



**Energy Action
Group**



Initial Response to Proposed Ministerial Council for Energy Framework Schedule for Transfer of Distribution and Retail Functions

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by the Energy Action Group and Energy Users' Association of Australia
with assistance from Marsden Jacob Associates. Funding assistance
was provided by the National Electricity Consumers' Advocacy Panel.
All views expressed are those of the EAG & EUAA.*

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1. Introduction

This initial submission contains a preliminary response to some of the issues listed by the Ministerial Council for Energy (MCE) Standing Committee of Officials (SCO) in a two-page document headed *Proposed Framework Schedule for Transfer of Distribution and Retail Functions*. MCE Energy Market Reform Bulletin No. 50 advised that the document contains a high-level listing of functions prepared by the SCO drawn from the NERA/Gilbert+Tobin (NERA *et al*) consultation paper.¹ Bulletin No. 50 also states that the list highlights the decisions that need to be made (by the MCE) including:

- which functions should be transferred to the new governance arrangements;
- whether the functions should be uniform or jurisdiction-specific;
- whether any functions should remain with jurisdictional regulators (apart from general safety, environmental and similar functions not part of standard economic regulation);
- whether any existing economic regulation functions would be redundant under a national framework; and
- the appropriate timing of any transfers.

This submission represents the initial and preliminary response by the Energy Action Group (EAG) and Energy Users Association of Australia (EUAA) to the list of high level issues. The comments in this submission do not indicate that other matters are of lesser relevance or importance to EAG and EUAA members. A separate and more detailed submission is being prepared to respond the NERA *et al* consultation paper.

Both EAG and EUAA are long-established consumer representative and advocacy organisations.

The EUAA was formed on 1 January 2001 by a merger of the Energy Users Group of Australia (EUGA) and the Australian Gas Users Group (AGUG) as a genuinely national association of energy users. The EUAA is a non-profit organisation funded by membership fees, internally generated revenue and external funds. Members determine policy, priorities and direction. The EUAA represents and advocates on behalf of business users with activities across all states and many sectors of the economy. It has over 80 members, including most of Australia's largest energy users. The EUAA is focused entirely on energy issues, cover national and State issues dealing with electricity and gas, as well as greenhouse and energy efficiency. The EUAA also encourages others with an interest in energy matters that affect end users to join as Supporting or Associate Members; and actively cooperates with organisations representing small to medium business and disadvantaged consumers. The EUAA has participated in over 20 regulatory determinations since the NEM started.

The EAG is a membership based, not for profit incorporated association formed in 1977, which advocates on behalf of less than 160 MWh electricity consumers across the NEM and less than 10 TJ gas consumers across the East Coast of Australia. The EAG has actively

¹ Downloaded from www.mce.gov.au 'What's New in MCE in early November 2005.

The two-page document contains a Footnote on page 1 that states "Generally derived from the NERA/Gilbert+Tobin paper titled '*Public Consultation on a National Framework for Energy Distribution and Retail Regulation – May 2005*'".

participated in 11 electricity and gas transmission and distribution revenue/pricing reviews across the east coast of Australia and the NEM since energy reforms actively started in 1996.

2. Background

In February 2005, the SCO retained NERA and Gilbert + Tobin (NERA *et al*) to prepare a consultation paper for the national regulation of energy distribution and retailing (other than retail pricing). The consultation paper was developed under the direction of a SCO working group and followed release by the MCE, in December 2003, of a report on energy market reform² and publication by the SCO, in September 2004, of an Issues Paper on the national framework for distribution and retail functions in the energy markets.³

This submission contains a preliminary response to some of the issues identified by the SCO from NERA *et al*'s consultation paper that are of importance to energy users. The views contained in this report are supported by the EUAA and EAG but may be subject to amendment during preparation of a more detailed response to the consultation paper that is due to be lodged with the SCO in mid-January 2006. The bases on which the response is presented are:

- EUAA and the EAG (and their consultant MJA) have a detailed working knowledge of regulatory processes, practices, policies and procedures that affect the practical execution of the issues covered in the NERA *et al* consultation paper.
- Both EUAA and EAG recognise that all Australian governments have, as part of implementing the COAG national competition policy, committed to the philosophy that market based mechanisms are more likely to lead to optimum economic outcomes for all Australians – and that where markets cannot be made effectively competitive, economic regulation will be implemented that seeks to “mimic” the economic outcomes of competitive markets. EUAA and EAG generally support this approach, albeit with some reservations based on practice, and believe that it has not always been effectively implemented in Australia.
- Effectively competitive markets arise where adequately informed consumers have sufficient economic power to ensure that goods and services are created, produced and delivered at a standard and price that meets the consumers’ expectations and requirements.
- Both EUAA and the EAG support the general thrust and direction of energy market reforms being pursued by the MCE. In particular, the EUAA and EAG support adoption in both the electricity and gas sectors of an objective based on benefits to end users and note the new objective specified in s7 of the new *National Electricity Law*, viz –

... to promote efficient investment in, and efficient use of, (energy) services for the long term interests of consumers of (energy) with

² *Reform of Energy Markets*, Ministerial Council on Energy Report to the Council of Australian Governments, 11 December 2003.

³ *National Framework for Electricity and Gas Distribution and Retail Regulation - Foreword and Issues Paper*, Ministerial Council on Energy Standing Committee of Officials, August 2004.

respect to price, quality, reliability and security of supply of (energy) and the reliability, safety and security of the national (energy) system.

- Both EUAA and EAG recognise the potential value to large and small energy consumers that could come from:
 - effective implementation of uniform policies and regulatory mechanisms that facilitate achievement of the above objective in both the electricity and gas sectors;
 - standardising and unifying the practice of economic regulation and retail energy market policies across Australia – particularly if this is through implementation of policies and administrative procedures that achieve a reduction in the cost and complexity of economic regulation and increase the economic benefits to large and small energy consumers.
 - however, the above is based on the assumption that regulation continues to be effective in the sense that it is targeted at energy networks that enjoy monopoly positions

The balance of this submission presents responses to the some of the key issues listed by the SCO that are intended to be entirely consistent with the bases outlined above.

Section 3 of the submission makes several key general observations on the NERA *et al* consultation paper, Section 4 addresses ‘National’ issues that are obviously of key importance to energy consumers. The numbering adopted in the SCO listing of issues has been retained in each of these sections of the submission.

