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5 May 2006

Mr Sebastian Roberts  
General Manager  
Australian Energy Regulator  
GPO Box 560J  
Melbourne VIC 3001

Dear Mr Roberts

**Re: Scoping Paper – Gas and Electricity Distribution Regulatory Guidelines**

AGL is pleased to make a submission in response to the AER scoping paper.

The scoping paper raises the important issue of the AER's preparedness to undertake the first round of electricity distribution reviews in its role as the national energy regulator. AGL agrees that the AER needs to be adequately prepared for this task, but as discussed in the submission, considers that there are preferred alternatives to the approach adopted in the scoping paper.

Should you wish to discuss or clarify any of our comments, please contact Chris Harvey, Manager Regulatory Development, on (02) 9921 2601.

Yours faithfully

Dr Robert Wiles  
General Manager Regulation and Policy

# AER Scoping Paper

## Gas and Electricity Distribution Regulatory Guidelines

### 1. AER rationale for guidelines

The main issue identified in the scoping paper is a need for the AER to be prepared to undertake the first round of electricity distribution reviews expected to commence in mid-2008.

AGL agrees that the AER does need to be adequately prepared for this activity. However, AGL suggests that the main focus of the AER should be on issues such as the key internal and external steps the AER would need to take in preparing for the reviews, and communicating these steps to stakeholders. In contrast, the scoping paper has concluded that there is an immediate necessity to commence development of "guidelines" for significant aspects of electricity distribution regulation (to be substantially in place by mid-2007). Although not stated explicitly in the scoping paper, AGL assumes the guidelines are intended to be mandatory for the businesses.

AGL is concerned that the approach adopted in the scoping paper:

- Establishes an inadequate and inappropriate means of preparation for forthcoming reviews;
- Pre-empts the level and scope of regulatory authority which is yet to be determined by the MCE and AEMC in a new distribution regulatory regime;
- Blurs the very clear distinction between rule making and rule administration in the new national regulatory governance framework, and has the effect of giving the AER the role of de facto rule-maker

These concerns are detailed below.

### 2. Preparation for forthcoming reviews

The AER does recognise in the scoping paper that one of the key elements in preparing for the forthcoming reviews (particularly its role as national administrator) is an understanding of previous regulatory decisions, philosophy and approaches. The paper notes that the AER will have regard to the existing regimes of jurisdictional regulators, and that it intends to work closely with them to ensure that the transition of regulation to the AER is smooth and that the necessary differences are accommodated<sup>1</sup>.

AGL commends the AER's recognition of a substantial body of pre-existing regulatory experience and practice that can be built upon by the AER in its preparation. AGL submits that this accumulated experience should be the starting point in the process of developing a national approach to regulatory administration.

AGL agrees with the scoping paper that there are important elements in the development of a national distribution framework which need to be finalised,<sup>2</sup> but notes that in the first instance, this is the role of the MCE and AEMC. Nevertheless, AGL considers that this does not prevent the AER preparing itself for electricity distribution regulation in 2008 by building upon previous regulatory experience.

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<sup>1</sup> AER Scoping Paper March 2006, p. 7.

<sup>2</sup> Ibid, p. 2. Matters cited in the scoping paper include the exact arrangements for the transition of distribution regulatory functions to the AER, and the status of existing derogations.

To make the best use of this experience in preparation for future reviews, AGL suggests that the AER should take the following steps:

- Set up working relationships with the jurisdictional regulators who have been responsible for electricity distribution regulation, and particularly the regulator responsible for the distribution businesses which will be subject to initial review in 2008;
- Commence developing the necessary level of expertise in dealing with gas and electricity distribution;
- In conjunction with the jurisdictional regulators, determine which elements of those previous reviews can be carried forward by the AER on a common basis, and which may require individual approaches;
- Begin to consider if non-binding guidelines for the common and individual elements of regulatory reviews are required ;
- Prioritise the AER work program towards the transition to national regulation, and the development of a body of knowledge that will assist in preparing for reviews when the national frameworks are fully in place.

