COMPLIANCE AUDIT FRAMEWORK FOR THE ELECTRICITY SECTOR

DISCUSSION PAPER

April 2004

ELECTRICITY

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REQUEST FOR SUBMISSIONS

The Essential Services Commission of South Australia ("the Commission") invites written submissions from interested parties in relation to the issues raised in this paper. Written comments should be provided by **11 June 2004**. It is highly desirable for an electronic copy of the submission to accompany any written submission.

It is the Commission's policy to make all submissions publicly available via its website (www.escosa.sa.gov.au), except where a submission either wholly or partly contains confidential or commercially sensitive information provided on a confidential basis and appropriate prior notice has been given.

The Commission may also exercise its discretion not to exhibit any submission based on their length or content (for example containing material that is defamatory, offensive or in breach of any law).

Responses to this paper should be directed to:

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1. INTRODUCTION

This discussion paper proposes an approach to compliance auditing for entities holding licences issued by the Commission under Part 3 of the *Electricity Act 1996 (SA)* ("Electricity Act"). Such entities are bound by licence conditions, including the terms of relevant Codes made by the Commission under the *Essential Services Commission Act 2002 (SA)* ("ESC Act"). The Commission believes it is important to establish a robust framework to ensure that licensees maintain high levels of compliance with such regulatory obligations.

The paper describes the compliance framework already established by the Commission for electricity licensees under its Electricity Industry Guideline No. 4, "Compliance Systems and Reporting"[1] ("Guideline No. 4"). This framework places a significant emphasis on compliance reporting, and the development of effective compliance systems, by licensees. However, compliance reporting may be supplemented as appropriate by compliance auditing, undertaken either by the Commission or by the licensee.

The Commission has periodically used compliance audits to investigate specific areas that it believed warranted such review. The paper proposes a more rigorous approach to the conduct of compliance audits, involving careful consideration of the audit scope, appointment of the auditor, conduct of the audit, and reporting the results of the audit. Compliance audits would not be undertaken in the absence of a strong rationale for such action, including the significance of the regulatory obligations that are the subject of the audit, and the risks associated with non-compliance with those obligations.

The paper also discusses several possible areas of application of this compliance audit framework, including quality assurance of performance data provided by certain licensees, as well as compliance with regulatory obligations arising from the commencement of electricity Full Retail Contestability ("FRC") in South Australia on 1 January 2003.

The Commission emphasises that the development of such a compliance audit framework does not represent a fundamental change in the Commission's overall approach to compliance matters, which will continue to be based on the periodic receipt of compliance reports from licensees. The release of this discussion paper provides an opportunity for stakeholder comment on the nature of, and potential application of, the compliance audit framework proposed in the paper.

[1] It is proposed that a similar Guideline be introduced in the South Australian gas industry.

2. COMPLIANCE FRAMEWORK

This section of the discussion paper describes in detail the current compliance framework established by the Commission for the electricity supply industry, including the role of compliance audits within that framework. It proposes a more structured and robust approach to the conduct of compliance audits on issues of critical regulatory importance that complements, and provides verification for, the existing compliance reporting framework. To this end, the section sets out the process and criteria by which critical compliance issues will be identified and audited, as required.

2.1 Legislative basis

The compliance framework adopted by the Commission for the electricity supply industry has a strong legislative basis.

The ESC Act specifies that the functions of the Commission include the monitoring and enforcement of compliance with, and promotion of improvement in, standards and conditions of service and supply under relevant industry regulation Acts (ESC Act, s. 5(1)(b)); and, in appropriate cases, the prosecution of offences against the ESC Act or a relevant industry regulation Act (s. 5(1)(i))[2]. This and other functions are undertaken by the Commission with the primary objective of ensuring that the long-term interests of consumers with respect to price, reliability and quality of electricity supply are protected.

The Electricity Act and regulations specify in more detail the compliance and enforcement powers of the Commission in relation to the electricity supply industry.

The objects of the Electricity Act include the establishment and enforcement of proper standards of safety, reliability and quality in the electricity supply industry (s. 3(c)). Part 3 of the Electricity Act establishes the Commission's licensing powers for electricity entities undertaking generation, transmission, distribution, retail and system control operations, and provides that the Commission may make such licences subject to appropriate conditions.