It should be noted that Section 5 lists ‘State/Territory’ issues and Section 6 lists issues that are proposed to be ‘Abolished’. These issues, and the balance of those in section 4, will be dealt with in the final EUAA-EAG submission to the SCO that is due in mid-January.

3. Comment on general issues

The NERA *et al* consultation paper provides a reasonable summary of the complex issues relevant to regulation of distribution and retail functions arising from the complicated, multi-jurisdictional implementation of energy reform that has occurred across Australia since the early 1990s. The EUAA and EAG agree entirely with NERA *et al* that this has produced:

... regulation of retail and distribution activities in the electricity and gas sectors (that) is currently characterised by a substantial number of very detailed obligations, contained across a range of legal instruments (including Jurisdiction specific legislation, national codes and licences, codes and guidelines issued by jurisdictional regulators)⁴. There is limited consistency in requirements between jurisdictions and between the two sectors.⁵

⁴ The complexity of national regulation is also compounded by the myriad of electricity and gas industry policies, practices and procedures that have been developed and implemented by individual supply-side entities (presumably) in an attempt to ensure compliance with both technical and economic regulation.

⁵ p. 3, NERA *et al*.

The EUAA and EAG also generally endorse the approach taken by NERA *et al*, which attempts to propose a ‘best practice’ approach to regulation of energy distribution and retailing’ and seeks to:

- achieve the maximum level of consistency across the electricity and gas sectors and across jurisdictions;
- minimise the areas and extend of difference by limiting the exercise of Jurisdictional Directions;
- base recommendations on explicitly defined Policy Criteria; and
- identify transitional issues.

However, the NERA *et al* consultation paper has several weaknesses that reduce the value of its recommendations. Each of these is outlined below.

- (a) Failure to include as one of the Policy Criteria a requirement that all policy changes or regulatory decisions, including acceptance of any Jurisdictional Direction or any change to an electricity or gas Rule, be linked to a robust demonstration that economic benefits will accrue to energy users (which also seems to ignore the Single Market Objective in the NEL).

The EUAA and EAG are firmly of the view that this should be a minimum condition for implementation of further energy market reform. It is unacceptable to expect energy consumers to bear the cost of policy initiatives and/or energy market Rule changes without being assured of an overriding economic benefit. Such an outcome would be expected in an effectively competitive market – where consumers have effective economic power. It is reasonable, therefore, to expect the same outcome from the cogitations of policy makers and regulators. This would also be consistent with achievement of the objective *to promote efficient investment in, and efficient use of, energy services for the long term interests of consumers*.

- (b) The scope of the consultation paper is limited by the compromises made by the MCE (and COAG) to accommodate ‘jurisdictional sensitivities’.

The limited scope of the consultation paper seriously limits NERA *et al*’s ability to propose recommendations that will achieve ‘best practice regulation’.

An important limitation is the exclusion of retail pricing for small consumers from the national arena. The proposals in the NERA *et al* consultation paper only deal with issues related to the ‘business relationships’ between DBs and retailers. That is too narrow and compromises achievement of regulatory initiatives in distribution pricing that might have potential to deliver benefits to consumers.

There are already serious deficiencies in the current jurisdictional arrangements because economic regulators have substantially greater powers and influence over pricing for distribution (and transmission) network services, but limited, or no, powers over retail pricing in the competitive market. This has led to absurd outcomes, where regulators and distributors have implemented specific and very costly policy initiatives in the distribution sector that have not been reflected in the retail market. An outstanding, bad, and very costly example is the decision by the Victorian ESC to mandate a \$500 million plus roll-out of manually read, half-hourly interval meters. This includes mandated application of a

principle that distribution tariff prices reflect increasing peak load costs – even though the ESC acknowledged it has no power to impose similar conditions on prices developed by energy retailers.⁶

Another example, also from Victoria, is the electricity distributor United Energy's initiative in 2001 to implement (what appear to be) reasonable and rational, cost-reflective, time-of-use network tariffs specifically designed for application to small consumers with half-hourly interval meters. United also apparently commenced a 'voluntary' (i.e. not mandated by the ESC) roll-out of manually read interval meters to newly connecting consumers and is understood to have made substantial IT investment to support application of the tariffs and billing of energy retailers. Yet by the end of 2005, not one retailer operating in Victoria offered any form of retail product to Residential consumers that passed through the costs/benefits of United's time-of-use tariffs.

We note that United will benefit (ie increase its overall revenue) from implementing cost-reflective, time-of-use tariffs so long as air conditioning penetration continues to increase and consumers' elasticity of demand for electricity with respect to price in low.⁷

There is no public domain information on the total investment undertaken by United to implement this program, but it is likely to have been well in excess of \$50 million. Whatever the amount, the investment has been accepted by the ESC⁸ and paid for by United's customers – without one cent in benefit being gained by consumers. Such an outcome is neither reflective of an effectively competitive market, nor in the long term interests of consumers.

There is very little evidence that either of these costly initiatives, both of which must be paid for by end-users, will be effective – primarily because of the existing limits on the power of regulators to deal with the same pricing issues in the distribution and retail sectors. In these examples, the regulator and the distributor have taken a 'pricing initiative' that each claim is intended to 'provide incentives' for end-users to respond in ways that facilitated economically efficient outcomes. However, the ESC acknowledges that persuasion is the only means available to stimulate transfer of these initiatives to retail pricing; and United

⁶ This is not the only serious deficiency in this programme. Others exist that suggest it is extremely unlikely that consumers will gain access to any net benefit on an individual or aggregate level. See *Comment on Essential Services Commission Draft Decision, Victorian Electricity Distribution Price Review 2006-2010*, Submission to the ESC on behalf of various consumer groups, Marsden Jacob Associates, 30 August 2005.

See also comment on the ESC's initial cost-benefit analysis in *Smart meters for smart competition? Will current proposals hand back power to consumers? Update 2003, A consumer-focussed comment on the Victorian Essential Services Commission Position Paper - Installing Interval Meters for Electricity Customers - Costs and Benefits*, Report for the Energy Action Group, Pareto Associates Pty Ltd, March 2003. Assumptions for this cost-benefit analysis were clearly deficient (key deficiencies are summarised on p. 36 of the above report). The 'oddest' assumption was a (supposedly) 'cost reflective' tariff that resulted in air-conditioner users facing lower bills than Off-Peak hot water users

⁷ Detailed analysis of the impact of United's time-of-use tariffs on a range of households with interval meters shows 'moderate;' air conditioning users (with electrical loads of 2kW to 4kW) would pay substantially more than on United's 'standard' accumulation meter network tariff. (See the Pareto Associates report referenced in the above Footnote for details).

