply to a review under clause 7.3, the reviewer will report in accordance with those standards or requirements.
- 7.5 The **Commission** will provide a copy of the reviewer's report to the **Electricity Entity** as soon as reasonably possible after it has been received from the reviewer.
- 7.6 The **Electricity Entity** will be responsible to pay the costs of undertaking that audit if the reviewer discovers any failure by the **Electricity Entity** to comply with a material obligation under this **Code**.
- 7.7 An **Electricity Entity** must report any breach of its obligations under this **Code** to the **Commission** as soon as reasonably possible after becoming aware that the breach has occurred and advise of the remedial action that is being undertaken to rectify the breach.

## **8. Exemption from Compliance with Specified Obligations**

- 8.1 As at the **Commencement Date** each **Electricity Entity** listed in column 1 of Schedule 1 is exempt from complying with the obligations under this **Code** set out in column 2 of Schedule 1 in relation to the **Prescribed Business** set out in column 3 of Schedule 1.

- 8.2 The **Commission** may, by notice to an **Electricity Entity**, exempt that **Electricity Entity** from compliance with any of its obligations (or any component of an obligation) under this **Code**. A notice requesting an exemption must include all information and materials necessary to support the **Electricity Entity's** application for exemption.
- 8.3 In determining whether to grant any exemption, the **Commission** will have regard to:
- (a) the matters listed in section 6(2) of the **Act**; and
  - (b) the general principle that the **Commission** will usually grant an exemption if it is satisfied that the benefit, or likely benefit, to the public of compliance with the relevant obligation is outweighed by the administrative cost to that **Electricity Entity** of complying with that obligation.
- 8.4 The **Commission** may grant an exemption:
- (a) on different terms to those sought by the **Electricity Entity**; or
  - (b) subject to such conditions as the **Commission** considers are appropriate in the circumstances including conditions requiring that:
    - (i) the exemption is for a fixed term;
    - (ii) the continuation of the exemption be subject to review by the **Commission** on such terms as the **Commission** considers appropriate in the circumstances;
    - (iii) the **Electricity Entity** report to the **Commission** concerning any matter relating to the operation or impact of the exemption; and
    - (iv) the grant of the exemption is conditional upon the occurrence of a nominated event (for example, the variation of the **Code** to impose an additional or varied obligation on the **Electricity Entity** or the implementation of agreed compliance procedures).
- 8.5 An **Electricity Entity** may apply to the **Commission** for an exemption from compliance with any obligation (or component of an obligation) under this **Code**.

- 8.6 When the **Commission** receives an application under clause 8.5 the **Commission** must:
- (a) if it considers that the application has been made on trivial or vexatious grounds, reject the application without further consideration; or
  - (b) in all other cases within 14 days after receipt of the application, inform each person known to the **Commission** who the **Commission** believes has a sufficient interest in the matter that it has received the application by publishing a written notice which at least:
    - (i) identifies the **Electricity Entity** who has applied for the exemption and the nature of the requested exemption;
    - (ii) states how copies of the application can be obtained; and
    - (iii) requests submissions by a date specified in the notice (not being a date earlier than 30 days after the date of the notice).
- 8.7 The **Commission** must provide a copy of the application to any person within 7 days after the person requests a copy and pays any reasonable fee required by the **Commission**.
- 8.8 The **Commission** must consider any submissions received by the date specified in the notice published under clause 8.6 and it may (but is not obliged to) consider any submissions received after that date.
- 8.9 Within 30 days (or such longer period as the **Commission** notifies) after the last day for submissions specified in the notice published under clause 8.6 the **Commission** must issue a draft decision stating whether or not it intends to grant the exemption sought in that application.
- 8.10 The **Commission** must:
- (a) provide a copy of its draft decision to the relevant **Electricity Entity**, any person who made a submission on the matter and any other person who requests a copy; and
  - (b) request submissions from persons to whom it provides the draft decision by a specified date (not being a date earlier than 30 days after the date the draft decision was issued).

- 8.11 The **Commission** must consider any submissions it receives by the date specified by the **Commission** under clause 8.10 and it may (but is not obliged to) consider any submissions received after that date.
- 8.12 Within 30 days (or such longer period as the **Commission** notifies) after the last day for submissions on the draft decision specified by the **Commission**, the **Commission** must issue a final decision stating whether or not it will grant the exemption sought in that application.
- 8.13 A notice under clause 8.12 has effect 30 days after the notice is given to the **Electricity Entity** or such later date as the **Commission** specifies in the notice.

## 9. Preservation of Other Obligations

Nothing in this **Code** will derogate from any obligation imposed upon an **Electricity Entity** under the **Act**, the *Electricity Reform Act 2000*, any regulation made under those Acts, any condition of a licence issued to the **Electricity Entity** or any other code made by the **Commission** under the **Act**.

## 10. Interpretation

- 10.1 In this **Code**, words appearing like **this** will have the meaning set out in clause 10.2.
- 10.2 In this **Code**, unless the contrary intention appears:

**“Accounting Procedures”** means the procedures of that name approved by the **Commission** under clause 4 for the purposes of this **Code**;

**“Act”** means the *Utilities Commission Act 2000*;

**“Associate”** means in relation to an **Electricity Entity**, a body corporate that is related to that **Electricity Entity** (if any) under Division 2 of Part 1.2 of the *Corporations Law* if sections 13, 14, 16(2) and 17 of that Law were repealed;

**“Code”** means this Ring-Fencing Code;

**“Commencement Date”** means the date set out in the notice published in the *Gazette* making this **Code** from which this **Code** will take effect;

**“Commission”** means the Utilities Commission of the Northern Territory established by the *Utilities Commission Act 2000*;

**“Confidential Information”** means information which is or has been provided to, or has otherwise been obtained by, an **Electricity Entity** in connection with the carrying on of a **Prescribed Business** and which is confidential or commercially sensitive and includes information which is derived from any such information;

**“Cost Allocation Procedures”** means the procedures of that name approved by the **Commission** under clause 4 for the purposes of this **Code**;

**“Customer”** means a person who engages (or proposes to engage) in the activity of purchasing goods or services from a **Prescribed Business**;

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

**“Information Procedures”** means the procedures of that name approved by the **Commission** under clause 4 for the purposes of this **Code**;

**“marketing staff”** means an employee, consultant, contractor or agent of an **Electricity Entity** who is directly involved in the sale, sale promotion or advertising of any goods or services provided by the **Electricity Entity** to **Customers** (whether or not that person is involved in other functions) but does not include an employee, consultant, or agent who is only involved in:

- (a) strategic decision making, including the executive officer or officers to whom **marketing staff** report either directly or indirectly; or
- (b) technical, administrative, accounting or service functions;

**“Prescribed Business”** means:

- (a) a business (or component of a business) carried on by an **Electricity Entity** which consists of:
  - (i) the operation of an electricity network and the provision of network access services in relation to that electricity network to **Customers**;

- (ii) the provision of power system control and dispatch services to **Customers**;
  - (iii) the sale of electricity to non-contestable customers; or
  - (iv) the provision of any other goods or services to **Customers** which the **Commission** determines are not reasonably contestable at that time; or
- (b) the business of generating electricity for sale to **Customers** carried on by the Power and Water Authority until such time as the **Commission** is satisfied that the Power and Water Authority no longer has a substantial degree of market power in the market for the generation of electricity for sale to **Customers** or after having regard to the matters listed in section 6(2) of the **Act** the Commission is satisfied that this **Code** should no longer apply to that business;

“**Procedure**” has the meaning given to it by clause 4.1 of this **Code**;  
and

“**Related Business**” means, in relation to an **Electricity Entity**, any business carried on or activities undertaken by that **Electricity Entity** other than a **Prescribed Business**.

10.3 In this **Code**, unless the context otherwise requires:

- (a) if a term is defined in the *Electricity Reform Act 2000* and is not otherwise defined in clause 10.2, that term will have the same meaning as is given to that term under the *Electricity Reform Act 2000*;
- (b) headings are for convenience only and do not affect the interpretation of this **Code**;
- (c) words importing the singular include the plural and vice versa;
- (d) words importing a gender include any gender;
- (e) an expression importing a natural person includes any company, partnership, trust, joint venture, association, corporation or other body corporate and any governmental agency and vice versa;
- (f) a reference to any thing includes a part of that thing;

- (g) a reference to a clause, Schedule or part of a clause or Schedule is a reference to a clause, Schedule or part of this **Code**;
- (h) a reference to any statute, regulation, proclamation, ordinance or by-law includes all statutes, regulations, proclamations, ordinances or by-laws varying, consolidating, re-enacting, extending or replacing them and a reference to a statute includes all regulations, proclamations, ordinances, by-laws and determinations issued under that statute;
- (i) other parts of speech and grammatical forms of a word or phrase defined in this **Code** have a corresponding meaning;
- (j) mentioning an example or anything after the words “include”, “includes” or “including” will not limit what else might be included;
- (k) a period of time:
  - (i) which dates from a given day or the day of an act or event is to be calculated exclusive of that day; or
  - (ii) which commences on a given day or the day of an act or event is to be calculated inclusive of that day;
- (l) a reference to:
  - (i) a day is a reference to a period commencing immediately after midnight and ending the following midnight; and
  - (ii) a month is a reference to a calendar month; and
- (m) a reference to an accounting term is to be interpreted in accordance with accounting standards under the *Corporations Law* and, if not inconsistent with those accounting terms, generally accepted principles and practices in use from time to time in Australia in the electricity supply industry.

10.4 Where this **Code** authorises the making of an instrument or decision:

- (a) the power includes the power to amend or repeal the instrument or decision; and

- (b) the power to amend or repeal the decision is exercisable in the same way, and subject to the same conditions, as the power to make the instrument or decision.

**SCHEDULE 1****Exemptions as at Commencement Date**

<b>Column (1) - <i>Electricity Entity</i></b>	<b>Column (2) - <i>Code Obligation</i></b>	<b>Column (3) - <i>Prescribed Business</i></b>
Power and Water Authority	Clause 4.10	Franchise Retail
Power and Water Authority	Clause 4.10	Generation

## SCHEDULE 2

### Accounting, Cost Allocation and Information Principles

#### 1. Common Principles

In addition to the matters referred to in clause 4.4 of the **Code**, the **Commission** will, when considering whether to approve any **Procedures** submitted by an **Electricity Entity** under clause 4.3 or to impose any conditions upon the grant of its approval, have regard to the need to achieve an appropriate balance between the public benefits of requiring an obligation to be included within those **Procedures** (or imposing the relevant condition) and the administrative costs to the **Electricity Entity** of complying with that obligation or condition.