Part 3 also establishes various mandatory licence conditions for different classes of licences (ss. 21-24). Such conditions include compliance with the terms of applicable Industry Codes or rules made by the Commission under Part 4 of the ESC Act (s. 21(1)(a)) and a requirement that licensees have all or part of the operations authorised by the licence audited and to report the results of the audit to the Commission (s. 21(1)(e)).

[2] The ESC Act also provides a system of warning notices to be issued by the Commission in relation to a person considered to be guilty of a contravention of the ESC Act (s. 40) and for the District Court of South Australia to grant an injunction requiring such a person to take specified action to remedy any adverse consequence of conduct considered by the Court to constitute a contravention of the Act (s. 42).

The Electricity Act specifies that a licensee must not contravene a condition of its licence and establishes a maximum penalty of $1 million for such a contravention (s. 25(1)). Part 7 of the Electricity Act deals with certain matters of enforcement and establishes a system of warning notices and injunctions similar to that of the ESC Act.

Given this legislative basis, the Commission views its compliance and enforcement functions as being a vital aspect of its regulatory role in the electricity supply industry. In particular, without a strong approach to compliance matters, the licensing system as established under Part 3 of the Electricity Act will be largely ineffective.

The general approach of the Commission to compliance matters is to require that licensees provide regular reports in a specified format concerning compliance with licence obligations (including compliance with applicable Codes), and that certain obligations be the subject of compliance audits from time to time. All licences issued by the Commission include a specific condition dealing with compliance matters. This condition has the following general form:

- The licensee must undertake periodic audits of the operations authorised by the licence and of its compliance with the obligations under the licence and any applicable Codes in accordance with any guideline issued by the Commission for this purpose;
- The results of such audits must be reported to the Commission in a manner outlined in such a guideline;
- The licensee must also conduct any further audits as required by the Commission, and the results of such audits must be reported to the Commission, in a manner approved by the Commission;
- The Commission may require the licensee to use an independent expert approved by the Commission to conduct such audits.

Sections 2.2 and 2.3 below outline the approach to compliance reporting and auditing established by the Commission for the purposes of this licence condition. This paper does not discuss the Commission's approach to enforcement matters. The reader may wish to refer to the Commission's Enforcement Policy[3], available from the Commission's website.

2.2 Compliance reporting

The Commission's approach to regulatory compliance reporting and auditing is set out in Guideline No. 4[4], available from the Commission's website. It specifies the Commission's

[3] This policy is currently being updated to incorporate additional regulatory functions of the Commission in industries other than electricity and gas.

[4] It is proposed that a similar Guideline be introduced in the South Australian gas industry.

requirements for the reporting of compliance. This approach is aimed at minimising costs and disruptions to licensees, while ensuring that compliance systems exist and operate efficiently and effectively. The obligation for licensees to comply with Guideline No. 4 is established through the general licence condition referred to in section 2.1 above. Guideline No. 4 was introduced in June 2000 and has been modified on several occasions since that time.

Guideline No. 4 requires that all licensees provide regular compliance reports to the Commission that:

- List applicable regulatory obligations;
- Testify that the licensee has a sound and effective compliance system to address compliance with those regulatory obligations;
- Report any non-compliances of the applicable regulatory obligations; and
- Briefly address the impact of such non-compliances on consumers and other entities as well as the implications for the effectiveness of the licensee's compliance system.

The compliance reporting procedure established by Guideline No. 4 is based on a requirement for licensees to provide immediate, quarterly and annual compliance reports to the Commission as follows:

- An immediate report is to be provided as soon as a licensee becomes aware of a breach of a Type 1 obligation as specified in Guideline No. 4. Type 1 obligations relate to breaches (e.g. material breach of an applicable Code[5], inability of the licensee to continue the operations authorised by the licence) which are deemed to require urgent reporting to the Commission. Immediate reports must be signed by the Chief Executive Officer (or equivalent) of the licensee.
- Quarterly reports (applicable only to distribution and transmission licensees) relate to Type 2 obligations as specified in Guideline No. 4, and must also be signed the Chief Executive Officer (or equivalent).
- Annual reports relate to compliance with Type 3 obligations for each financial year as specified in Guideline No. 4, and must be approved by the licensee's Board after signing by at least two Directors of the licensee (one of whom is an External Director as defined in Guideline No. 4) or by an independent and external auditor as approved by the Commission[6].