⁸ The ESC has not explicitly reviewed United's implementation of this program, but has (effectively) accepted on faith that whatever amount United invested in the program was efficient – because the ESC believes the 'efficiency incentives' embedded in the Victorian regulatory regime are effective. However, it is the EUAA and EAG's view that such investment cannot possibly be efficient if consumers get no benefit whatsoever.

acknowledges (in its Annual Tariff Reports) that retailers have shown little interest in developing 'retail products' for small consumers that match these new tariffs.

These examples indicate that it may be futile to permit the AEMC and AER to implement intricate policies that encourage distributors to develop economically efficient cost-reflective pricing, without including retail price regulation within the AEMC/AER mandate. Further, and formal, separation of regulatory powers implied in the NERA *et al* consultation paper is only likely to aggravate the current deficiencies, allowing jurisdictional Governments (or regulators) to implement retail pricing policies that seek to protect small consumers from their fears that financial pressures might be created by any initiatives taken by the AEMC and/or electricity distributors to implement improved network pricing arrangements.

- (c) The recommendations do not address (or even refer to) the wasteful approach of maintaining separate processes for review of revenue/price for each electricity and gas transmission entity and each group of electricity and gas distribution entities.

Continuing the current arrangements for separate and sequential regulatory processes will perpetuate a significant cost of regulation for energy consumers, taxpayers and regulated entities. NERA *et al*'s (and the MCE's) silence on this matter ignores the obvious benefits that would come from regulating transmission and distribution services in single, nationally consistent processes – or following the UK initiative to integrate the regulation of both electricity and gas transmission into a single national process.

The costs of not addressing this issue are substantial. For example, the Victorian ESC is reported to have spent \$7-8 million to conduct the recently completed electricity distribution price review. Replication of this cost, or anything like that amount, by the AER for separate reviews for each jurisdictional-based electricity and gas distribution sector and electricity and gas transmission entity would incur costs well in excess of \$100 million over one regulatory cycle. Even the net costs (i.e. after accounting for the costs of a streamlined regulatory process) are likely to be substantial. The only benefit of this might come from maintaining employment levels at the AER and providing continuous 'on the job' training in the practical application of regulatory economics. There is unlikely to be any benefit to energy consumers.

The AEMC should be charged with the responsibility of developing a transition program to bring all electricity distribution reviews into a single process, all gas distribution reviews into a single process and all electricity and gas transmission reviews into a single process in a manner that minimises regulatory costs and optimises the regulatory process.

- (d) There are repeated references⁹ to the benefits to distributors of 'regulatory certainty' without making any attempt to comment on any balancing benefits that may (or may not) accrue to energy users.

The EUAA and EAG acknowledge that policy and regulatory uncertainty is likely to have some influence on investment. However, a single focus on supply side investment impacts without consideration of consumer impacts creates an appearance of bias, or at least unbalanced focus, which is 'unhealthy' and ignores the Single Market Objective to promote '*efficient investment ... for the long term interest of consumers*'. Focusing solely on investors with unreasonable expectations (i.e. that differ from the reasonable expectations of

⁹ pp 11, 13, 19, 20 and 34, NERA *et al*.

efficient capital and debt markets) is undesirable and will serve only to increase costs to consumers¹⁰ and reduce the international competitiveness of the Australian economy. The MCE, AEMC and AER should not ignore the economy-wide investment that comes with good regulation.

The AEMC should be charged with a clear focus on policy development and regulatory practice that fosters investment by ‘efficient investors’, that is, those with reasonable expectations and who reasonably understand the relatively low investment risk associated with monopoly energy networks.

- (e) Lack of a responsible and a consistent approach in respect of the irrevocable nexus between service standards, including technical and safety standards regulated by ‘technical regulators’ – and ‘consumer service standards’ that are to remain with jurisdictions.

NERA *et al* separates ‘technical and safety’ standards, and argues these should remain *in the domain of the relevant technical regulators, rather than the economic regulator*,¹¹ while specification of ‘other’ service standards remain to economic regulators (and jurisdictions) – but refers only to ‘*inappropriate financial incentives for businesses to reduce costs at the expense of the standard of service provided*’ in the context of the ‘other’ standards.

The EUAA and EAG understand the desire to maintain a distinction between technical and safety standards that are enforced through legal sanction and service standards that are set at the discretion of regulators and/or governments through commercial incentives. However, our experience with numerous regulatory reviews is that technical and safety standards are a source of increasing cost pressures that have a significant bearing on economic regulation and that regulated businesses often make exaggerated claims about these costs. It is therefore imperative that the nexus be acknowledged and a path developed to ensure that the national regulator can make well informed assessments about the robustness of such claims.

The AEMC and/or the AER should also be given a role and powers in questioning the benefit to consumers of inconsistently applied, inadequate or costly ‘service standards’ imposed by Jurisdictional Direction (or even via technical and safety regulators).

- (f) There is no reference in the NERA *et al* paper to deficiencies in current connection agreement arrangements.

The ability to establish connection to electricity network with the terms and conditions of connection that are fair and cost-effective is important to energy users.

The EUAA has been concerned for a number of years about several problems with the current approach to energy network connection agreements. These concerns are based on the experience of EUAA members across all NEM jurisdictions (that are consistently relayed to the EUAA – and that been passed onto jurisdictional regulators and the ACCC without effecting any changes to date).

¹⁰ For example, Australian regulators – particularly the ACCC and Victorian ESC – continue to ignore evidence from financial markets that strongly suggest that lower values for the Market Risk Premium and Equity Beta could be adopted in their estimates of weighted average cost of capital. The inevitable result will be higher costs than might otherwise be achieved from investors with expectations that are consistent with financial markets.

¹¹ p. 30, NERA *et al*.