#### 2. Accounting Principles

- 2.1 The **Accounting Procedures** will only be approved by the **Commission** if:
- (a) they ensure compliance with the relevant ring-fencing minimum obligations stated in clause 3 of this **Code**;
  - (b) they are consistent with the accounting policies and procedures for other regulatory instruments;
  - (c) their utilisation involves a recognisable and rational economic basis;
  - (d) the resultant financial information satisfies the concepts of relevance and reliability, thereby ensuring that the substance of the underlying transactions and events is reported; and
  - (e) they comply with the principles set out in this Schedule 2.
- 2.2 The **Accounting Procedures** must be presented to the **Commission** in a manner that ensures that the **Commission** may readily understand the methodologies and procedures comprising such **Procedures** and the resultant regulatory financial statements and reports of the **Prescribed Business**.

- 2.3 The **Accounting Procedures** shall conform to Australian Accounting Standards wherever possible.
- 2.4 The **Accounting Procedures** shall ensure the reporting of the substance of transactions by:
- (a) where substance and form differ, reporting the substance rather than the legal form of a transaction or event;
  - (b) in determining the substance of a transaction, considering all its aspects and implications, including the expectations of and motivations for, the transaction; and
  - (c) for the purposes of determining the substance of a transaction, viewing in aggregate a group or series of transactions that achieves, or is designed to achieve, an overall commercial effect.
- 2.5 A **Prescribed Business** must maintain accounting and reporting arrangements which:
- (a) enable financial statements to be prepared for that **Prescribed Business**; and
  - (b) provide information in the financial statements that can be verified.
- 2.6 Information shall be presented in financial statements in the most understandable manner, without sacrificing relevance or reliability.
- 2.7 The accounts prepared by an **Electricity Entity** in compliance with its obligations under this **Code** must:
- (a) give a fair and reasonable view of the profit and loss and the balance sheet relating to each **Prescribed Business**; and
  - (b) be capable of certification as such by an auditor when and if required by the **Commission**.
- 2.8 Regulatory financial statements shall be prepared for the **Prescribed Business**. They shall be derived from the statutory accounts or their equivalent of the **Prescribed Business** and any **Related Business** that contain the entirety of the activities of the **Prescribed Business** by:
- (a) eliminating costs not related to the **Prescribed Business**;

- (b) not consolidating amounts from statutory accounts of different entities; and
  - (c) consolidating or disaggregating statutory account amounts within an entity in order to prepare financial statements.
- 2.9 If some or all of the activities of a **Prescribed Business** are carried out by an entity that does not have statutory accounts, all financial representations of **Prescribed Business** activities by such an entity must be capable of being audited by an external independent auditor.
- 2.10 A **Prescribed Business** shall present on a fair and consistent basis, from the accounting records that underlie its statutory accounts, the costs, revenues, assets employed and liabilities that may be reasonably attributed to the **Prescribed Business**.
- 2.11 The regulatory financial statements of a **Prescribed Business** must, in so far as is reasonably practicable, be prepared in accordance with the accounting principles and policies applicable to the statutory accounts.
- 2.12 The regulatory financial statements of a **Prescribed Business** must, in so far as is reasonably practicable, be prepared in a consistent manner so that the **Commission** can make comparisons between them over time.
- 2.13 A **Prescribed Business** shall provide to the **Commission** full and detailed documentation of any policies and procedures that the **Prescribed Business** may have used to prepare the regulatory financial statements, that are additional to or in place of, the accounting principles and policies used to prepare its statutory accounts.
- 2.14 A **Prescribed Business**' directors are responsible for the preparation and presentation of the regulatory financial statements, and the information they contain.
- 2.15 A **Prescribed Business**' directors shall ensure that a **Prescribed Business** keeps accounting records that:
  - (a) correctly record and explain the transactions and financial position of the **Prescribed Business**;
  - (b) enable regulatory financial statements to be prepared in accordance with this **Code**; and

- (c) are capable of allowing an auditor to conveniently and properly form an opinion on the regulatory financial statements in accordance with the requirements of this Schedule.

### 3. Cost Allocation Principles

- 3.1 The **Cost Allocation Procedures** will only be approved by the **Commission** if:
- (a) they ensure compliance with the relevant ring-fencing minimum obligations stated in clause 3 of this **Code**;
  - (b) they are consistent with the accounting policies and procedures for other regulatory instruments;
  - (c) their utilisation involves a recognisable and rational economic basis;
  - (d) the resultant financial information satisfies the concepts of relevance and reliability, thereby ensuring that the substance of the underlying transactions and events is reported; and
  - (e) they comply with the principles set out in this Schedule 2.
- 3.2 The **Cost Allocation Procedures** must be presented to the **Commission** in a manner that ensures that the **Commission** may readily understand the methodologies and procedures comprising such **Procedures** and the resultant **Prescribed Business**' regulatory financial statements and reports.
- 3.3 The cost allocations prepared by the **Electricity Entity** in compliance with its obligations under this **Code** must be capable of certification as such by an auditor when and if required by the **Commission**.
- 3.4 For the purpose of regulatory financial statements, the allocation of statutory accounts between a **Prescribed Business** and the business activities of a **Related Business** and across segments of a **Prescribed Business** shall be based on the principle that:
- (a) items which are directly attributable to the **Prescribed Business** and segments of the **Prescribed Business** are assigned accordingly; and
  - (b) items not directly attributable, shall be allocated to the **Prescribed Business** and across segments of the **Prescribed Business** using an appropriate allocator, as indicated in following paragraphs.

- 3.5 An item may be directly attributable to the **Prescribed Business** but not directly attributable to a segment of the **Prescribed Business**. In this circumstance, the allocation across segments of the **Prescribed Business** will be made using an appropriate allocator as indicated in the following paragraphs.
- 3.6 Items that are not directly attributed either to a **Prescribed Business** or to a segment of a **Prescribed Business** are to be allocated on a causation basis. Allocation based on avoidable cost is not permitted.
- 3.7 A **Prescribed Business** shall produce for each item that has not been directly attributed to the **Prescribed Business** and/or **Prescribed Business** segment supporting paper work that includes:
- (a) the amounts that have been allocated to the **Prescribed Business** and/or **Prescribed Business** segment and amounts that have not been so allocated; and
  - (b) the numeric quantity of each allocator.
- 3.8 If an item is immaterial and a causal relationship cannot be established without undue cost and effort, the **Prescribed Business** may effect an allocation of these items on a non-causal basis, provided it is accompanied by a supporting note documenting for each such item:
- (a) a defensible basis of allocation which shall not be avoidable cost;
  - (b) the reason for choosing that basis; and
  - (c) an explanation why no causal relationship could be established.
- 3.9 Non-causal bases of allocation shall only be applied to the extent that:
- (a) the aggregate of all items subject to all non-causal bases of allocation is not material to the financial statements; or
  - (b) a **Prescribed Business** can demonstrate that there is likely to be a strong positive correlation between the non-causal basis and the actual cause of resource or service consumption or utilisation that those costs represent.
- 3.10 An item is material if its omission, misstatement or non-disclosure has the potential to prejudice the understanding of the financial

position and nature of the **Prescribed Business**, gained by reading the financial statements.

- 3.11 Bases of allocation should be explained and documented in the **Cost Allocation Procedures**.

#### 4. Information Principles

- 4.1 The **Information Procedures** will set out the procedures to be followed by staff involved in the conduct of a **Prescribed Business** for the purpose of identifying, and then appropriately handling, storing, sharing and publishing, information that is either:

- (a) deemed to be **Confidential Information**; or
- (b) capable of materially affecting the commercial interests of a competitor of a **Related Business**.

- 4.2 The proposed **Information Procedures** shall contain procedures for ensuring that the identification and the handling, storing, sharing and publishing of such information will not provide a competitive advantage to the **Related Business**.

- 4.3 If an **Electricity Entity** was proposing to allow the disclosure of information of the type referred to in clause 3(d) to an employee, consultant, contractor or agent involved in the conduct of a **Related Business**, the **Information Procedures** should identify categories of information which will also be made available to competitors of the **Related Business**.

- 4.4 Without limiting the matters which may be covered in the **Information Procedures**, those **Procedures** should deal with the electronic, physical and procedural security measures that the **Electricity Entity** proposes to employ in respect of the conduct of a **Prescribed Business** (including separation of office space, access to information systems and procedures for the minimisation of **Customer** confusion and opportunities for preferential treatment or other unfair competitive advantage).

#### 5. Scope of Principles

Nothing in these principles will limit the matters which the **Commission** may take into account in approving any **Procedures** or imposing any conditions upon its approval of any **Procedures**.

**APPENDIX****A****EXPLANATORY NOTES ON REVISIONS****Introduction**

1. In preparing the revised draft Code, the Commission has considered each of the submissions received in response to its July 2000 Discussion Paper and the initial draft Code issued with that Discussion Paper. In addition, the Commission has closely monitored developments in each of the other jurisdictions with respect to ring-fencing issues.

2. The revised draft represents the current views of the Commission concerning the most appropriate ring-fencing arrangements for the Northern Territory electricity supply industry and has been developed having regard to the matters listed in section 6(2) of the *Utilities Commission Act 2000* (“UCA”).

3. The purpose of this Appendix is to:

- address a number of issues raised in submissions received by the Commission;
- provide a brief response to those issues; and
- highlight the amendments that have been made in the revised draft and the Commission’s reasons for making those amendments.

4. The Commission does not intend to specifically respond to each issue raised in the submissions received by it or to provide a detailed justification for each decision that the Commission has made in preparing the revised draft.

5. A number of other jurisdictions are currently considering the form of ring-fencing arrangements to apply to their electricity supply industries. The Commission will continue to monitor developments in each of those jurisdictions with a view to identifying whether any of those developments should also be implemented in the Northern Territory.

6. In addition, the Commission will continue to review the revised draft during the further consultation period in order to identify any aspects of the revised draft which still require fine tuning. However, the Commission believes that the

amendments that have been made to the revised draft address a significant number of the concerns expressed by interested parties in their submissions, and represents an appropriate balance between the requirement to promote competition and fair market conduct and economic efficiency.

### **Legislative authority and requirements**

7. In making the Code, the Commission is exercising its function under section 6(1)(d) and section 24 of the UCA. As a consequence, the Commission must obviously comply with the requirements of the UCA.

8. In particular, in making the Code, the Commission must have regard to the need:

- (a) to promote competitive and fair market conduct;
- (b) to prevent misuse of monopoly or market power;
- (c) to facilitate entry into relevant markets;
- (d) to promote efficiency;
- (e) to ensure consumers benefit from competition and efficiency;
- (f) to protect the interests of a consumer with respect to reliability and quality of services and supply and regulated industries;
- (g) to facilitate the maintenance of the financial viability of regulated industries; and
- (h) to ensure an appropriate rate of return on regulated infrastructure assets.