The requirement for Board approval of annual compliance reports reflects the importance that the Commission attaches to the credibility of the compliance reporting scheme as an alternative to external, independent audits. The Commission does not believe that the

[5] Clause 2.4 of Guideline No. 4 comments on the Commission's view as to what might constitute a material breach. It will be determined in part by the impact of the breach on consumers including financial impact, number of consumers affected and the impact on safety and risk to the public.

[6] Clause 3.1 of Guideline No. 4 provides a range of alternative options for signing of annual compliance reports.

requirement for such reporting should add significantly to the cost of compliance by the licensee. Such reports are of the kind that would ordinarily be expected to be approved by a Board of Directors in the furtherance of their duties.

The pertinence of this compliance reporting system can be demonstrated by the fact that it draws upon the principles put forward by the Australian and New Zealand Standard on Compliance Programs, AS/NZS 3806:1998 (as amended) and the fact that other regulators and bodies also rely on similar reporting arrangements with respect to corporate governance[7]. Overall, the Commission considers that the current compliance reporting framework is operating effectively as a mechanism to ensure that licensees focus, at a senior level, on compliance issues in a disciplined manner and report in a consistent manner to the Commission.

2.3 Use of compliance audits

This section of the paper outlines the current approach of the Commission to the use of compliance audits. The compliance reporting scheme specified in Guideline No. 4 is intended to reduce the need for costly and resource intensive external audits and review of licensee compliance. However, the Commission's compliance framework envisages the use of compliance audits in one of three ways.

- As discussed previously, Guideline No. 4 provides that an annual compliance report may be signed by an independent auditor approved by the Commission in circumstances specified in the Guideline. This option has been used by a number of licensees for whom there is no suitable External Director available to sign the annual compliance report. In signing the annual compliance report, the auditor provides some independent assurance to the Commission about the effectiveness of the licensee's compliance system and about the extent of non-compliances during the year in question.
- Consistent with the general licence condition as discussed in section 2.1 above, Guideline No. 4 notes that the Commission reserves the right to require, at any time, an external, independent audit, to be paid for by the licensee, of some or all of the licensee's obligations if the Commission considers that such a course of action is necessary (refer to clause 3.1.1 of Guideline No. 4). The Commission identifies the need for such compliance audits in a number of ways, including:
  - The formal reporting of non-compliance with the licence and Code provisions, through immediate, quarterly or annual compliance reports;
  - Informal reporting by, and discussions with, the licensee about compliance matters;

[7] For example, refer to the Prudential Standard GPS220 of the Australian Prudential Regulation Authority and the ASX Listing Rules on continuous disclosure requirements.

- Information sharing mechanisms and referrals involving other authorities such as the Energy Industry Ombudsman of South Australia, the Office of the Minister for Energy, and the Technical Regulator; and
- External sources such as consumer complaints, media reports and commentary.

These sources of compliance information provide the Commission with an insight into those areas that might be subject to audit, particularly if it is apparent that there may be systemic issues of concern or non-compliance with licence and Code obligations among licensees. Examples of the use of this form of compliance audit by the Commission include a review of the compliance by ETSA Utilities with voltage variation obligations of the Electricity Distribution Code and regulations under the Electricity Act[8], and a review of the compliance by AGL SA ("AGL") with the billing requirements of the Electricity Retail Code[9]. In each of these cases, the auditor was appointed and paid for by the Commission. At this stage the Commission has not developed any guidelines or principles regarding the conduct of such compliance audits. review

- Both ETSA Utilities and ElectraNet SA are required as a condition of licence to develop an Operational and Compliance Audit Plan ("OCAP") for approval by the Commission. Such a plan outlines the procedures of the licensee to ensure compliance with regulatory obligations, to measure and quantify levels of non-compliance, and to report on such matters to the Commission. In effect, the Commission has through this licence condition, sought to ensure a more direct oversight of the compliance system developed by the licensee. In the case of ETSA Utilities, the Commission in consultation with the licensee specifies on an annual basis certain regulatory obligations that are to be the subject of compliance audits and reporting for OCAP purposes. Such audits are incorporated within the audit business structure of ETSA Utilities (through the outsourced, internal audit function of the licensee), thus minimising any disruption or unnecessary costs.