The AER's proposed focus on new regulatory guidelines will, in AGL's view, give priority to the least beneficial means of preparing for the forthcoming reviews – both for the AER and the regulated distribution businesses. The latter have participated in multiple reviews and have developed particular approaches in responding to those reviews. To the extent that well established existing procedures can be carried forward, the experience of both the jurisdictional regulators and the businesses should be seen as a benefit to, and the foundation of, the AER's approach in the early stages of national regulation.

AGL recognises that there is an immediate need for the AER's regulatory practice to consolidate the different jurisdictional approaches applied to date. However, there appears to be an unstated presumption in the scoping paper that the AER needs to adopt a relatively "clean sheet" approach to regulatory administration in its early reviews, as evidenced by the perceived need for guidelines.

AGL also notes with some concern the statement in the scoping paper that development of the proposed guidelines "is grounded in the objective of achieving regulatory consistency where possible in regulated industries"<sup>3</sup>. The concern is not so much with the objective, as with the AER apparently taking the lead ahead of the MCE and AEMC. The major components of regulation (scope, form, content and procedure) are matters for the relevant laws and rules, and the latter are the main instruments through which consistency between industries should be achieved. In AGL's view, the regulator's role - as administrator of the rules – is to begin with the degree of consistency that will be contained in these instruments and not seek to influence or pre-empt it through the use of guidelines or any other method.

### **3. Pre-emption of authority to be determined for the AER**

While the AER accepts that there "still exists legislative uncertainty surrounding the regulatory framework for the gas and electricity industries"<sup>4</sup>, it has chosen to base its concept of the use of guidelines on three sources:

- The Gilbert and Tobin/NERA discussion paper on a national framework for energy distribution and retail regulation;
- The AEMC draft Rule proposal on electricity transmission revenue;
- The outcomes of the Expert Panel review.

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<sup>3</sup> Ibid, p. 2.

<sup>4</sup> Ibid, p. 20.

The AEMC's approach is described as "particularly instructive" as to how the future distribution framework may be constituted "given the similarities between electricity transmission and distribution"<sup>5</sup>.

AGL does not agree that any of the above sources gives the AER grounds for presuming that it will have the authority to develop mandatory guidelines under the law and Rules in a new national distribution framework, or that it can or should initiate a process to develop such guidelines now. The reasons are:

***The Gilbert and Tobin/NERA paper***

The Gilbert and Tobin/NERA paper is a consultation document only, which presents a particular view of a heavy handed distribution regulatory framework, and one that was far from wholly supported in the public consultation process. Further, the MCE has not responded to the consultation document or indicated what the next steps will be in developing a national framework for energy distribution and retail regulation. Finally, the energy industries have received indications from MCE/SCO that, at least in respect of distribution access regulation, this document has been superseded by MCE's consideration of the Expert Panel report and its response to the Productivity Commission recommendations.

The AER notes that the Gilbert and Tobin/NERA paper puts forward the concept of "Statements of Requirements" to be issued by the AER which would be detailed and binding upon service providers. AGL observes that this concept is contrary to the governance arrangements in place for national energy market reform (see next section), and appears to reflect the regulatory frameworks of those jurisdictions that have not adhered to the principle of the "separation of powers" that is embodied in these governance arrangements.

It is AGL's firm view that no clear authority can be attached to the document's recommendations and submits that it would be entirely inappropriate for the AER to rely on this source<sup>6</sup>.

***The AEMC draft Rule proposal on electricity transmission revenue***

AGL does not agree with the scoping paper's comment that the draft Rule indicates how the future distribution framework may be constituted. The AEMC has so far only put out a transmission Rule proposal for consultation and has not indicated that its approach to electricity transmission would be applicable to distribution. Moreover, the AEMC received a substantial number of submissions putting the view that significant elements of the draft Rule would not be appropriate for either transmission or distribution. In the light of the number of submissions received, the AEMC has delayed issuing a Draft Determination<sup>7</sup>.

In view of the importance that the AER appears to attach to the AEMC proposal, AGL wishes to highlight significant concerns with key elements of the draft Rule that emerged during the consultation process.