In the EUAA's experience it is a reasonable generalisation to say that these concerns apply equally across all jurisdictions, with the principal concerns as follows:

- standard or implied connection agreements used in each of the jurisdictions are vague, lack transparency, refer to nebulous (to energy users) material such as electricity supply legislation or "good electricity practice" and are weighted heavily in favour of energy networks;
- the agreements provide virtually no comfort to end users about what they can expect from energy networks in terms of service standards (other than in the most basic or vague terms);
- most of these agreement date back to the start of the NEM (or before), are outdated and need revision;
- some end users have tried to negotiate individual connection agreements with distributors but have generally found this to be a frustrating and not very constructive process; and
- the ability to negotiate connection issues needs revision and development of a framework (and protections) around which these matters can be more effectively negotiated (by end users) seeking to do so with distributors

The EUAA urges the MCE to consider these matters in the current review and put in place steps whereby the process of connection and development of connection agreements can be improved for end users. This would be consistent with the single market objective of the NEL.

The EUAA has previously made an application to the Advocacy Panel to assess these matters systematically and in more detail, but the Panel rejected the application. This proposal, if approved, would have allowed the EUAA to work closely with its members, other business users, regulators and the networks to assess connection issues. It would also have allowed us to provide better input on this matter to the AEMC.

4. Response to 'National' issues

This section of the submission provides comments on issues listed by the SCO that are clearly of importance to energy consumers. As noted above, the numbering is the same as that used in the SCO list.

1. Scope of distribution price regulation (services included, services excluded) – *determination of basic regulated services/core services which are to be included in price regulation.*

The EUAA and EAG are firmly of the view that costs and standards of the service must be subject to regulation where energy users cannot reasonably be expected to get services from providers other than the monopoly.

NERA *et al* propose a definition of a basic, or 'core', regulated service as:

being a natural monopoly service, access to which promotes competition in a related market. However, the scope of this core service is deliberately limited under the definition, so that other services that may also be provided by the distributor can either be excluded completely from regulation, or regulated on a more 'light handed' basis than the price cap applying to the core distribution service.¹²

Accordingly, NERA *et al* propose criteria for exclusion (from 'price cap' regulation as 'core services') where:

- (i) the service is a natural monopoly (uneconomic to duplicate) BUT access to the service is not expected to promote competition in a related market; or*
- (ii) the service is either one for which there is or is likely to be effective competition OR for which it is expected that, absent regulation, there would be effective competition.¹³*

There should also be a requirement for the AER to demonstrate that competitive provision of service is likely to deliver a net economic benefit to consumers. Competition for the sake of competition, but without effective economic power being available to consumers is unlikely to benefit consumers.

There should also be a requirement for both the AER and energy utilities to clearly and transparently disclose the full range of charges applying to each consumer in a consistent and integrated way. This would overcome the deficiency that exists currently where tariff prices are published, and presented, separately to non-tariff prices. This has led to outcomes that are misleading. For example, Victorian electricity distributors have been required to produce Annual Tariff Reports since 2001 (and from 2006 will be required to also produce a 5-yearly Tariff Strategy Report). However, the Tariff reports contain no information at all on Excluded Service Charges, even where such charges may be imposed on all consumers subject a particular tariff.¹⁴

A further and related issue is that regulatory approval processes for 'price cap' tariff charges and non-tariff charges must be made consistent. Currently, all regulators maintain two separate processes for approval of tariff prices, which are generally audited to ensure consistency with price adjustment formulae, and non-tariff prices, which are generally *ad-hoc* and may not be subject to public disclosure (and have not been in Victoria).

2. Price cap regulation for distribution services - *CPI-X price or revenue cap (or some incentive-based variant) form of regulation.*

NERA *et al* (and/or the SCO) overlook the constraint imposed by the Victorian Electricity Supply Industry Tariff Order. Clause 5.10(a) of the Tariff Order requires the regulator

¹² p15, NERA *et al*.

¹³ p16, *Ibid*.

¹⁴ A specific example is United Energy's interval meter, time-of-use tariffs. United's Tariff report states that these tariffs offer benefits to consumers because there is no Fixed Charge component. But United is also permitted (and does) impose a fixed annual Excluded Service Charge for the interval meter, and that charge is at a higher rate than the 'standard' two-part tariff Fixed charge.

It is not yet clear that the ESC's revised obligations on tariff/price reporting will clarify such issues.

(specified as the ORG in the latest version) to *utilise price based regulation adopting a CPI-X approach and not rate of return regulation*. The Victorian ESC Appeal Panel and the Victorian Supreme Court have determined that the ‘tariff basket’ form of price cap regulation (with ‘side constraints’) implemented by the ORG in 2000 and confirmed by the ESC in its recent Determination is an acceptable form of ‘price based regulation’.

Similar, but slightly different versions of that same approach have been implemented for electricity distribution in the NSW (in 2004),¹⁵ and South Australia;¹⁶ and in the Victorian and NSW gas distribution sectors. The ACT and Queensland retain revenue caps, although the arrangement in Queensland include a high degree of ‘regulatory tinkering’, including *an ‘unders and overs account’, review triggers based on maximum demand and customer numbers and cost pass-through for major unexpected changes and certain additional capex*.¹⁷ The Tasmanian energy regulator (OTER) set final retail prices in its 2003 review, which included distribution prices based on a simple revenue cap because *‘Aurora is not in a position where a tariff basket approach or a revenue formula, which specifically accounts for load growth, could be adopted, and is thus satisfied with the current modified revenue cap’*.¹⁸

Given the amount of ‘regulatory energy’ committed to debate and discussion on the ‘form of regulation’, it would seem to be a ‘done deal’ that a ‘tariff basket’ price cap approach be adopted for all distribution services will take Australia closer to ‘best practice regulation’. The two provisos being that the distributors’ affairs (and pricing policies) are up to the task and recognition that adopting a uniform application of a ‘tariff basket’ price cap creates a

¹⁵ The Independent Competition and Regulatory Commission decided in 2004 to continue to apply a revenue cap to ActewAGL’s prescribed electricity distribution services. (see p 19, *Final decision, Investigation into prices for electricity distribution services in the ACT*, ICRC, March 2004).

¹⁶ See: p. (iii), *2005 - 2010 Electricity Distribution Price Determination, Part A - Statement of Reasons*, Essential Services Commission of South Australia, April 2005.