9. This list of factors is set out in section 6(2) of the UCA and the Commission is under a specific obligation to have regard to each of these factors in performing its functions. The list of factors set out in section 6(2) of the UCA is exclusive not inclusive. In other words these factors are not expressed as examples of the types of matters to which the Commission must have regard to when performing its functions.

10. The authority of the Commission to make the Code has been raised during the consultation process. Section 24(1) of the UCA provides that the Commission may make codes or rules relating to the conduct or operations of a regulated industry or licensed entity.

11. The electricity supply industry is clearly a regulated industry. However, section 24(2) of the UCA operates to qualify the Commission's right to make codes or rules to circumstances where the Commission is authorised to do so by the relevant industry regulation Act (in this case the *Electricity Reform Act*) or by regulation made under the UCA.

12. It has been suggested during the consultation process that the *Electricity Reform Act* ("ERA") does not specifically authorise the making of an electricity ring-fencing code. It is not necessary for the Commission to express a view concerning

this issue. Rather, it is the Commission's belief that any doubts concerning the authority of the Commission to make the Code will undermine its effectiveness and therefore need to be definitively resolved now.

13. To this end, the Commission has requested the Northern Territory Government to make a regulation under the UCA specifically authorising the Commission to make a ring-fencing code. Drafting instructions for that regulation have been prepared and it is hoped that the regulation will be made early in the new year. It is expected that the regulation will both confirm the authority of the Commission to make the Code and go some way towards defining the scope of operation of the Code.

14. Section 24 of the UCA also obliges the Commission to consult with the Minister and representative bodies and participants in the relevant regulated industry prior to making, varying or revoking any codes or rules. That consultation process commenced in February 2000 and has continued throughout the year via the discussion paper and submissions process.

15. This paper represents the next stage in that consultation process. The Commission encourages all interested parties to communicate any questions or comments they wish to make concerning the revised draft to the Commission so that the widest possible range of views are considered by the Commission in preparing the final version of the Code.

### **General issues**

16. There are a number of general issues which the Commission wishes to address in this Appendix before overviewing the specific amendments that have been made to the revised draft. These issues are fundamental to the operation of the Code and the promotion of competitive and fair market conduct in the Northern Territory electricity supply industry.

#### **(a) Definition of a prescribed business**

17. The revised draft continues to use the term "Prescribed Business" to define the scope of the obligations being imposed.

18. However, the Code has been redrafted so that it applies to any "Electricity Entity" that carries on a prescribed business (rather than purporting to impose the obligation on a prescribed business). It is obviously only possible to impose an obligation upon an entity as a whole as compared to a particular part of that entity.

19. This approach also avoids the problems caused by the definition of "Related Body Corporate" in the ERA as it applies to PAWA.

20. This aspect of the revised draft differs from the guidelines being proposed in each of the other jurisdictions (and under the *Gas Pipelines Access (Northern Territory) Act*). Each of those other Ring-Fencing Guidelines define the scope of their operation by reference to the type of services being provided by the relevant entity.

For example, the ACCC's Transmission Ring-Fencing Guidelines impose obligations upon entities that provide "ring-fenced services".

21. Ring-fenced services are essentially those services provided by a Transmission Network Service Provider which are determined by the ACCC as *not being contestable*.

22. This distinction enables the Ring-Fencing Guidelines in the other jurisdictions to distinguish between non-contestable and contestable services provided by a network service provider (for example, consulting services as compared to use of system services).

23. The Commission has sought to reflect this concept in the revised definition of "prescribed business" while removing the focus on the existing business divisions within PAWA.

24. The Commission has also sought to incorporate the distinction between contestable and non-contestable services by extending the definition of a "prescribed business" to the business of generating electricity for sale to customers carried on by PAWA until such time as the Commission is satisfied that PAWA no longer possesses substantial monopoly market power in the Northern Territory market for the generation of electricity for sale to customers.

25. PAWA has argued in its submission that the definition of "prescribed business" (and accordingly, the scope of the Code) should not extend to PAWA's generation business. PAWA has provided a range of reasons in support of this contention. This issue is addressed more specifically in Appendix B.

#### **(b) Accounting, cost allocation and information guidelines**

26. The obligations set out in the revised draft have been significantly modified to address a number of PAWA's concerns. In particular, the inclusion of a procedure for the development and approval by electricity entities of Accounting, Cost Allocation and Information Procedures will allow:

- the consideration of various requirements at a micro level; and
- the achievement of an appropriate balance between the costs of complying with those requirements and the likely benefits to the public in promoting competition.

These matters are dealt with more specifically in Appendix C.

#### **(c) Exemptions**

27. The revised draft has been significantly amended to provide greater flexibility in relation to the fine tuning of the application of particular obligations to particular electricity entities. This is consistent with the approach adopted in other jurisdictions and, in particular, the approach adopted by the ACCC in relation to the Transmission Ring-Fencing Guidelines.

28. The ACCC noted that it has selected a set of arrangements that provide the flexibility for the ACCC to waive elements of the ring-fencing arrangements where the costs of compliance outweigh any apparent benefit from imposing the ring-fencing obligations.

29. The Commission has extended this flexibility beyond that currently provided for in the other jurisdictions by permitting electricity entities to develop their own specific procedures with reference to a general set of principles enunciated by the Commission.

30. In this way, the micro application of a particular ring-fencing requirement to a particular electricity entity can be tailored so that an appropriate balance is reached between the costs of compliance and the benefits to the public as a result of compliance.

31. In developing the revised draft, the Commission has had regard to the particular circumstances of PAWA who it acknowledges will be primarily affected by the Code. However, it is essential that the Code be drafted so that it applies broadly to all electricity entities who carry on a prescribed business. The specific application of the Code to a particular entity can be modified by the use of the approved procedures, the additional obligations provision and the exemption provision.

32. In addition, the revised draft provides for the staged implementation of various obligations under the Code, thereby providing electricity entities with a further opportunity to approach the Commission with a view to modifying the application of a particular requirement.

**(d) Public benefits test**

33. As noted above, the Commission is specifically required by section 6(2) of the UCA to have regard to the various factors listed in that sub-section when performing its functions. Those functions include the making of the Code.

34. The revised draft has been amended to make it clear that the Commission has had regard to these matters when making the Code.

35. In having regard to these factors and in preparing the revised draft, the Commission has sought to achieve an appropriate balance between the benefits of ring-fencing, the costs of compliance and enforcement and the efficiencies from the integrated operations which may be foregone by the introduction of ring-fencing requirements.

36. The starting point for this process must be the fundamental principle underlying the Competition Principles Agreement to which the Northern Territory Government has bound itself to comply. In particular, clause 5 of the Competition Principles Agreement notes that the guiding principle in relation to legislation restricting competition is that no regulatory instrument should restrict the competition unless it can be demonstrated that:

- the benefits of the restriction to the community as a whole outweigh the costs; and
- the objectives of the legislation can only be achieved by restricting competition.

37. The Commission has had regard to this guiding principle in its interpretation of the requirements set out in section 6(2) of the UCA. In particular, the Commission believes that in developing the Code, the Commission needs to consider the benefits to the public arising from the introduction of the Code as a whole when seeking to achieve this balance.

38. The revised draft contains a number of mechanisms whereby the administrative costs to a particular electricity entity of complying with a particular obligation are measured against the public benefits arising from compliance with that obligation in order to determine whether the general rule should be modified in that particular case.

39. This is consistent with the approach adopted in other jurisdictions, and in particular with the approach that has been adopted by the ACCC in the Transmission Ring-Fencing Guidelines.

40. PAWA in its submission seems to be suggesting that the Commission should assume that the administrative costs of complying with each ring-fencing obligation will outweigh the public benefits resulting from compliance with that ring-fencing obligation until it can be otherwise demonstrated. If this is in fact PAWA's contention, then the Commission disagrees with that contention.

41. The Commission believes that its approach is supported by the approach taken by the ACCC, the Queensland Competition Authority and IPART.

42. In particular, IPART does not propose to undertake a detailed cost benefit analysis in relation to the application of each ring-fencing requirement to each electricity entity during its consultation process. Rather, its draft Ring-Fencing Guidelines start from the premise that they should apply to all electricity entities unless upon application by an entity for a waiver of a particular obligation, IPART is satisfied that the administrative costs to that entity of complying with the obligation outweigh any public benefit arising from meeting those obligations.

43. This approach has been consistently adopted (or proposed to be adopted) in other jurisdictions. It has its genesis in the Ring-Fencing Guidelines incorporated within the *Gas Pipelines Access Law*. Those Ring-Fencing Guidelines were accepted by the Northern Territory Government when it adopted the *Gas Pipelines Access Law* as a law of the Northern Territory via the *Gas Pipelines Access (Northern Territory) Act 1998*.

44. As noted above, the Commission is restrained by section 6(2) of the UCA with respect to the matters it can have regard to when performing its function of making the Code. The Commission has had regard to those factors and has sought to balance the public benefits of the Code against the potential costs that will be

incurred by electricity entities, the Commission and the public as a whole from requiring compliance with those obligations.

45. PAWA has eluded to the implication that the Commission has denied natural justice in relation to the development of the Code. The Commission strongly denies that any such implication can be drawn from the manner in which the Commission has conducted the consultation process. Section 24 of the UCA requires the Commission to consult with interested parties before making a code.

46. The manner in which the Commission undertakes that consultation process is left to the discretion of the Commission. The Commission has encouraged, and will continue to encourage through the remainder of the consultation process and during the operation of the Code, interested parties to raise any issues of concern with the Commission, so that the Commission can consider those issues and determine in the Commission's discretion (and having regard to the matters set out in section 6(2) of the UCA) whether modifications are required to restrict the scope of the Code.

47. PAWA has suggested that the Commission should adopt the approach taken by IPART and quotes Table 5.2 on page 15 of the September 2000 IPART Discussion Paper as an example of this approach.

48. The Commission believes that the approach it has adopted is consistent with that adopted by IPART (and other regulators). In particular, the table referred to simply highlights some of the benefits and costs associated with a more prescriptive approach to ring-fencing.

49. In the end, IPART has proposed to combine elements from both the "high level approach" and the "specific rules approach" as a means of avoiding the major costs associated with both approaches. In particular, the framework proposed by IPART would involve three key features, namely:

- a high level statement prohibiting anti-competitive conduct;
- a set of detailed activity-focused default ring-fencing guidelines; and
- a mechanism whereby the network service providers could seek to alter the default guidelines.

50. This is the same approach which the Commission is adopting. In particular, IPART proposes that the default guidelines will be compulsory unless IPART agrees to modify or waive them. IPART considered this approach had the capacity to be effective and avoid uncertainty while also being flexible enough to avoid outcomes that placed unfair obligations on network service providers.

51. Once again, this is the approach that the Commission has adopted. In the Commission's view, this is the only approach that can reasonably be adopted. It is impossible for any regulator to assess the costs of compliance with a particular obligation without specific and detailed input from the entity required to comply with that obligation.