Several participants (including AGL and the AER itself) submitted that the level of detail in the proposed transmission Rule constituted a regime that was overly restrictive on either the regulator or service providers.

A major concern in submissions was the proposed use of mandatory guidelines to be developed by the AER consistent with principles set out in the transmission Rule.

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<sup>5</sup> Ibid, p. 1.

<sup>6</sup> AGL submitted in the public consultation that such "statements" should not impose obligations on market participants, but rather clarify and define existing obligations within the rules.

<sup>7</sup> AEMC website, Review of electricity transmission revenue and pricing Rules, <http://www.aemc.gov.au/electricity.php?r=20051216.093023>, last accessed 4 May 2006.

AGL's submission highlighted the following issues<sup>8</sup>:

- While the NEL includes a provision for the AEMC to make Rules that empower the AER to make enforceable "*guidelines, tests, standards and procedures*" there was concern with the AEMC's approach to the use of this power in the draft Rule;
- The separation of Rule making and Rule administration is a central feature of the new energy market institutional and governance arrangements established by the MCE in July 2005. The power to make guidelines appears to have been included as a matter of practical necessity to deal with procedural matters. Accordingly, Rules for setting guidelines should be kept to a minimum to ensure that the separation of powers is maintained;
- The matters on which the AEMC proposes to empower the AER to make guidelines are substantive. It is inconsistent with the policy objective of separating rule making and administration/regulation to delegate to the regulator a power to create regulatory obligations;
- The draft Rule already includes more than sufficient detail, obviating the need for further guidelines.

AGL concludes that even if the AEMC Final Determination substantially implements the current Rule proposal for transmission, it would be pre-emptive and highly misleading to assume that this framework would be appropriate for electricity and gas distribution. At this stage, there should be no presumption that the AER will have authority under the law and Rules to develop mandatory distribution guidelines of the kind envisaged in the scoping paper.

### ***The Expert Panel Review***

The MCE/SCO has cautioned that:

*In releasing the report, SCO notes that the Panel's report represents an input to the MCE's deliberations and no part of it should be considered as representing the MCE's position on any of the matters the report considers. The MCE is still considering its response to the Productivity Commission's Review and will take the Panel's report into account in its deliberations<sup>9</sup>. (emphasis added)*

The Expert Panel's recommendations, while not insignificant, are only one input into the SCO/MCE deliberations and do not form a 'blueprint' for the AER to proceed with the development of mandatory guidelines.

AGL observes that the Expert Panel has put forward its own view of what constitutes a "guideline" under the new national framework and this may be of some value. The Panel notes that a guideline is made with delegated authority of the AEMC under the Rules, with scope to cover

*Detailed technical matters that rely substantially on operational information/knowledge and matters limited to industry segments or likely to be subject to exceptions<sup>10</sup>.*

This view appears to support the concept that a guideline should be strictly limited to operational and procedural matters, and is not an instrument for influencing significant elements of the regulatory framework.

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<sup>8</sup> AGL, 21 March 2006, AGL submission to the AEMC on its review of the Electricity Transmission Revenue and Pricing Rules – Transmission Revenue Rule Proposal Report.

<sup>9</sup> Ministerial Council on Energy, 19 April 2006, Energy Market Reform Bulletin No 60.

<sup>10</sup> Expert Panel on Energy Access Pricing, April 2006, Report to the Ministerial Council on Energy, Table 1 p. 23.

#### 4. Distinction between rule making and rule administration

AGL submits that, despite clear and unequivocal statements by the MCE of its intention to separate Rule making and Rule administration in the new national framework, several aspects of legislative drafting in the National Electricity Law and Rules have compromised this intent. AGL regards these developments as a most undesirable outcome, and one that has not been subject to appropriate consultation. The AER proposed guidelines would further compromise the MCE's initial intent.