The ESCoSA does not use the term ‘tariff basket’ in its recent Determination. The form of price control applied in South Australia was specified by Government in the Electricity Pricing Order, and appears to have remained unchanged. It is clearly a ‘price cap, not a ‘revenue cap’ and the process of the price control is described by ESCoSA as:

- *The Price Determination results in an initial one off adjustment of prices on 1 July 2005, which is a reduction in the average revenue that ETSA Utilities can recover across all customer groups of approximately 4%. Following this, the average revenue will change by the CPI each year commencing 1 July 2006.*
- *Once this yearly adjustment has been made to the average revenue controls, ETSA Utilities is required to determine its distribution tariffs, such that they recover no more revenue than allowed for by this Price Determination.*
- *The Price Determination proposes a tariff rebalancing constraint of CPI+2.5% for all tariff components, together with an additional constraint that the supply charge of a residential distribution tariff cannot increase by more than \$5 per year.*

That is, individual tariff prices can be adjusted independently provided the total revenue remains below the forecast ‘average revenue’, and the ‘side constraints’ are observed. This appears to be functionally identical to the ‘tariff basket’ process implemented by the ORG/ESC and IPART.

¹⁷ p. (i), *Final Determination - Regulation of Electricity Distribution*, Queensland Competition Authority, April 2005

¹⁸ p. 100, *Investigation of Prices for Electricity Distribution Services and Retail Tariffs on Mainland Tasmania - Final Report and Proposed Maximum Prices*, Office of the Tasmanian Energy Regulator, September 2003.

It is also noted that OTER concluded that *‘a tariff basket would be the preferred means, but, in the absence of distribution tariffs, a revenue formula control is preferable to a revenue cap. However, the Regulator recognises a number of practical issues that would need to be addressed in developing a revenue formula.’* (see p. 97)

basic conflict between the way regulation is implemented for transmission (through revenue caps) and distribution services (mainly price caps).

In addition, it will be necessary to deal regulatory ‘tinkering’ with the ‘tariff basket’ formulae to address each jurisdictional regulator’s preferred ‘side constraint’ (that rate at which individual tariff prices may be adjusted); and deal with the fact that a number of regulators (notably the Victorian ESC, ESCoSA and IPART) have also added jurisdictional-specific ‘incentive Factors’ that are intended to ‘bribe’ the regulated utility to do something that is supposed to deliver an efficiency benefit.¹⁹

The benefits attributed to the ‘tariff basket’ approach are, essentially, that it provides:

- a direct commercial incentive for regulated entities to reasonably forecast business conditions (including their costs and consumer demand for services);
- a direct commercial incentive for regulated entities to link unit prices for each regulated tariff component to underlying costs; and
- a ‘self-compensating’ mechanism that adjusts for the financial effects on the regulated entity from differences between forecast and actual demand for services within a regulatory period.

As experience showed in the NSW electricity distribution sector in the period between 1999-2004, these are not attributes of a (hybrid) revenue cap arrangement.²⁰

However, the ‘tariff basket’ approach is no guarantee that regulation will be effective or protect/promote the long term interests of consumers. Poorly constructed forecasts can still create problems for regulated entities and regulators. A forecast of consumer demand and/or costs that is not robustly based could still result in a (presumably unexpected) shortfall in revenue for the regulated utility. An alternative, and more likely, outcome is for significant over recovery of regulated revenue (which would be retained by the regulated entity as what is euphemistically called an “efficiency gain”) that would present the AER with a serious challenge in appropriately separating ‘strategic behaviour’ from reasonable demand/cost trends under the revenue building block approach.²¹

¹⁹ For example, the Victorian ESC has an ‘S-Factor’ and an ‘M-Factor’; ESCoSA has a ‘P-Factor’; and IPART has a ‘D-Factor’ – and differing approaches to addressing ‘efficiency carryover’.

²⁰ NSW electricity distributors substantially under-forecast both costs and energy sales– and more importantly peak demand growth – from 1999 through 2004 as part of IPART’s 1999 Determination process. This problem was compounded when IPART selected inappropriate parameters as primary cost drivers to be included into the ‘hybrid revenue cap’ formulae. As a result, the NSW distributors faced substantially higher costs than forecast that could not be compensated directly through the price control mechanism. IPART responded in its 2004 Determination process by implementing a (more effectively self-compensating) ‘weighted average tariff basket’ price cap regime and allowed for very much higher expenditure than indicated by the 1999-2004 trends for each distributor.

²¹ The Victorian ESC confirmed the challenge that ‘strategic behaviour’ presented during the recently completed review of electricity distribution services. Neither the EUAA nor the EAG is any doubt that the ESC’s Final Determination failed to adequately address this challenge in that it significantly increased expenditure for each of the distributors (which will now be paid for in higher charges than would otherwise have prevailed).

3. Regulatory requirements in relation to tariff settings – Tariffs for small customers which should lie between the incremental cost (lower bound) and the stand-alone cost (upper bound) of serving them.

NERA *et al* propose the following five principles in relation to tariff setting:²²

- (i) *tariffs (sic)²³ for individual customers should lie between the incremental cost (lower bound) and stand-alone cost (upper bound) of serving them;*
- (ii) *the allocation of fixed or common costs should be transparent;*
- (iii) *there should be constraints on the extent to which tariffs can be changed year-on-year;*
- (iv) *distributors should be permitted to give discounts on published tariffs where this reduces costs for all customers, compared to a situation in which discounts were not allowed. Distributors should be allowed to recover the revenue foregone as a result of such discounts from other customers; and*
- (v) *tariffs should take into account any explicit jurisdictional policy requirements as set out in the Jurisdictional Direction.*

It is acknowledged that NERA *et al*'s principles (i) and (ii) are generally considered (by regulators) to be the least controversial in that they are either universally applied by jurisdictional regulators (principle (i)) and/or logical or simple common sense (principles (i) and (ii)).

The EUAA and EAG accept that, as a general principle, there is nothing wrong with requiring tariffs to be within the so called *Baumol band* described in principle (i) above. This principle aims to achieve the goal of ensuring there is no 'economic cross-subsidy', but does little else.

The EUAA and EAG also accept that there can never be strictly specified procedures for cost allocation and pricing that will always deliver a 'fair and reasonable' outcome for all utility network users. It is simply not practical to do this where significant costs must be shared between 'classes' of consumers with similar consumption behaviour. It is an inevitable fact in pricing practice that judgements (and even arbitrary decisions) form some part of cost allocation and pricing processes - even at the most basic cost accounting level. Nevertheless, this needs to be exercised wisely, consistently and robustly.

However, the EUAA and EAG are concerned that allowing prices to be set within the very wide 'Baumol' band allows DBs to 'play games' with tariffs that can and does lead to outcomes that are not 'fair and reasonable' for some energy users.