The development of a more structured compliance auditing program by the Commission on issues of significant regulatory importance arguably calls for a re-consideration of the manner in which compliance matters are identified and audits are undertaken in South Australia. This work should not be interpreted as a change in the basic compliance framework developed by the Commission through Guideline No. 4, which is based upon the submission of appropriate compliance reports to the Commission. At the least, however, the Commission intends to develop certain key principles for the future conduct of compliance audits as described above, by means of a program that complements the existing compliance reporting framework.

[8] Kellogg Brown & Root, "Audit Report on ETSA Utilities – Low voltage standards", 14 April 2003 available from the Commission's website.

[9] KPMG, "AGL SA – billing system review", May 2003 available from the Commission's website.

In order to appreciate the value and role of regulatory compliance audits, and for the purpose of determining the most appropriate approach to the future conduct of compliance audits for the electricity supply industry in South Australia, it is worth considering auditing frameworks established by other regulatory authorities:

- **Essential Services Commission of Victoria ("ESCV")**

  The compliance audit framework developed by the ESCV for the Victorian electricity supply industry is specified in Electricity Industry Guideline No. 9 – "Regulatory Audits of Distribution and Retail Businesses"[10] ("ESCV Guideline No. 9"). This Guideline was developed in March 2003 for the purpose of auditing compliance with FRC obligations in Victoria. Among other things, the Victorian model requires the conduct of audits of the performance of distributors and retailers against key licence obligations, no more than annually. The model is based on what is referred to as a "staged approach to approving and conducting audits" which begins with the ESCV issuing an audit scope to licensees. The ESCV's scoping exercise is based on a risk assessment of non-compliance designed to identify key obligations and compliance issues that are required to be audited at a minimum. After a process of consultation and ESCV approval of the auditor nominated by the licensee, all parties sign a tripartite contract. The licensee then submits an audit proposal to the ESCV for approval. At the completion of the audit (which is required to be considered, but not varied, by the Board of Directors of the licensee being audited), a final report is submitted to the ESCV for review and further action, as required. Compliance is ultimately assessed using "standard confidence and compliance grades" for comparative purposes of the audits' results. The costs of the audits are borne by the licensees.

- **Independent Pricing and Regulatory Tribunal of NSW ("IPART")**

  In 2002, IPART commissioned FRC audits for both the gas and electricity licensees operating in the NSW small retail market. The audits were conducted by an independent audit firm, according to the terms and conditions of a Consultancy Agreement. The stated primary objective of this audit program was to assess licensees' internal compliance systems, with the addition of targeted performance auditing of obligations of particular policy importance to Government. Specifically, the program focused on the assessment of the following areas of compliance - *viz.*: licensees' design of compliance systems; the operational performance of such systems; and, adequacy of internal compliance program and framework. Like the

[10] It should be noted that the ESCV's approach to compliance auditing is currently being reviewed in relation to electricity distribution licensees - refer to their draft Guideline No. 16 – "Regulatory Audits of Distribution Businesses".

ESCV, the IPART audit results are based on compliance ratings[11]. The cost of the NSW audit program is borne by the licence holders.

- **Office of the Technical Regulator ("OTR")**

  The South Australian OTR relies on a compliance auditing process to monitor the safety and technical standards of certain electricity licensees. Generation, distribution and transmission licensees are required to prepare and implement a Safety, Reliability, Maintenance and Technical Management Plan. On a yearly basis, the OTR conducts an auditing process of compliance of such electricity entities with the approved Plan. In order to verify compliance with all relevant topics, a "rolling" audit program is used whereby compliance with all the key sections of the Plan is conducted over a two to three year cycle. Some aspects of the operations are audited by the licensee, using if appropriate an independent external auditor, while the OTR covers the remaining areas. Unlike the ESCV and IPART, the OTR does not develop compliance scores.

Having considered the experience gained from previous compliance audits conducted by the Commission, and after reviewing the approaches to compliance auditing adopted by other regulatory authorities, the Commission has formed the view that the future approach to such audits should be based on a more structured and robust approach.