52. The Commission would be happy to receive information from PAWA as to the likely costs of complying with particular obligations. This will assist in determining whether those costs outweigh the obvious public benefits associated with the introduction of ring-fencing requirements in respect of monopoly or near monopoly businesses that have related or associated businesses competing in competitive markets.

53. The Commission has considered the unique circumstances of the Northern Territory electricity supply industry in developing the revised draft. Many of the differences between the revised draft and the guidelines being proposed in another jurisdiction results from these unique circumstances.

54. The Commission has further accommodated the individual circumstances of electricity entities by the inclusion of an approval process for procedures, and the right to apply for exemptions. The Commission has not simply picked up another jurisdiction's approach and applied it in the Northern Territory (although, the approach applying in those other jurisdictions in relation to ring-fencing has already been adopted in the Northern Territory under the *Gas Pipelines Access (Northern Territory) Act 1998*).

55. However, the Commission must also have regard to the need to promote competitive and fair market conduct. To that end, the Code does not seek to restrict PAWA's ability to achieve appropriate advantage over its competitors through fair competition. It does seek to prevent PAWA using its monopoly or near monopoly position in relation to certain business activities to unfairly advantage its related businesses operating in competitive markets.

56. Given the decision to maintain PAWA as an integrated electricity entity, the implementation of an appropriate ring-fencing code is even more critical to:

- the promotion of competitive and fair market conduct in the Northern Territory electricity supply industry; and
- the prevention of misuse of monopoly or market power.

**(e) Access to information versus use of information**

57. After considering the submissions received from PAWA and NT Power concerning the limits on information flows, the Commission has determined to retain a general restriction on the disclosure of nominated types of information obtained by a prescribed business.

58. The Commission does not accept the submission that a restriction on the use to which information can be put is sufficient to ensure that information obtained by a prescribed business is not used by a related business to obtain an unfair advantage over the competitors of the related business. Once information obtained by a prescribed business is available to a related business, it is almost impossible in practical terms to restrict the use to which that information can be put.

59. However, the Commission has had regard to PAWA's submissions concerning the costs that it would incur in implementing the arrangements necessary to restrict

disclosure of all types of information falling within the current descriptions set out in the Code.

60. In order to address this issue, the Commission proposes to suspend the obligation prohibiting disclosure pending the development and approval of adequate information procedures. During this process, the Commission will be seeking the views of PAWA and other interested parties as to the type of information which, if disclosed to a related business, would provide that business with a significant advantage over its competitors.

61. This process will enable both the Commission and PAWA to specifically focus on the types of information that should be covered by this obligation, and the types of information which should only be subject to the restriction as to use of information.

62. If it is demonstrated that the costs of implementing the disclosure restriction will outweigh the benefits to the public of imposing that restriction, the Commission will investigate alternative methods of preventing the inappropriate use of this information by a related business.

63. For example, the benefit sought to be achieved by the implementation of this type of obligation could also be achieved without imposing additional costs upon PAWA by requiring that any information falling within this category cannot be disclosed to a related business without also being disclosed to the competitors of the related business.

64. This approach would address PAWA's concerns in relation to the costs of restricting access to information within a vertically and horizontally integrated business at the same time as promoting competitive and fair market conduct. Public disclosure of this type of information avoids these costs and demonstrates the integrity of the regulatory system to third parties.

### **Specific Amendments**

65. Set out below is a brief explanation concerning the amendments the Commission has made to the Code and the reasons for those amendments. The Commission does not propose to deal with each of the amendments that have been made to the Code, but rather to focus on the material amendments.

66. Given the extent of the amendments made to the Code, the Commission encourages interested parties to review the revised draft as a whole.

#### *Clause 3 – Legal entity*

67. In view of the inclusion of a definition of “electricity entity” in the Code, the Commission has removed the requirement that a prescribed business must be a legal entity. The definition of “electricity entity” is the same as that used in the ERA and has been extended to Associates in appropriate circumstances.

#### *Clause 3 – Restrictions on conduct of related business*

68. The Commission has removed the restriction on an electricity entity conducting a prescribed business and a related business through the same legal entity. This provision appears in the Ring-Fencing Guidelines of other jurisdictions as a non-qualified prohibition.

69. In the Northern Territory, PAWA is already permitted to undertake related businesses under the terms of its licences. Accordingly, the retention of this prohibition would in the view of the Commission simply further entrench PAWA's market position by limiting the structural options available to competing businesses. In view of the particular circumstances of the Northern Territory, the Commission has determined that the retention of this prohibition would be of little value.

*Clause 3(a) – Financial accounts*

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

*Clause 3(b) – Cost allocation*

71. The Commission has amended the obligation in relation to cost allocation to remove reference to cross subsidies. The issues concerning cross subsidies are now dealt with in the principles set out in Schedule 2 to the Code. An electricity entity will be required to have regard to these principles when preparing its cost allocation procedures for the approval of the Commission. The issues associated with the revised draft Code no longer including an explicit reference to cross subsidies are addressed more specifically in Appendix D.

72. In addition, the Commission has included a requirement that the allocation of costs is done in a manner which is otherwise fair and reasonable. This is consistent with the approach adopted in other jurisdictions and PAWA's submission concerning this obligation.

*Clauses 3(c) & (d) – Information use and disclosure*

73. After considering the submissions received and reviewing the approach adopted in other jurisdictions, the Commission has decided to retain both the restriction on the use to which information can be put and the obligation not to disclose information.

*Clauses 3(e) and (f) – Dealings to be on a non-discriminatory basis*

74. These obligations have been redrafted to focus on the requirement that a prescribed business deals with all customers (including its related businesses) on a non-discriminatory arm's length basis.

75. This is consistent with the approach adopted in a number of jurisdictions and is more objective and easier to implement than the requirement that a prescribed business does not provide services to a related business on more favourable terms than those applying to a competitor of the related business. This concept allows differences between the terms and conditions applying to different customers based on legitimate commercial grounds.

*Clause 3(g) – Marketing staff*

76. After considering the submissions received concerning this obligation, the Commission has decided that this obligation should be retained, given its limited scope and the importance placed on the separation of marketing staff by all ring-fencing guidelines.

77. It is inappropriate for the same marketing staff to be used in both a prescribed business and a related business, given the fact that it is the role of marketing staff to promote the goods and services of the related business to consumers. In doing this, marketing staff would seek to promote all of the benefits of dealing with the related business, such as its position in the market, its experience and ability to provide customer service. In the absence of structural separation, it is easy to envisage a situation where consumers will treat the related business as part of the prescribed business if the customer is dealing with the same person in relation to each business.

*Clause 4 – Compliance with approved procedures*

78. Clause 4 has been extensively amended to introduce a process for the development and approval of accounting procedures, cost allocation procedures and information procedures in respect of each electricity entity.

79. The main features of this clause are:

- procedures will be developed over a number of months following commencement of the Code in order to allow electricity entities sufficient time to develop and implement these procedures;
- electricity entities will prepare their own procedures subject to compliance with the general principles set out in Schedule 2 to the Code and the general obligation that the procedures must be designed to ensure compliance with the electricity entity's obligations under the Code;
- the Commission is not only required to have regard to the matters set out in section 6(2) of the UCA, but also the principles set out in Schedule 2 of the Code in determining whether or not to approve procedures;
- the Commission is now entitled to grant its approval subject to conditions and this will provide the Commission with the necessary flexibility to provide for fine tuning of procedures over time with reference to the effectiveness of those procedures and a level of compliance;
- the electricity entities are entitled to apply at any time to vary approved procedures; and

- the Commission will only institute its own procedures if the electricity entity fails to submit procedures for approval within the required time frame.

80. The Commission has decided to retain the right for a person to obtain copies of accounts provided to the Commission upon the payment of an approved fee. The Commission believes this requirement is important to promote confidence in third parties in relation to the effectiveness of the Code (and in particular, the implementation of the cost allocation obligation).

81. In order to facilitate this disclosure process, the Commission has requested the Northern Territory Government to specifically authorise the disclosure of information of the type referred to in the Code under the terms of the proposed regulation authorising the making of the Code.

#### *Clause 5 – Adding to or amending this Code*

82. The Commission has modified clause 5 to comply with its obligations under section 24 of the UCA. In particular, the Commission has now clarified that it will comply with the procedures set out in section 24 of the UCA where it proposes to impose an additional obligation or vary an existing obligation in respect of a particular electricity entity.

83. In exercising this power, the Code now provides that the Commission will not only have regard to the matters listed in section 6(2) of the UCA, but also, in the case of the imposition of an additional obligation or the variation of an existing obligation in respect of a particular electricity entity, the principle that the administrative costs to that electricity entity of complying with the additional or varied obligation, should not, or should not be likely to, outweigh the benefits to the public for compliance with that additional or varied obligation.

#### *Clause 7 – Compliance procedures and compliance reporting*

84. The form of this clause remains essentially the same. However, the Commission has included a six month period in which an electricity entity is required to establish and implement an appropriate internal compliance procedure.

85. Once again, the Commission has been determined to retain the right for the Commission to make publicly available a compliance report prepared by an electricity entity. This is consistent with the practice adopted in a number of other jurisdictions concerning compliance reporting, and it is critical to establishing and maintaining the confidence of third parties in the effectiveness of the Code.

86. The Commission has also retained the right to undertake audits of an electricity entity's compliance with its obligations under the Code. However, in recognition of the fact that the licences issued to electricity entities already require annual compliance audits, the Commission has accepted the responsibility to pay the costs associated with conducting these additional audits if the audit does not disclose a failure to comply with a material obligation under the Code.

87. If such a failure is disclosed by an audit, then the electricity entity will be responsible for paying the costs of that audit. The Commission believes that this achieves an appropriate balance between the costs associated with undertaking an audit and the obvious benefits of ensuring (particularly during the initial years of the Code), that the obligations set out in the Code are being complied with.

88. The Commission notes that no other regulator has been prepared to accept responsibility for the costs of undertaking these types of audits, regardless of whether the audit actually reveals any non-compliance.

*Clause 8 – Exemption from compliance as specified obligations*

89. The Commission has redrafted clause 8 to reflect the modified requirements set out in clause 5 of the Code. In particular, an electricity entity is entitled at any time to apply for an exemption from any of its obligations under the Code.

90. In determining whether to grant that exemption, the Commission is required to have regard not only to the matters listed in section 6(2) of the UCA, but also the principle that the exemption should be granted if the benefit or likely benefit to the public of compliance with the relevant obligation is outweighed by an administrative cost to the electricity entity of complying with that obligation.

91. This approach is consistent with the approach adopted in other jurisdictions and provides the flexibility to both the Commission and electricity entities to fine tune obligations under the Code over time.