In effect, this band is so wide as to provide virtual *carte blanche* in terms of scope for monopoly pricing abuse. This is especially the case where the monopoly provider is permitted substantial discretion over cost allocation practices and tariff designs. It is the EUAA and EAG view that it can be safely assumed that such providers will have strong

²² NERA *et al*, p 28.

²³ The correct tem should be 'tariff revenue'.

incentive to maximise the ability to exploit this "discretion" in their favour. It would be naive of regulators and the MCE to assume otherwise.

Hence, there is a need to apply any such principle with the added protection (for end users) of constraints on the use of such discretion through appropriately modified pricing principles, greater and more effective consultation with users about tariffs and tariff changes, an unambiguous obligation for full disclosure (and explanation) of pricing policies, practices and procedures and some right to seek recourse to an 'umpire'.

NERA *et al* support application of principle (iii) on the basis that it:

*recognises that there is a very wide range between the upper and lower bounds established under (i), within which distributors are free to set tariffs. It would not be desirable for tariffs to fluctuate widely from year to year, as this would make it difficult for customers to make decisions predicated on future energy prices.*²⁴

The EUAA and EAG generally support this principle for the reason offered by NERA *et al* and also because it is highly undesirable to allow regulated monopolies the latitude to 'fluctuate tariffs widely from year to year'. However, there have been circumstances where regulators have allowed, even encouraged, 'one-off' adjustments to tariff prices to 'accelerate' tariff restructuring. For example, the ORG 'encouraged' Victorian distributors to use the opportunity offered by substantial *Po* reductions in 2000 (that greatly exceeded the *CPI*+2% 'side constraint' on individual tariff components that applied in the regulatory periods both before and after) to facilitate tariff restructuring (although, as indicated above, only United Energy took any 'bold' initiatives in this area).

There may also be overall benefit to consumers to allow (or require) greater latitude where a utility or regulator identifies circumstances where clearer (or stronger) signals/incentives may allow consumers to make rational long term decisions about their energy consumption choices. A specific current example is pricing that signals the increasing cost of air conditioning use. It is beyond doubt that current two-part tariffs are manifestly ineffective in signalling to consumers the costs they impose on the electricity system from infrequent air conditioning use. Some estimates put the 'hidden cross subsidy' in favour of air conditioning users at hundreds of dollars per year for a typical 'small' (2-3kW electrical load) split system refrigerative unit, possibly running to a thousand dollars or more for the largest 'whole of house' refrigerative systems (that can exceed 20kW electrical load).

The EUAA and EAG recognise that this is as much a matter of tariff design as pricing constraints, which suggests the NERA *et al* principles be extended to require distributors to also abide by a principle that tariff prices reflect increasing peak load costs, which the Victorian ESC expressed as '*each distribution tariff should signal the impact of additional usage on future investment costs.*'²⁵

Hence, unfettered and unqualified support for principle (iii) is unwise and likely to result in serious distortions.

²⁴ NERA *et al*, p 28.

²⁵ p. 465, *Electricity Distribution Price Review 2006-10, Final Decision Volume 1 - Statement of Purpose and Reasons*, Essential Services Commission, October 2005.

NERA *et al*'s principles (iv) and (v) are problematic and inimical to achievement of 'best practice regulation'.

The EUAA and EAG accept that circumstances may arise where consumers overall may be better off if one particular customer is 'encouraged' to stay connected to a network by a specific pricing discount (principle (iv)). But given the natural negotiating advantage that monopoly entities have, there may also need to be specific regulatory scrutiny of such 'deals' to ensure both the consumer being offered the 'discount' and all other consumers' interests are being considered. For example, a gas or electricity distributor with a financial interest in an embedded generator may seek to offer a 'discount' to that generator – and recover the foregone revenue from other consumers.

However, the 'need' for and 'form' of regulatory scrutiny must be conditioned by the possible 'dead hand' effect of involving regulators in any negotiation process. It is the EUAA and EAG's firm view that principle (v) should be qualified by the condition that the jurisdictions demonstrate that consumers gain a positive net economic benefit from any constraint specified in a Jurisdictional Direction.

4. Service performance targets – *Service reliability, service quality and customer service measures.*

As noted in item (e) in section 3 above, there is a lack of consistency in the consultation paper about the irrevocable nexus between service standards, including technical and safety standards and 'consumer service standards', and the cost of providing regulated services.

Other aspects of NERA *et al*'s proposals are generally supported by the EUAA and EAG. In particular, EUAA and EAG agree that:

*'The issue of service performance targets is closely linked to cost and therefore pricing. Effective enforcement of (non-safety related) service standard regimes is likely to be linked closely to allowed revenues. Where performance targets (accepted and/or set by the AER) are not met, penalties would apply. In addition, there may be reward incentives for improvements above the average service performance targets set by the jurisdiction, or if not set by the jurisdiction, set by the AER, where the value of those improvements to customers is greater than their cost.'*²⁶

However, it will be extremely important for the AEMC and AER to ensure that consumers are effectively involved in establishing the value of any incentive for performance improvements and the mechanism by which that value is transferred to (or from) the distributors.

The Victorian ORG implemented a service incentive mechanism in 2000 through a so-called '*S-Factor*' incentive that incorporated the 'reward/penalty' mechanism as a parameter in one of the 'tariff basket' formulae.²⁷ This proved to be totally opaque to consumers, with the

²⁶ p. 32, NERA *et al*.

²⁷ The Victorian regime has four forms of 'service incentive'; the '*S-Factor*' (for reliability and interruptions); a Guaranteed Service Level (GSL) payment scheme (for appallingly bad service); an 'appliance surge damage' compensation scheme (where uninsured small consumers are compensated for damage caused by voltage fluctuations); and a 'competition by comparison' performance reporting scheme. It is not at all clear how each of these schemes contribute to service performance enhancement, but there is evidence to suggest

ESC unable to provide any estimates of the annual or total value paid either to or by distributors. The ESC made some effort to refine and improve the transparency of the ‘S-Factor’ scheme applying for the five years from 2006.

However, the scheme remains highly complex and is now based partly on a very high values attributed to ‘Value of Customer Reliability’ in a poorly crafted survey undertaken by CRA for VENCORP in 2002.²⁸ The EUAA and EAG also note that there was no direct, or effective, involvement of consumers in design or interpretation of the CRA survey. Nor did the ESC show any inclination to take note of the criticisms offered by consumer groups of the CRA survey.