As an example of this apparent legislative ambiguity, AGL cites the *Australian Energy Market Agreement* signed by first Ministers on 30 June 2004, which defined the role of the AER as one limited to the monitoring, reporting on compliance and enforcing the National Electricity Code - which was soon to become the Law and Rules - and the economic regulation of networks. However, the subsequent draft electricity Rules did not appear to recognise this limitation. In a response to the exposure draft of the National Electricity Rules, the Energy Networks Association (ENA) commented that<sup>11</sup>:

- The ENA strongly endorsed the previous decision by Ministers to separate energy market rule making from regulation through the establishment of the AEMC and AER;
- The ENA considered that there were some aspects of the allocation of functions between the AER and AEMC in the exposure draft Rules that did not reflect this separation;
- As an example, the ENA cited the AER's new powers to impose enforceable reporting requirements which were not available to its predecessor (NECA)<sup>12</sup> and observed that there had been a shift from enforcement to rule making, whereby the previously constrained enforcer was now granted additional powers to draft rules;
- The separation between rule making and enforcement should limit the role of the AER to enforcing rules developed by the AEMC.

AGL submits that these observations are still completely relevant to the draft AEMC transmission Rule and the AER proposal for "guidelines".

AGL acknowledges that s.34(3)(e) of the NEL gives the AEMC the power to confer a function on the AER to "*make or issue guidelines, tests, standards, procedures or any other document in accordance with the Rules*". Nevertheless, it is AGL's clear view that the use of mandatory guidelines - as proposed in the AEMC draft Rule and (it is assumed) in the AER scoping paper - would defeat the stated MCE policy objective of separating Rule making and Rule administration.

AGL believes that the MCE stated policy intent requires that the NEL s.34(3)(e) be interpreted such that guidelines issued by the AER are either:

- Non-mandatory, or
- If mandatory, must be restricted (by the Rules which authorise the making of guidelines) to low-level technical or procedural issues on any matter to do with economic regulation. Guidelines must not be permitted to create substantive obligations in the economic regulatory framework.

AGL accepts that guidelines may have the value of informing the market and regulated businesses of the regulator's application of the Rules and certain procedural matters. However, these guidelines must not impose significant additional regulatory obligations on market participants.

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<sup>11</sup> ENA Submission to the Ministerial Council on Energy Standing Committee of Officials, 28 January 2005, National Electricity Rules – Response to Exposure Draft.

<sup>12</sup> In clauses 8.2.10(c) and 8.7.2(a).

## 5. Comment on the appropriate scope of guidelines

AGL acknowledges that the MCE reform process is seeking to align (as far as practicable) access regulation for gas and electricity, and for transmission and distribution. However, there are natural limitations to the degree of alignment possible, so that different Rules (and if needed, guidelines) should apply to each. Some differences between the sectors include:

- The obligatory nature of capital investment in electricity transmission, as opposed to the discretionary nature of capital investment in distribution, especially gas distribution, thereby suggesting different regulatory approaches to the appraisal of capital expenditure;
- The integrating role of electricity transmission networks in the NEM, both as the central element connecting electricity production with demand centres, and also as a means of linking jurisdictional transmission networks. In contrast, distribution networks stand alone;
- The much tighter link between customer satisfaction and reliability on one hand, and the level of operating and capital costs on the other, which exists in the electricity industry compared with gas, thereby suggesting different service standard regimes for each;
- While revenue caps may be appropriate for the regulation of electricity transmission, they are not appropriate for electricity or gas distribution.

Given the substantial sectoral differences, AGL concludes (in answer to specific questions raised in the scoping paper<sup>13</sup>) that in respect of any *appropriate* guidelines, which the AER may develop:

- The process for development of electricity transmission guidelines should be separate from the process for developing electricity distribution guidelines;
- There should be a separate process for the development of guidelines for gas;
- To the extent that there are common features between the sectors, these can be reflected in each sector's guidelines.

AGL also notes that three of the AER's proposed guidelines are additional to those proposed by the AEMC<sup>14</sup>. The scoping paper presents no case why these should be developed, and there is no overall framework in place at present to suggest why they should be developed.

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<sup>13</sup> See pp. 24 and 25.

<sup>14</sup> Tariff setting, connection and capital contributions and ring fencing.