*Clause 10 – Interpretation and definitions*

92. Some additional definitions have been included (e Commission, net public benefit, accounting guidelines, cost allocation guidelines, separation guidelines etc). There are also some general interpretation provisions.

93. The definition of “Associates” has been retained, but note that it will only apply where an electricity entity is a *Corporations Law* company.

94. The definition of “Confidential Information” has been extended to information obtained by an electricity entity in connection with the carrying on of a prescribed business. In many cases, the information in relation to which the Commission is concerned would not have been directly provided to an electricity entity. Rather, it will become aware of the information as a result of carrying on the prescribed business.

95. The definition of “Prescribed Business” has been amended to overcome deficiencies in the definition in the initial draft and to make clear that PAWA Generation is to be a “Prescribed Business” only for as long as it retains significant market power.

**APPENDIX****B****RING-FENCING OF PAWA GENERATION****Introduction**

1. Of the issues raised in submissions, a key area where the revised draft Code has not been modified in response to criticisms of the initial draft is in the area of the ring-fencing of PAWA Generation from PAWA's contestable businesses (in effect, from PAWA Contestable Retail). This Appendix looks at this issue.

**Clarification of the Commission's earlier draft proposals**

2. While the revised draft issued by the Commission has not changed the substance of the ring-fencing obligations proposed for PAWA Generation, certain changes in the form which the minimum obligations and associated procedures now take in general (see Appendix A) should be noted.

**(a) Role of net public benefits test**

3. The Commission has approached the task of preparing the revised draft mindful of the role of the net public benefit test. Hence, this should go some way towards addressing PAWA's view that:

"In imposing any ring-fencing code, it is essential that the Commission consider and apply a public benefits test. ...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." (para. 25)

4. This Appendix is intended to provide further detail of the Commission's analysis of the net public benefits of retaining the proposed ring-fencing of PAWA Generation.

**(b) Transitional nature of generation ring-fencing obligations**

5. The revised draft has sought to clarify the intention that the ring-fencing obligations on PAWA Generation were only intended to apply while PAWA Generation retains its dominance of the Territory's generation market.

6. If and when PAWA Generation is no longer dominant, these obligations will no longer apply. Initially, an exemption would be granted until the Commission was satisfied that a more permanent variation to the Code was justified.

### **(c) Absence of legal separation requirement**

7. Reflecting both the view it put in the July 2000 Discussion Paper and the general consensus in submissions that legal separation is costly and unnecessary in the Northern Territory context, the revised draft does not require legal separation of PAWA's prescribed businesses.

8. The Commission broadly agrees with the view as expressed by NT Treasury that:

"... strict legal separation would not fall far short of structural separation of PAWA's operations and would be of questionable public benefit. The Commission's discussion paper acknowledges that legal separation would add to costs. Apart from the establishment costs of the holding and subsidiary companies, there would be ongoing costs such as those associated with public reporting requirements and the operation of separate Boards. There would appear to be little public benefit in pursuing this option given the additional costs, and particularly given the Commission's concern that legal separation may, in any case, not eliminate the need for other ring-fencing arrangements."

### **(d) Implication of clarifications**

9. Together, these clarifications should reduce the concerns of those critical of the Commission's decision to impose ring-fencing obligations on PAWA Generation as well as PAWA's on-going monopoly businesses (networks, franchise retail and power system control).

10. The Commission concedes, however, that these clarifications may not eliminate all the concerns. The analysis presented by the Commission in the remainder of this Appendix endeavours to focus on those arguments that may continue to apply notwithstanding the clarifications noted above.

### **Views in submissions**

11. NT Power expressed the view that all of PAWA's business divisions should be subject to the same ring-fencing requirements, given the Northern Territory Government's decision to retain PAWA as an integrated entity. In particular:

"Exempting one link in the value chain could open an avenue for the incumbent to circumvent the guidelines put in place. For example, if PAWA Generation is exempt from information sharing guidelines, then it would be possible for PAWA Distribution to provide information to PAWA Generation, which could then provide it to PAWA Retail, without breaching the specific restrictions in the code." (p.7)

12. NT Treasury did not comment specifically on the generation ring-fencing issue. The only comment relevant was an indirect one, namely:

"While effective ring-fencing arrangements are central to the operation of the competitive electricity market, it would be of concern if the arrangements imposed

significant costs. To avoid this outcome, it would be preferable to take a conservative approach, starting with arrangements that are not overly intrusive or costly. Subsequently, should the initial ring-fencing not prove effective, an incremental approach could be adopted to further strengthening the arrangements.”

13. Finally, PAWA submitted that:

“...PAWA does not accept that it is appropriate, reasonable, or in the best interests of consumers to ring fence generation.” (para. 70)

14. Essentially, PAWA argued against the ring-fencing of PAWA Generation for the following reasons:

- the Territory Government did not intend that PAWA Generation be ring-fenced from PAWA’s other contestable businesses (not envisaged in the ERA; no thought of a wholesale market);
- no other jurisdiction considers it necessary;
- there are no grounds for regulation of generation in addition to that already in place (franchise generation effectively regulated by CSOs/Treasury; PAWA is regulated in the out-of-balance (OOB) energy market; the Commonwealth Trade Practices Act (TPA) anti-monopolisation provision should be sufficient);
- PAWA does not (or will not) dominate the Territory’s generation market, because there are no barriers to entry; and
- the significant administrative costs imposed on PAWA would be passed onto final consumers and would give rise to a considerable competitive disadvantage.

15. In summary, PAWA acknowledged no net public benefit from the ring-fencing of PAWA Generation, asserting instead that such ring-fencing would only give rise to a range of costs.

### **Analysis of “benefits”**

#### **(a) Northern Territory Government’s intentions**

*PAWA’s view*

16. PAWA’s submission stresses the fact that section 25 of the ERA does not include a provision similar to that contained in sections 26, 28 and 30 of the ERA. PAWA interpreted that to mean that:

“...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.” (para. 74)

17. In addition, PAWA asserted that the Territory Government had not intended that there be a wholesale electricity market:

“...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.” (para. 82)

*Commission’s analysis*

18. The principles enunciated in the Competition Principles Agreement are central to (and represent the fundamental considerations driving) the reform of the Northern Territory electricity supply industry. Competition is the overwhelming focus of these principles. This is reflected in clause 5(1) of the Competition Principles Agreement.

19. That clause adopts the principle that regulatory instruments should not restrict competition unless it can be demonstrated that:

- the benefits of the restriction to the community as a whole outweigh the costs; and
- the objectives of the legislation can only be achieved by restricting competition.

20. These concepts are also reflected in the objects underlying the UCA. Section 2 of the UCA provides that the object of the UCA is to:

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

21. Despite the various arguments raised by PAWA concerning the intentions of the Northern Territory Government and the nature of the competitive market in the Northern Territory electricity supply industry, the central fact remains that the driving force behind the recent regulatory reforms has been the creation of competition in the electricity supply industry.

22. The greatest potential for competition exists in the retail market. Competition will only be created if retailers other than PAWA seek to enter the Northern Territory electricity retail market. These retailers must overcome a number of barriers to entry into that market. The most critical of those barriers is the need to obtain a supply of electricity from a generator on reasonable commercial terms.

23. A number of large Eastern State retailers have already approached the Commission concerning the possibility of retailing electricity in the Northern Territory. These retailers are particularly concerned by the fact that their largest competitor is also the main generator of electricity (particularly in the Darwin market).

24. It is difficult to envisage any significant increase in competition in the Northern Territory electricity retail market if potential competitors cannot be assured via the regulatory system that PAWA will deal with them on a non-discriminatory arm’s length basis and not unfairly prefer PAWA’s own retail business over an independent retailer.

25. The Northern Territory Government clearly decided that it was not appropriate to split PAWA into separate businesses because the diseconomies associated with structural separation would have been too large, given the small size of the Northern Territory electricity market. However, the Northern Territory Government did resolve to implement and encourage the development of competition in the Northern Territory electricity supply industry.

26. If the Code is not extended to apply to PAWA's generation business, and thus provide independent retailers with some comfort that they will be treated fairly in their dealings with PAWA, it is unlikely that any independent retailers will choose to operate in the Northern Territory electricity retail market.

27. PAWA has argued that ring-fencing obligations should only apply to "truly monopoly businesses" and that the Commission should avoid "any unnecessary intervention in competitive market sector".

28. The Commission does not agree that its power under the UCA to make codes is limited to "truly monopoly businesses". The Commission is specifically required when exercising its function of making the Code to have regard to the need "...to prevent misuse of monopoly or market power" and "...to facilitate entry into relevant markets". This is further supported by the objects of the UCA which include the promotion, in the absence of a competitive market, of an economic regulatory framework that promotes the simulation of competitive market conduct and the prevention of misuse of monopoly power.

29. PAWA has sought to rely upon Ministerial statements concerning the nature of the wholesale electricity market in the Northern Territory. While the Commission accepts that the Northern Territory Government has made a decision that it is not feasible to establish a wholesale electricity *pool* in the Northern Territory (similar to that operating in the National Electricity Market), this does not necessarily mean that there should be no wholesale electricity market in the Northern Territory.

30. If this was the case, then the only persons who could retail electricity in the Northern Territory would be entities who also own and operate a generation business. This would represent a significant barrier to entry for new competitors, particularly given the fact that any person wishing to establish a new generation business in the Northern Territory would need to have access to an appropriately priced fuel source. It also fails to explain the provision made in the ERA for separate generation and retail licences.

#### **(b) Consistency with other jurisdictions**

##### *PAWA's view*

31. PAWA noted that:

"...there are no regulatory precedents in any other jurisdictions for this [generation ring-fencing] requirement." (para. 92)

The implication appears to be that consideration of such a requirement in the Northern Territory context is therefore unwarranted.

*Commission's analysis*

32. The Commission does not deny that the ring-fencing guidelines promulgated by other jurisdictional regulators generally do not include electricity generation as a business to be ring-fenced from other businesses undertaken by a power utility.

33. Rather than implying that the separation of generation from other electricity businesses is considered unimportant, the reasoning is quite the opposite. In other jurisdictions, vertical and horizontal integration of utilities has been viewed as anti-competitive and restrictions have been imposed by government owners or regulators. One way or another, all other jurisdictions have structurally separated their incumbent generators from their host retail businesses. For example, the government of Victoria imposed cross ownership restrictions between electricity generators and network businesses and between competing generators in the context of privatisation.

34. In the absence of structural separation, the existence of a ring-fencing code is the only method available to achieve a degree of separation between the incumbent generator and the host retailer.

35. All this means that the need for an effective ring-fencing code is more pressing in the Northern Territory than in Queensland, New South Wales, Victoria or South Australia.