The Victorian scheme, which is the most advanced in the NEM, also remains focussed on the impact of averages, which masks pockets of poor service; there is no attention to specific needs of large users; and the ‘incentive’ is for DBs to focus only on locations or service measures identified in the incentive mechanism, but not others that are excluded. End-users also consider it legitimate to ask why distributors (and other service providers) should get an incentive to improve service on average (when they should be providing that anyway). There is also a problem that arises because the ‘incentive’ mechanisms generally rely on (relatively) simple service quality parameters, such as System Average Interruption Duration Index (SAIDI – or average minutes off supply) that are ‘easy’ to measure but have little relevance to consumer impact, while limited attention is paid to other quality of supply measures that have substantial effect on productive use of electricity. An appropriate analogy is that all end-uses get plain vanilla (service) when some prefer different flavours;

5. Information disclosure – Rules that define the information that must be provided to AER by distributors for regulatory functions.

The EUAA and EAG are firmly of the view that effective and enforceable rules that define the information that must be provided to the AER must be established. These rules must provide reliable and verifiable information about the actual costs incurred in providing services, including for un-regulated activities, and the levels of service performance.

The rules should limit discretion as tightly as is reasonably possible. This would appear to be the only way of minimising the exercise of ‘strategic behaviour’ and/or regulatory confusion over information disclosure. Two examples are offered in support of this suggestion.

that the performance of Victorian distributors has generally improved (or got no worse), while some service performance attributes have declined in NSW and Queensland where more limited and political regimes exist.

²⁸ The ESC notes (p 87 of the Final Decision) that ‘the study was undertaken by Charles River Associates (CRA) for VENCORP and indicates that the value that Victorian customers place on reliability is the state-wide VCR of \$29 600 per MWh (CRA 2002). Its results remain current, and they are similar to a Monash study conducted in 1997 at a state-wide level.’

However, the MCE should note that segmented results obtained by CRA differed dramatically to the VPX-Monash survey. For example, the value of VCR attributed to the Residential sector was 15 times higher in the CRA study than the Monash study (see Tables 3 and 4, pp 5-6, *Assessment of the Value of Customer Reliability (VCR)*, Charles River Associates (Asia Pacific) Pty Ltd, December 2002.

It is inconceivable that Residential consumers’ perceptions of value would be so volatile, which is in itself reason to question to robustness of the CRA/VENCORP report (and the general methodology).

The first relates to the use made by Victorian electricity distributors of ‘related parties’. The ESC reported in its (recent) Final Determination that four of the five distributors had entered into asset management and other service contracts with ‘related parties’ through arrangements other than ‘arms length’ competitive tendering. In one case involving United Energy, the distributor declined to provide information on the actual efficient cost in providing services for ‘regulated activities’, which led to the ESC issuing a legal notice to provide the relevant information. The distributor appealed the notice, which was upheld by an Appeal Panel.

What is of direct relevance is that the distributor claimed that it was impractical to provide the information requested by the ESC within the time available. Indeed, it asserted in evidence to the Appeal Panel that:

- *it would take between 16, 382 days and 228 days to examine file registries which contain millions of pages of documentation identifying the documents that were required.*
- *it did not keep accounts that identified the profitability of individual customers or contracts.*
- *it provided virtually all of the regulatory services required including the preparation of the regulatory accounts that utilised many of the terms used in the Notice. The balance of the terms were shown to be in common parlance or used by accountants.²⁹*

It is of concern to the EUAA and EAG that ‘efficient costs’ that would have been useful to the ESC were not available. Even though the ESC subsequently made its own estimates of ‘efficient costs’ for United, this is not the same as getting a regulated entity to disclose its costs and shows the importance of effective information disclosure powers.

It appears to the EUAA and EAG that the only way to address this area is to place requirements on and explicitly limit the discretion provided to regulated entities – and their related parties - in recording and reporting financial and service performance.

The second example relates to IPART’s use of system reliability performance data to assess the performance of NSW distributors during the most recent NSW electricity distribution price review. In this case, IPART used information sourced from the Electricity Supply Association of Australia to compare system reliability performance of NSW and Victorian distributors that led IPART to conclude that “(g)enerally, NSW customers experienced smaller number of outages (SAIFI) and shorter duration (SAIDI) per annum than the customers in Victoria. However, on average each outage experienced by a NSW customer was longer than Victoria over the period as reflected in CAIDI.”³⁰ However, the data from the ESAA was not consistent with data in the Victorian ESC Performance Reports or data in IPART’s own Price and Service reports.

Both examples emphasise the need for regulators to be very specific about information and to be diligent in ensuring it is provided in a form that suits the purpose intended.

²⁹ *Statement of Reasons for Decision*, Essential Services Commission Appeal Panel, Reference E2/2005. 12 September 2005. (See: ‘ESC Appeal Panel Decisions’, A-Z Index at <http://www.legalonline.vic.gov.au/CA2569020010C266/Homepage>).

³⁰ p. 187, IPART Draft Report

In addition, the experience of past regulatory reviews and suggest the need for strong information powers and penalties for non-compliance if regulation of energy networks is to be effective. In the past, powers have been far too weak and regulators have also sometimes been far too lenient with regulated businesses in regards to information provision and its timeliness.

6. Connection and capital contributions requirements – *basis for the distributor to charge for new connections and capital contributions for capital works.*

The EUAA and EAG generally endorse the approach recommended by NERA *et al* that distributors be prevented from ‘double-dipping’ and recovering the cost of assets paid for by consumers (or government). We note that this has been a contentious area with several of our members and it is not always obvious that they have received a fair deal or fair treatment. Further comments will be provided in the final submission to the SCO.

7. Distribution network expansion rules – *rules clarifying when extensions are part of a regulated service and how charges are levied on a national basis.*

The EUAA and EAG generally endorse the approach recommended by NERA *et al* that regulators separately consider issues associated with non-contiguous extensions to distribution networks. Further comments will be provided in the final submission to the SCO.

8. Distributor obligations to provide connection services – *distributor to provide connection and related services to users; the contractual relationship between distributor, retailer and end-use customer.*

The EUAA and EAG generally endorse the approach recommended by NERA *et al* that a clear relationship be retained between distributors and end-use consumers. This issue is critically important for large consumers, and given the substantial ‘intervention’ powers granted to distributors under technical and safety regulators, equally important to small consumers. Further comments will be provided in the final submission to the SCO.

