

Our Ref:

Ms Lia Finocchiaro, MLA
Chairperson
Public Accounts Committee
Legislative Assembly of the Northern Territory
GPO Box 3721
Darwin NT 0801

Dear Chair

RE: SUBMISSION TO THE INQUIRY INTO THE SPLITTING OF THE POWER AND WATER CORPORATION

I refer to your invitation for the Commission to make a submission to the inquiry into the splitting of the Power and Water Corporation (PWC). This letter forms the Commission's submission to the inquiry and specifically addresses the Terms of Reference below.

By way of introduction, the Commission is a statutory authority established under the *Utilities Commission Act* as an independent economic regulator for the Territory. The Commission's current set of functions (which are confined almost entirely to the electricity industry) includes administration of a licensing regime and industry codes, network pricing and regulation, establishing target standards for electricity network services and monitoring of performance, annual power system reporting, dealing with complaints from industry participants, providing advice to the Regulatory Minister (Treasurer) and Portfolio Minister (Minister for Essential Services) as requested from time to time, and conducting inquiries as requested by the Regulatory Minister. The Commission's objectives, as set down in legislation, emphasise the achievement of economic efficiency and market-based approaches in the conduct of its functions.

Comments on Terms of Reference:

a) *The provisions of the PWC Legislation Amendment Bill 2014 serial 63, the Power Generation Corporation Bill 2014 serial 64, and the Power Retail Corporation Bill 2014 serial 65.*

The Commission has not been involved in the development of these Bills and has no comment to make on this Term of Reference.

b) *The fiscal and economic impact of the PWC being split into three separate entities.*

This Term of Reference invites comment on the economic underpinnings of the proposed structural separation of PWC. In responding to this invitation, the Commission notes that it has not undertaken any fiscal or economic analysis of the proposed separation. The Commission is only permitted to undertake functions that are authorised under the *Utilities Commission Act* and no authorisation currently exists in relation to the analysis of policy matters, such as the proposed structural separation of PWC.

Nevertheless, the Commission notes that structural separation of the type now proposed for PWC has been commonplace amongst Australian jurisdictions over the past two decades. In all cases, such structural separation has been a key component of reform measures designed to enhance

economic efficiency in the electricity industry and thereby improve economic competitiveness and output while ensuring that standards of service (such as, supply reliability) to consumers are not compromised. Indeed, it might be expected that the levels of service to consumers would be enhanced through an appropriately designed reform package. For most Australian jurisdictions, reform of the electricity supply industry has occurred within the framework of the evolving National Electricity Market and its associated rules and institutions.

Key elements of reforms have included the adoption of arrangements that would expose the electricity industry to the forces of competition where feasible (essentially within the generation and retail sectors of the industry) while driving efficiency improvements in the natural monopoly (network) segment of the industry through appropriate regulation.

The electricity industry in all jurisdictions has historically been dominated by an incumbent vertically integrated entity with near monopoly market power. Vertical separation of the potentially competitive generation and retail sectors of that entity from the natural monopoly network sector has been considered necessary, to establish management structures that focus on the efficiency of each separated business, enhance the likelihood of effective competition emerging in the contestable sectors by reducing the prospect that the network business economies could be used to protect related retail and generation businesses, establish independent market and power system management processes that maintain power system security and reliability while facilitating competition, and to increase the effectiveness of regulation of the network business.

Such structural separation is not in itself a *sufficient* condition for competition to emerge; other important factors include the development of appropriate market arrangements in the contestable generation and retail sectors, and establishment of an effective network access regime. It is understood the Territory Government is also pursuing a package of regulatory reforms for market and power system management in the electricity industry. Nevertheless, structural separation has been considered a *necessary* factor to control the market power of the incumbent entity.

Inevitably, structural separation can increase costs in some parts of the industry, through the loss of economies of scale and scope, increased transaction costs, and reduced dividend flows from government-owned electricity businesses where market share is lost through competitive pressures. But it has generally been held that such costs are outweighed by the economic benefits associated with the resultant efficiency gains in the electricity industry (refer, for example, Industry Commission Research Report on the Electricity Industry in South Australia).¹

The Commission observes that the stated objectives for structural separation of PWC are similar to those associated with similar reform in other Australian jurisdictions. The Commission supports these objectives. The Commission believes that there is significant potential for efficiency gains, both in operational and investment terms, to be made in PWC, particularly in the generation and network business units. Structural separation would assist in the realisation of these gains, but it must be accompanied by related measures to establish appropriate market arrangements in the generation and retail sectors and to ensure effective regulation of the network sector. In this respect, consideration should be given to the adoption of market and regulatory arrangements that are closely aligned with those of the National Electricity Market.

¹ Productivity Commission, Industry Commission Research Report, Electricity Industry in South Australia, 1996, <http://www.pc.gov.au/industry-commission/research/independent/saelect/finalreport>

c) Any other matters in relation to the proposed split of PWC

As noted in previous public reports by the Commission, there is also a need for greater focus, transparency and independence in relation to functions of power system planning, operation, monitoring and reporting.² These functions are currently undertaken by System Control within PWC, although power system reporting is currently primarily undertaken by the Commission. It would be reasonable, and more consistent with practices in the National Electricity Market, for these functions to sit with an independent market and system operator. As an interim measure, the Commission supports the proposed location of System Control within the residual PWC entity, separate from the generation and retail corporations and with management that is also independent of the network business.

The Commission notes finally that an important benefit of structural separation is that it facilitates, both at Board and management level, a much stronger focus on the specific issues facing each entity. This assists in driving efficiency gains but also in improving technical performance in key areas such as power system reliability and security of supply.

The Commission consulted with the Australian Energy Market Operator (the operator of the energy markets and systems for the National Electricity Market) in the preparation of this submission.

Please contact Vanessa Sutcliffe, Director Utilities Commission on 08 89 995480 if you wish to discuss this submission.

Yours sincerely



Dr Patrick Walsh
Utilities Commissioner

24 April 2014

² For example, Utilities Commission, Report on Electricity System Planning and Market Operations Roles and Responsibilities, January 2012, <http://www.utilicom.nt.gov.au/Newsroom/Lists/Posts/Post.aspx?ID=39>