36. Furthermore, contrary to PAWA's assertions, ring-fencing in other jurisdictions is not limited in principle only to monopoly businesses. The Utility Regulators Forum Discussion Paper defines ring-fencing as:

“...identifying and isolating the activities, assets, costs, revenues and community service obligations of goods or services that are derived from a monopoly element, *or one not subject to strong competitive pressures*, that are provided by an integrated entity.” (emphasis added) (October 1999, p.2)

37. The relevance of ring-fencing in the Northern Territory context – notwithstanding what the situation is in other jurisdictions – has been affirmed by the National Competition Council (NCC). In its recent draft determination on the Northern Territory Government's application for certification of the Territory's network access regime, the NCC stated that:

“PAWA operates the full range of electricity industry businesses, making ringfencing arrangements a central concern. ...[The Council] will consider the views expressed in submissions to [its] draft recommendation, as well as to the ringfencing review currently being conducted by the Regulator, to ensure that there is sufficient confidence in the proposed arrangements to allow new entry.”

### (c) Regulatory duplication

#### *PAWA's view*

38. A further set of arguments put forward by PAWA is that, in effect, PAWA Retail/Generation is already subject to regulation such that the additional impost of a ring-fencing obligation would give rise to no *additional* public benefits (and so only costs). There were three broad strands to PAWA's argument in this regard:

*(i) franchise generation is already regulated:*

"Franchise generation is already effectively regulated by PAWA's CSO obligations, overseen by NT Treasury. These obligations already prohibit PAWA Generation from subsidising the contestable market." (para. 75)

"...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." (para. 88)

*(ii) the existing TPA section 46 prohibition on monopolisation should be sufficient:*

"... 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" (para. 88)

"...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." (para. 90)

*(iii) PAWA is not able to exercise any monopoly power in the out-of-balance ("OOB") energy market:*

"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.

...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." (paras. 83-84)

#### *Commission's analysis*

39. Of PAWA's three strands, the Commission only sees merit in the third (OOB).

40. The Commission is far from convinced that the present CSO arrangements effectively constrain PAWA's capacity to shift costs between its prescribed and contestable businesses, and it is misleading to suggest otherwise.

41. The Commission acknowledges that section 46 of the *Trade Practices Act* provides a level of protection against any exploitation of PAWA Generation's market dominance. However, in implementing the recommendations of the Hilmer Report, the Commonwealth Governments recognised that the existence of section 46 of the *Trade Practices Act* was not sufficient to promote competition in many circumstances. This should be contrasted to the much-plagued approach adopted by the New Zealand Government.

42. The Commission does not believe that a simple prohibition on anti-competitive conduct is likely to be effective if the incentive and opportunity to engage in such conduct still exists. It therefore has a responsibility to seek to modify anti-competitive behaviour by developing a clear code of competitive conduct by specifying the behaviour required with regard to activities.

#### **(d) Extent of PAWA's market power in the Northern Territory generation market**

##### *PAWA's view*

43. The next set of arguments put forward by PAWA was that:

"The Commission has not stated how PAWA Generation could exploit its market dominance to the detriment of competitors to PAWA Retail ..." (para. 87)

44. The main strands of PAWA's counter-argument are:

(i) *PAWA Generation will not be dominant after tranche 4:*

"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." (para. 79)

(ii) *PAWA Generation does not dominate standby or any other generation market because:*

"...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.

... If PAWA overprices, the third party will invest in its own generating capacity." (paras. 80-81)

##### *Commission's analysis*

(i) *Scope for market power?*

45. PAWA has asked the Commission to explain how PAWA Generation could exploit its market dominance to the detriment of the competitors to PAWA Retail. It is not the Commission's role in the current process to suggest ways in which market dominance could be exploited. It is clear however, that there is little chance of promoting competition in the Northern Territory electricity retail market if independent retailers are not provided with some comfort via the regulatory system that they will be fairly dealt with by PAWA.

46. Just because a sizeable share of the Territory's electricity market will eventually be opened to competition does not negate the possibility that PAWA Generation could remain the dominant generator – in possession of substantial market power – for the foreseeable future.

47. Market power is defined as the ability of a firm to raise and maintain price above the level that would prevail under effective competition. If it so chooses, a firm with substantial market power is able to provide a lower level of service quality or choice, or charge a higher price, without suffering a decline in profit. In other words, the firm may be able to:

- charge prices which equate to a higher than expected rate of return on assets over the medium to longer term;
- allow service quality to decline to a level below that which might be expected in a competitive market; or
- impose onerous terms and conditions upon customers.

48. If an incumbent firm (like a generator) possesses substantial market power, this does not mean that that it is abusing – or will abuse – that market power. However, it does establish the grounds for economic regulation aimed at preventing cases of abuse from arising, and providing assurance to competitors that anti-competitive conduct would be punished if it did occur.

49. The main concern with respect to generation arises as a result of the potential for preferential dealing with its associated contestable businesses. Such preferential dealing can take the form of:

- discriminatory sharing of commercially sensitive information between associated businesses;
- discriminatory access (in respect of price and non-price terms and conditions) to power supplies by associated and third party retailers; or
- joint marketing activities between associated businesses.

50. Such behaviour can undermine regulatory objectives and significantly erode the economic benefits of competition. It can result in reduced competition in upstream and downstream markets, distortions in the development of competition in related markets, and increased prices in the regulated sector. Anti-competitive conduct can improve the position of an integrated or associated business in the

competitive market to the disadvantage of consumers in the regulated market and competitors in the unregulated market. Ring-fencing codes aim to prevent these outcomes by imposing rules that prevent anti-competitive behaviour.

51. The Commission acknowledges that economic regulation has no role to play where competition exists. Competition exists in a market where firms or sellers independently strive for the patronage of buyers in order to achieve their business objectives, e.g., profits or market share. Competition is an important process by which firms are forced to become efficient and offer greater choice of products and services at lower prices.

52. Efficient competition requires that all incumbent and prospective firms be given equal opportunities to compete for customers.

“... In the context of competitive sports, fair rules are supposed to show no partiality toward any team or individual. They should result in outcomes that depend solely on the skills of the participants – that is, the best should always win. In the marketplace, fair rules should produce winners on the basis of their ability to satisfy customers, nothing else. This means that new entrants should have the same opportunities as incumbents to succeed while, at the same time, incumbents are not unduly restricted in their market activities.” (IPART, p. 9 )

53. Only where an electricity business dominates a market – in that it enjoys a position of economic strength such that it can behave to an appreciable extent independently of its competitors and customers – does economic regulation have a role to play.

54. To establish a *prima facie* case that an electricity generator maintains substantial market power, the Commission is attracted to adopting the market share benchmark of 40 per cent used by other regulators in Australia as the minimum level necessary. For example, this is the threshold adopted by the ACCC (in their Merger Guidelines) to define a situation of “unilateral market power”, which the ACCC describes as being similar to the concept of single firm dominance.

(ii) *What role of barriers to entry?*

55. Having said all this, the Commission acknowledges that a high market share is a necessary but not sufficient condition for a generator to have the capacity to exercise substantial market power. The exercise of market power is only possible in the absence of ameliorating factors such as easy entry. If the entry of new competition would rapidly and effectively constrain a price increase, then PAWA Generation could not exercise market power even in a concentrated market.

56. Likely, timely and sufficient entry can therefore obviate concern about the ability of a dominant firm to raise prices above reasonable levels, by assuring that increased supply from independent sources will defeat efforts to exercise market power. If entry is quick (and the costs of entry are recoverable if the entry does not succeed), the exercise of market power is unlikely even if there is only one current supplier.

57. Actual competition may therefore not be important as the existence of a “contestable” market. A fully contestable market is one in which:

- there are no barriers to entry or exit;
- all firms, both incumbent and potential entrants, have access to the same production technology;
- there is perfect information on prices, available to all consumers and firms; and
- entrants can enter and exit before incumbents can adjust prices.

58. A contestable market may have any number of firms (including only one or a few) and these firms need not be price-takers. In a contestable market, the dominant incumbent will maintain prices close to the competitive level because of the threat posed by potential entrants. If incumbents raise prices, entry will occur (no barriers to entry), and the entrants will be able to produce as efficiently as incumbents (access to technology). Moreover, if price declines as a result of the entry, the entrant will be able to exit the industry quickly and costlessly (no barriers to exit).

59. Establishing whether a market is effectively contestable is therefore of considerable importance. An analysis of the applicable barriers to entry is essential in this regard. Barriers to entry are factors which prevent or deter the entry of new firms into an industry even when incumbent firms are earning excess profits.

60. PAWA’s position is, simply, that:

“...there are *no* barriers to entry to any part of the generation market.” (emphasis added) (para. 80)

61. The Commission has a great deal of difficulty accepting PAWA’s assertion on this matter. While it is true that there are no longer any *statutory* barriers to entry into the Territory’s electricity generation and retail markets, it is difficult to deny the existence of *market* barriers to entry arising from basic industry characteristics such as technology, costs and demand.

62. A barrier to entry can be any factor which discourages new entry into a market, so that incumbents are not faced with the threat of competition. Barriers to entry can include:

- sunk costs, such as those costs incurred in entering a market that cannot be recovered if entry fails. Sunk costs are an important barrier to entry in infrastructure industries. Examples of sunk costs include infrastructure construction, staff training and advertising and promotional costs associated with establishing a recognised presence in the market. New generation is said to cost in excess of \$1 million per MW. Since such costs must be incurred by entrants, but have already been borne by incumbents, a barrier to entry is created. In addition, sunk costs reduce the ability to exit and thus impose extra risks on potential entrants. In assessing the significance of sunk costs, it is not just the amount that is important, but also the length of time before these costs can be expected to be recovered;

- access to scarce resources (gas);
- information advantages, for example, where the market structure is such that an incumbent entity immediately becomes aware of any existing customer changing supplier thereby enabling the entity to target that customer;
- the nature of relationships in the market. For example the existence of long term contracts in an industry can represent a major barrier to entry for a potential entrant due to these contracts effectively rendering a proportion of the market non-contestable;
- brand loyalty and customer inertia. While a degree of buyer loyalty exists for any product, in certain instances, the need to gain market acceptance of a new entity can significantly delay successful entry and therefore constitute a barrier to entry. Inertia can arise for many reasons, including fear and uncertainty of change, lock-ins (where the customer will remain dependent on the incumbent for some of its services), lack of information regarding choices and high changeover costs; and
- insufficient demand, that is, where the minimum efficient scale of an enterprise in the industry is large relative to current demand, the number of efficient firms in a market will be small. In such instances, the presence of an incumbent may preclude entry by prospective efficient entrants because the market simply may not be big enough to support them. This is likely to be the case where there are economies of scale or scope associated with production technology.

63. In the Commission's view, PAWA's denial of the existence of such barriers to entry may be a sufficient case in itself for the imposition of clear ring-fencing obligations. There is a danger that a dominant firm operating under such a misapprehension may also fail to recognise anti-competitive conduct and the like.