9. Distributor disconnections and reconnections of small end-customers – *regulation of circumstances in which a distributor can disconnect or reconnect a small end-user customer and circumstances in which a retailer can arrange a disconnection.*

The EUAA and EAG generally endorse the approach recommended by NERA *et al* that connection/disconnection of small consumers continue to be subject to regulation.

Consideration also needs to be given to the powers that distributors have in ‘tariff assignment’ for newly connecting and re-connecting consumers. For example, the Victorian ESC recently relaxed constraints on tariff re-assignment following installation of interval meters, which is very likely to result in large numbers of small consumers being assigned (eventually) to higher cost, time-of use tariffs. While the EUAA and EAG to not oppose wider application of such tariffs, some care is required to ensure that small consumers understand the implications of such tariffs – and the powers granted to distributors in respect of ‘compulsory re-assignment’. Further comments will be provided in the final submission to the SCO.

10. Distributor interface with embedded generators – regulation of relationship between electricity distribution businesses and embedded generators.

This is a particular issue that the EUAA and EAG intend to comment on in detail in the final submission to the SCO. The position presented by NERA *et al* is overly simplistic and ignores a range of issues that will impact on both large and small consumers who choose to invest in embedded generation.

11. Distributor interface with retailers – regulations relating to dealings between retailers and distributors including use of system agreements.

The EUAA and EAG generally endorse the approach recommended by NERA *et al* that regulators oversee (and determine) minimum terms and conditions for use of system agreements, particularly given the potential impact these terms and condition will have on end-use consumers. Further comments will be provided in the final submission to the SCO.

12. Other distribution related market rules.

The EUAA and EAG generally endorse the approach recommended by NERA *et al*. Further comments will be provided in the final submission to the SCO, where warranted.

13. Network planning – determination of network investments.

It is not entirely clear to which part of the consultation paper this item refers. However, the regulatory treatment of forecast investment and actual investment is a crucial issue that impacts substantially on costs borne by consumers. Accordingly, it is an issue that will be dealt with in detail in the final EUAA and EAG submission to the SCO.

14. Metering – obligations to install, maintain and read meters. Includes the rights in relation to entry of premises for metering purposes.

The EUAA and EAG agree with NERA *et al* that issues associated with metering are complex and must be given detailed consideration. Reference is made above to the particularly poorly conceived initiative by the Victorian ESC to mandate roll-out of manually read interval meters.

The right to enter premises has often been a contentious issue for EUAA members with some expressing a strong view that the playing field remains to stacked in favour of the networks and that they need to be able to exercise more control over entry and activities on their premises. The weaknesses in existing connection agreements, including so-called ‘implied’ agreements in all jurisdictions is relevant here.

Further detailed comment on the issues raised by NERA *et al* will be provided in the final submission to the SCO.

15. Retail price regulation – relates to the model to be developed by the Commonwealth.

Again, it is not entirely clear to which part of the consultation paper this item refers. The essential thrust of the policy initiatives agreed by the MCE is to exclude retail price regulation from the national arrangements. As noted above, the EUAA and EAG consider this to be a substantial shortcoming and a clear failure by the MCE to meet its own stated objectives of creating a national market. There is substantial evidence that current

jurisdictional arrangements are unsatisfactory. Accordingly, the EUAA and EAG will address this issue in more detail in the final submission to the SCO.

- 16. Retailer obligation to supply to small end-customer – *obligations on designated retailers (local retailers) to supply customers and minimum protections in terms and conditions of default/standing offers.***
- 17. Retailer failure arrangements – *arrangements to ensure the continuity of energy supply to customers and integrity of wholesale market settlements.***
- 18. Retailer: Small end-customer market contracts – *retailers must obtain informed customer consent to enter Market Contracts.***
- 19. Retailer: Small end customer marketing – *regulation of marketing conduct of energy retailers.***
- 20. TPA and Privacy Act provisions relevant to market contracts and marketing.**
- 21. Other retail related market rules not covered elsewhere.**

Each of the issues listed in items 16 through 22 will be dealt with as warranted in the EUAA and EAG’s final submission to the SCO. It is clear there are issues that need to be dealt with nationally in respect of the relationships between small consumer and retailers. A clear focus of any further policy initiatives must be to achieve the Single Market Objective in the context of a competitive retail energy market.

- 22. Balancing regime and settlements, effecting customer transfer in balancing and settlements system – *regulation to ensure settlements and accurate financial reconciliation of supply/consumption transactions and regulate churn of contestable customers.***

This issue will be dealt with in the EUAA and EAG’s final submission to the SCO.

23. Merits and judicial review.

The EUAA and EAG believe this to be a crucially important issue. The current arrangements have the effect of excluding consumers from review/appeal processes, either explicitly or because of lack of resources to support their participation. Given the cost impacts on consumers that can arise from the outcomes of a review process, this is totally unacceptable and must be resolved by the MCE.

Both organizations have also made separate and detailed submissions on this matter in the context of the MCE’s consultation on Review mechanisms for regulatory decisions.

5. Response to ‘States/Territories’ issues

- 24. Business authorisation – *refers to licensing and authorisation schemes that require distributors to demonstrate technical capability.***

25. **Distributor – Small end-consumers dispute resolution – *distributors’ requirement to have internal dispute resolution schemes for the small end-customers and participate in independent alternative dispute resolution schemes.***
26. **Retailer – Small end-customer dispute resolution – *obligation of retailers to have internal dispute resolution/record keeping procedures and participate in independent alternative dispute resolution schemes.***
27. **Load Shedding and curtailment – *rules for reduction of supply of energy to customers in order to maintain system security.***
28. **Community Service Obligations – *jurisdictionally based service obligations applied on distributors and retailers.***
29. **Environmental obligations – *relates to jurisdictionally based greenhouse gas abatement schemes and consideration of demand side response.***
30. **Local gas market arrangements.**
31. **Fair trading legislation provisions relevant to market contracts and marketing.**

Each of the issues listed in items 24 through 31 will be dealt with in the EUAA and EAG’s final submission to the SCO.

6. Response to issues proposed for ‘Abolishment’

32. **General business authorisations (licensing) for retailers and distributors – *includes any matters other than technical capability and safety.***
33. **Taxes and levies – *jurisdictionally based which are linked to energy services.***
34. **Redundant regulatory instruments – *recognising that some requirements may have been incorporated elsewhere.***

Each of the issues listed in items 32 through 34 will be dealt with in the EUAA and EAG’s final submission to the SCO.