### **Analysis of "costs"**

#### **(a) PAWA's view**

64. PAWA's submission highlighted its concern that the ring-fencing of generation would impose significant costs (and competitive disadvantage) on PAWA:

"...the ring-fencing of the contestable business of generation, [by] placing an additional cost on that business, will put PAWA Generation at a disadvantage to its competitors." (para. 74)

#### **(b) Commission's analysis**

65. The Commission recognises that there is a trade-off between the benefits of effective competition and the economies of scale and scope that can be achieved by an integrated and coordinated entity. Ring-fencing obligations should remain in place where there is a net public benefit in doing so. As with all regulatory regimes, the Commission will consider the costs associated with adopting the ring-fencing obligations. These include compliance costs and monitoring costs, which can arise as a result of an administrative burden, and the loss of economies of scale and/or scope.

66. There will be some compliance and monitoring costs imposed on PAWA Generation, although these are likely to be marginal considering the organisation will need systems and procedures to deal with ring-fencing of networks, system control and franchise retail. Furthermore, the accounting separation required should involve little more than normal management requirements, thereby implying few additional compliance costs.

67. The loss of economies of scope is potentially of more significance in PAWA's case. PAWA's existing multi-utility structure allows it to take advantage of scope economies. This is very important to the overall potential cost efficiency of PAWA because of its lack of scale. Hence, the anti-competitive aspects of horizontal and vertical integration need to be balanced against the efficiency benefits that result from economies of scale (for example, the spreading of overheads) and operating synergies which exist, particularly between network and retail functions.

68. Economies of scope involves the efficiencies that derive from providing a variety of services. Apart from the spreading of corporate overheads, economies of scope are particularly evident in:

- the application of information technology;
- billing systems;
- field operations; and
- call centres.

69. The real question is: what economies of scope are being prevented by the imposition of ring-fencing obligations on PAWA Generation? The Commission has deliberately focused on "conduct" rather than "structural" obligations, to ensure any losses of economies of scope are minimized.

70. The only "structural" obligation imposed on PAWA Generation is the obligation that its marketing staff be kept separate from that of PAWA's contestable businesses (notably PAWA contestable retail). The cost should not be too great given the different competencies that are expected between marketing at the retail level and that in the wholesale market (involving other licensed retailers and generators).

**APPENDIX****C****RING-FENCING ACCOUNTING REQUIREMENTS****Introduction**

1. Of the issues raised in submissions, another key area where the revised draft Code has not been modified in response to criticisms of the initial draft is in the area of the regulator providing guidelines on accounting separation and cost allocation. This Appendix looks at this issue.

**Views in submissions**

2. In response to the Commission's July 2000 Discussion Paper, PAWA and NT Power provided differing views as to the requirements for ring-fenced accounting processes.

3. NT Power expressed a number of concerns including:

"NT Power expresses its concern at the level of control PAWA wishes to retain over its accounting separation, cost allocation, and financial reporting. NT Power is very concerned that this level of control would allow PAWA to commit and conceal actions which disadvantage market entrants." (p.10)

"NT Power is strongly opposed to giving the incumbent carte blanche to define its cost allocation methodologies. Cost allocation methodologies should be set by the Commission, and be subject to a public review process." (p.14)

4. NT Power submitted that the Commission should require PAWA to follow a set of clear accounting guidelines.

"If PAWA is to be left with the responsibility of preparing its accounting guidelines, it should be given detailed instructions on its accounting requirements and a specified timetable to achieve the issue of the guidelines and the full implementation of these guidelines." (p. 10)

5. In its submission, PAWA accepted the objective of accounting separation. It expressed some concerns about implementation of such separation:

"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.

...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 on how it complies." (para. 113)

6. Moreover, PAWA also asserted 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." (para. 123)

### **Approach in other jurisdictions**

7. In other jurisdictions, regulators have taken a prescriptive approach to regulatory accounting including the publication of quite detailed guidelines.

8. The Office of the Regulator-General (ORG) in Victoria has published the "Electricity Industry Guideline No. 3 - Regulatory Accounting Information Requirements". This guideline is quite prescriptive and even includes a template for the structure of the financial reports. In its issues paper "Ring-fencing in the Electricity and Gas Industries", the ORG proposes to expand its requirements through the application of further guidelines and rules including a standardised set of cost allocation and transfer pricing rules.

9. The NSW Regulator (IPART) has also issued a discussion paper and draft ring-fencing guidelines - "Ring-fencing of the New South Wales Distribution Network Service Providers". The proposed framework has three key features:

- a high level statement prohibiting anti-competitive conduct;
- a set of detailed, activity-focused default ring-fencing guidelines; and
- a mechanism whereby the regulated businesses could seek to alter the guidelines.

### **Commission's response**

10. The appropriate allocation of costs is necessary where a utility operates in both regulated and competitive markets and/or in separately regulated markets. Services are generally shared between the businesses in order to gain the benefits arising from consolidation of common services and economies of scale.

11. Cost allocation refers to the process of assigning a single cost to any activity, function, or process. In many cases there are direct cost drivers that enable costs to be causally allocated. However indirect costs such as the cost of the corporate support and IT functions often do not have a simple cost driver and thus create a more complex allocation of non-attributable, common costs.

12. Appropriate allocation of costs is required to promote economic efficiency while limiting the ability of an entity:

- to extend its monopoly powers from the regulated business to the contestable parts of the industry;
- to ensure effective price regulation of the monopoly business; and
- to ensure that the regulated activities do not cross subsidise non-regulated (or contestable) activities within the regulated business itself or within associated businesses.

13. The regulated businesses need to establish accounting policies and procedures that ensure the appropriate allocation of costs between different regulated businesses and between regulated and non-regulated activities.

14. In the July 2000 Discussion Paper, the Commission was supportive of an approach to financial accounting and cost allocation which allowed prescribed businesses to put forward their accounting and cost allocation methodologies to the Commission for approval, rather than the Commission prescribing how accounting records are created and maintained. The proposed policies and methodologies would then be assessed in the context of the objectives of the Code and to ensure their effectiveness in promoting competition in related markets.

15. The Commission is also mindful that other regulatory instruments such as the Electricity Networks (Third Party Access) Code impose obligations on the segregation of the regulated entities accounts and records and that regulatory consistency is necessary. For the sake of economy and efficiency, any regulatory accounting requirements should be, as far as is possible, aligned and consistent with the policies and procedures in place for the purposes of management reporting and statutory accounts.

16. In light of submissions, the Commission has decided to take a light-handed regulatory approach through:

- the establishment of a set of high level ring-fencing accounting and cost allocation principles;
- allowing the regulated businesses to establish the necessary policies and procedures to give effect to the principles; and
- reviewing and approving the policies and procedures proposed by the regulated businesses.

17. The Commission believes that the accounting and cost allocation principles included in Schedule 2 of the revised draft Code reflect good corporate practice and

thus should be already incorporated in existing business accounting policies and procedures.

18. A logical starting date for the approved accounting procedures to begin would be from the beginning of the new financial year, 1 July 2001. In order for both the Commission and the Prescribed Businesses to dedicate sufficient time and resources the following timeline is proposed.

### Schedule 2 Implementation Timeline

Target Date	Responsibility	Task
Through to 1 April 2001	Prescribed Business	Develop policies and procedures as outlined in clause 2 of the Code following the guidance in Schedule 2.
1 April 2001	Prescribed Business	Submit policies and procedures as outlined in clause 4 of the Code following the guidance in Schedule 2.
1 April – 1 June 2001	Prescribed Business and the Commission	Undertake an iterative approach to refining the prescribed business' policies and procedures, if not already approved.
7 June 2001	Commission	The Commission undertakes to reach a decision on the prescribed business' policies and procedures, if not already approved.
8 June – 30 June 2001	Prescribed Business	Implement policies and procedures ready for the start of the 2000-01 financial year. The Commission would expect the implementation of the policies and procedures to have been assessed and started before 8 June 2001, thereby giving the prescribed business time for development and testing.

**APPENDIX****D****CROSS SUBSIDY DEFINITION AND THE PROPOSED  
COST ALLOCATION PRINCIPLES****Introduction**

1. Of the issues raised in submissions, a notable area where the revised draft Code takes a different approach than proposed in the initial draft is in the area of cross subsidies and cost allocation. This Appendix looks at this issue.

**Approach proposed in the initial draft**

2. In the July 2000 Discussion Paper, the Commission proposed use of the following definition of a cross subsidy, based upon the approach advocated by the Commonwealth Competitive Neutrality Complaints Office:

“6.5 A cross subsidy exists where, for any costs that are jointly incurred by related businesses, the costs allocated to a contestable business are less than the long run avoidable cost of their supply.

‘Avoidable cost’ means the cost of any output that could be saved over the long term by not producing it.”

3. As to the related question of cost allocation/attribution, the July 2000 Discussion Paper stated that:

“6.13 The Commission considers that details of the methodology of cost and revenue allocation for common (or joint) costs to each monopoly activity should be provided by PAWA for the following costs categories:

- fixed assets;
- working capital;
- depreciation;
- direct operating costs; and
- administrative (or corporate overhead) costs.

The cost drivers used to allocate costs between activities, products and services need to be identified and justified.”

4. In this way, the Commission drew a distinction between the related concepts of cross subsidies and cost allocation.

### Views in submissions

5. Submissions agreed that prevention of cross subsidisation between monopoly and contestable businesses was an essential feature of effective ring-fencing.

6. However, submissions disagreed on the definition of cross subsidies.

7. In PAWA's view:

"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." (para. 120)

"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." (para. 124)

8. In its submission, NT Power stated that:

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

For example, PAWA could allocate its corporate overhead costs to the contestable retail business at a level just above the avoidable costs, and the remainder to the franchise network and retail businesses. This would 'under load' the contestable business relative to other market participants who do not have regulated monopoly businesses to carry the bulk of the corporate overheads." (p.12)

### Approach in other jurisdictions

9. There is widespread acknowledgement among regulators in Australia that cost allocation is a key ring-fencing requirement. For example:

"Cost allocation issues arise when costs cannot be allocated precisely or unambiguously to particular customers or services. In particular, costs may relate jointly to the operation of contestable and non-contestable activities, such as network and metering activities within the distribution entity, or between distribution and retail businesses. In such circumstances, the potential exists for costs that correctly belong to the contestable business to be allocated to the regulated distribution business, creating a competitive advantage for the contestable activity. An appropriate cost allocation methodology is therefore critical to effective ring-fencing."<sup>2</sup>

10. However, only the Queensland regulator's ring-fencing guidelines explicitly prohibit cross subsidies. In the Queensland guidelines, a cross subsidy is defined as occurring where:

"...for any costs that are jointly incurred by the distribution and retailing entities, the cost allocated to one entity is less than the additional (or incremental) cost incurred

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<sup>2</sup> IPART, *Ring Fencing Discussion Paper*, September 2000, p.22

in providing that service, and the costs allocated to another entity are greater than the stand alone cost of its supply”<sup>3</sup>

11. Other ring-fencing codes (e.g. NSW) merely prohibit allocating shared costs in a manner inconsistent with approved allocation methodologies. This approach sees a focus on specifying appropriate methods of cost allocation. It does not mean, however, that there is no general agreement over the underlying definition of a cross subsidy. For example, the NSW Regulator (in its September 2000 ring-fencing discussion paper) explicitly states its agreement with the Queensland definition (and so the use of the “long-run avoidable cost” concept).

“There should be no cross subsidy between the prescribed and non-prescribed services. A cross subsidy exists where, for example, for any costs that are jointly incurred by the distribution and retailing entities, the costs allocated to one entity are less than the long run avoidable cost of supply.”<sup>4</sup>

12. Notwithstanding these comments, both the NSW and Victorian regulators have also published cost allocation guidelines that refer to common costs being allocated on a “causation basis” – which is based on the principle that costs should be allocated in relation to the way resources are consumed or utilised.<sup>5</sup> Moreover, these regulators state that allocations based on avoidable cost are not permitted.

13. The Victorian regulator’s explanation for this stance against the use of avoidable cost is as follows:

“Avoidable cost as an allocation base attributes the total cost of a good or service to one cost centre on the basis that the cost will unavoidably be incurred by that cost centre irrespective of whether or not it is now shared with another cost centre. The Office requires that a cost be allocated across all cost centres that benefit from the service or good.”<sup>6</sup>

### **Modified approach proposed by the Commission**

14. On the face of it, there is some confusion about the role of avoidable cost in cost allocation. For example, PAWA has equated cost allocation with avoidable cost. Moreover, there appears to be some tension within interstate regulatory approaches between the definition of cross subsidies based upon avoidable cost concepts on the one hand and cost allocation principles that discourage the use of avoidable cost concepts on the other.

15. Rather than following the Queensland approach (as was the case in the initial draft replacement code), the Commission now proposes to remove any explicit reference to cross subsidies from the replacement Code. The requirement instead

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<sup>3</sup> Queensland Competition Authority, *Final Determination - Electricity Distribution Ring-Fencing Guidelines*, September 2000, p.12.

<sup>4</sup> IPART, p.22.

<sup>5</sup> IPART, *Regulatory Information Requirements and Guidelines for Electricity Distributors in NSW*, p.7; and ORG, *Electricity Industry Guidelines No.3: Regulatory Accounting Information Requirements*, para 3.4.7).

<sup>6</sup> ORG, para. 3.4.8.

will be that prescribed businesses follow cost allocation methods approved by the Commission.

16. Moreover, the cost allocation principles appended to the revised draft Code follow the approach taken in NSW and Victoria discouraging the use of the avoidable cost concept *for cost allocation purposes*. The Commission will, however, continue to draw on the avoidable cost concept *for pricing purposes*.

17. The Commission's explanation (and reconciliation) of these apparently conflicting stances is set out in the following paragraphs.

18. The focus of cost allocation principles is on the allocation of common costs **to** prescribed businesses. The generally accepted principle among regulators in Australia is that common costs should be allocated to a prescribed business on a "causation" – and not avoidable cost – basis. This sees costs generally allocated **to** prescribed business on a "fully distributed cost" (FDC) basis.<sup>7</sup>

19. As the prices charged by prescribed businesses are regulated (and are cost reflective as a result), ensuring that common costs are allocated to a prescribed business on an appropriate (causation) basis will be *sufficient* to ensure that the prescribed businesses are not the source of cross subsidisation of related contestable businesses (via cost shifting).

20. For contestable businesses, however, appropriate cost allocation is a necessary but not sufficient condition for avoiding cross subsidies. Once common costs have been appropriately allocated to prescribed businesses, the balance of such costs is then allocated to other (contestable) businesses. Whether the contestable business makes a loss (and so needs to be somehow subsidised) then depends upon the extent to which the contestable business set its prices at levels that would recover all costs that have been allocated to that business.

21. The pricing of truly contestable businesses is not a matter for the Commission. Economic principles suggest that, provided *prices* are set above avoidable cost, cross subsidisation cannot be said to be occurring. Thus, provided a contestable business is registering accounting losses, this may provide evidence that cost shifting to prescribed businesses is not occurring. Provided costs are allocated to the prescribed businesses and the prices charged by those business are regulated so that only a normal return on capital can be earned, the prescribed business will not be in a position to cross subsidise any of its related businesses.

22. If subsidisation of a contestable business occurs in these circumstances, it would involve either cross subsidies between customers (present or prospective) of that businesses or support by the parent company or shareholders (funded by the profits made on non-prescribed activities or by a shareholder prepared to tolerate low rates of return for a period). In the case of government, these possibilities may

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<sup>7</sup> See discussion of the FDC concept in the July 2000 Discussion Paper, p.21.

give rise to “competitive neutrality” concerns that the effective ring-fencing of prescribed businesses is not capable of addressing.<sup>8</sup>

23. In summary:

- “cost shifting”, where cost are inappropriately allocated between related businesses to favour or support a contestable business, is a major (but not the sole) source of cross subsidies;
- ring-fencing obligations can only deal with cost shifting forms of cross subsidisation – where the costs associated with providing a contestable service or product are recovered through *prices* charged by a *prescribed* business;
- fully distributed cost is an appropriate concept when it comes to allocating costs between an integrated entity’s lines of business, and in particular to a business with monopoly or substantial market power; and
- avoidable cost is an appropriate concept when the focus is on the recovery by a particular line of business – through user charges – of costs assigned to that business from different customers or groups of customers.

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<sup>8</sup> The Commission has not been assigned the role of the Territory’s competitive neutrality complaints office – this is currently the responsibility of the NT Treasury.

**APPENDIX****E****REGULATION DRAFTING INSTRUCTIONS**

1. PAWA's submission drew the Commission's attention to the fact that the various "ring-fencing" provisions in the Electricity Reform Act 2000 ("ERA") – obliging related or associated monopoly and contestable electricity businesses to be operated separately – may not work as intended with respect to the Power and Water Authority on account of a faulty definition of "related body corporate" in the ERA.
2. The Commission has received legal advice that amendments to the ERA are unnecessary provided the ring-fencing code which the Commission has made, and the replacement code which is currently the subject of public consultation, are made binding in their own right. Such a code can only be binding under section 24(2) of the *Utilities Commission Act 2000* ("UCA") if the Commission is authorised to make a ring-fencing code by either the relevant industry regulation Act or by a regulation made under the UCA itself.
3. In light of the above, the Regulatory Minister (the Treasurer) has approved the drafting of a regulation under the UCA to authorise the Commission to make "ring-fencing" codes with respect to industries declared to be regulated industries under relevant industry regulation Acts. This regulation is expected to be in place in the new year.
4. The drafting instructions to be provided to the parliamentary draftsman follow.

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1. The Treasurer has approved the drafting of a regulation under the UCA to authorise the Commission to make “ring-fencing” codes with respect to industries declared to be regulated industries under relevant industry regulation Acts.

### **Authorisation to make a specific code**

2. The regulation should state that the Commission is authorised to make a ring-fencing code (or codes).

3. Section 6(d) of the UCA provides that one of the functions of the Commission is to make, monitor the operation of, and review from time to time, codes and rules relating to the conduct or operations of a regulated industry or licensed entities under relevant industry regulation Acts (including the ERA). The electricity supply industry is a regulated industry for the purposes of the UCA (section 13, ERA).

4. The power of the Commission to make industry codes and rules is conferred by section 24 of the UCA. Section 24(1) provides that the Commission may make codes or rules relating to the conduct or operations of a regulated industry or licensed entities. Section 24(2) provides that the Commission may only make a code or rule under sub-section (1) if authorised to do so by the relevant industry regulation Act or by regulations under the UCA itself.

5. As the ERA does not authorise the making of a ring-fencing code, a regulation under section 24(2) of the UCA authorising the making of a ring-fencing code is required.

### **Definition of a “ring-fencing code”**

6. The regulation should define a ring-fencing code (or codes) as a code which sets out, in the detail considered appropriate by the Commission:

- (a) the types of businesses within the regulated industry (the prescribed businesses) which must be operated separately from all related or associated business or businesses; and
- (b) with respect to each type of prescribed business, the manner and the extent to which that business must be operated separately from other businesses.

### **Guiding principles in making a Code**

7. In having regard to the matters listed in section 6(2) of the UCA when making a ring-fencing code, the regulation should authorise the Commission to seek an appropriate balance between the benefits of ring-fencing, the costs of compliance and enforcement, and the efficiencies of integrated operations which might be

foregone by the introduction of ring-fencing obligations (the “net public benefit” principle).

### **Definition of “regulated industry”**

8. The regulation should authorise the making of ring-fencing code (or codes) in any industry declared to be a regulated industry for the purposes of the UCA, rather than specifically define that industry to be the electricity supply industry. This will authorise the Commission to make such a code (or codes) for the water and sewerage industries once those industries are declared regulated industries.

### **Definition of “relevant provisions” in a relevant industry regulation Act**

9. The regulation should state that the making of a ring-fencing code is authorised only with respect to a regulated industry where the relevant industry regulation Act contains provisions authorising the Commission to require any business in that industry undertaken by an integrated entity to be operated separately from any other business undertaken by that entity in that or any other industry (“relevant provisions”).

### **Definition of a “prescribed business”**

10. So as not to constrain the Commission’s powers under (for example) sections 24(4), 25(2), 26(3) and 28(3) to make the various licences subject to any terms and conditions it thinks fit, the definition of the business or businesses within a regulated industry to which any ring-fencing code may apply (“prescribed business”) should not be confined to the types of businesses within the regulated industry specifically referred in that Act.

### **Definition of a “related business”**

11. While the meaning of the related or associated businesses which are to be operated separately to the nominated businesses should be left to the Commission, for the purpose of ring-fencing codes businesses must be related or associated on account of common (or shared) ownership, management or operations.

### **Transitional provisions**

12. As the Commission has already issued a ring-fencing ‘code’ to give effect to certain licence conditions it has imposed, and the replacement ‘code’ is currently the subject of public consultation, the regulation should also include a transitional provision along the lines of section 45 of the UCA. This would provide that if:

- (a) the Commission takes any action to enable the Commission to perform functions under, or obligations imposed by, the regulation before the regulation comes into force in anticipation of the regulation coming into force; and
- (b) the action was taken so far as reasonably practicable in accordance with the regulation (as though the regulation was in force at the time the action was taken),

then, after the regulation comes into force, the action is to be taken to have been taken validly in accordance with the regulation.

NT Treasury  
February 2001