In determining issues of regulatory concern, the Commission proposes to use a risk management approach that reflects the principles and processes of the Australian and New Zealand Standard on Risk Management, AS/NZS 4360:1999 (as amended), where risk may be defined as:

> "the chance of something happening that will have an impact on objectives […] measured in terms of consequences and likelihood"[12].

The risk management approach in this Standard consists of 5 distinct steps, as outlined in Table 1, that require continuous communication and consultation on risks with key stakeholders on the one hand, and monitoring and review of risks, on the other.

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[11] While not forming part of the FRC audit report, the auditor has provided to IPART, by request, suggestions for ongoing audit requirements. One such suggestion is that compliance ratings be linked to the length of the audit and reporting cycle, with a reduction of same in the case of the highest compliance scores. This suggestion stems from the fact that NSW licensees are required to submit, among other things, quarterly compliance reports. In comparison, the compliance reporting regime adopted by the Commission is less onerous since, save and except for distribution and transmission licensees, the requirement to report on compliance quarterly has been dispensed with in South Australia.

[12] Australian and New Zealand Public Sector Guidelines for Managing Risk (HB 143:1999).

Table 1: 5 steps of the risk management approach embodied in AS/NZS 4360:1999

Establish the context – for the purposes of the present exercise, the context is the legal and regulatory environment that applies to the South Australian electricity sector as well as the Commission's regulatory functions and objectives;

Identify the risks – this is based on a clear understanding of the relevant legislation and other instruments (such as Industry Codes) and an identification of the risks that may arise by considering both empirical data and public context;

Analyse the risks – requiring a consideration of the consequences, by reference to likelihood and impact, of the regulatory risks that may arise from time to time;

Evaluate the risks – this is a "screening" process where risks are examined in the context of any acceptable level of regulatory risk tolerance and the attitude of stakeholders towards managing the potential risks identified;

Treat the risks – a process which involves determining what action to take, having regard to the existing compliance measures in place (i.e. annual reporting under Guideline No. 4) and any action by stakeholders to address the issue of regulatory concern and avoid its reoccurrence.

Subject to the public consultation process associated with the release of this discussion paper, it is the Commission's intention to modify Guideline No. 4 to incorporate a compliance audit framework for the South Australian electricity sector that complements the existing compliance reporting framework.

It is proposed that the decision as to whether or not to proceed with a compliance audit in a specific case will be largely based on the risk assessment approach outlined in the ESCV guidelines on compliance audits and will utilise the principles and processes set out in the Australian and New Zealand Standard on Risk Management, AS/NZS 4360:1999 (as amended).

The framework for the conduct of compliance audits would consist of the following four steps:

(i) Defining audit scope

The Commission will dialogue with the relevant licensee(s) regarding the need for, and scope of, compliance audits in a particular area. Such dialogue would generally be initiated through provision of a written statement from the Commission to the relevant licensee(s) outlining the Commission's assessment of these matters.

In the Commission's view, such an approach would lead to a situation where compliance audits are reserved to matters of significant regulatory importance – for example, where significant consumer impact may result from non-compliance and where the Commission has reason to believe that some level of non-compliance may already exist.

The audit scope will be finalised by the Commission after considering comments from licensee(s) and would include the obligations to be audited, specific compliance issues and the timeframe for the audit.

The Victorian approach, as specified in ESCV Guideline No. 9, provides an opportunity for the licensee to extend the scope of the audit beyond the minimum requirements of the ESCV. This would occur if, for example, the licensee has identified certain high-risk regulatory obligations that it believed should be audited. Such an approach could also be adopted by the Commission.

(ii) Appointment of auditor

It will be necessary for an external auditor, independent of the licensee, to conduct such compliance audits. This might occur either through appointment by the licensee(s) with the approval of the Commission, or through appointment directly by the Commission. In general, it would not be appropriate for such compliance audits to be conducted through the Internal Audit function of the licensee, even where such a function has been outsourced. Remuneration of the external auditor would be dealt with either through the Commission or the licensee(s), as determined by the Commission on a case-by-case basis. It is noted that clause 3.1.1.2 of Guideline No. 4 requires that the licensee must, if requested by the Commission, pay for the costs of such an independent, external audit. The Commission will consider the appropriateness of requiring that, in the appointment of the auditor, a tripartite agreement be entered into by the licensee, the auditor and the Commission, as is the case with compliance audits in Victoria. The Commission's present view is that it would prefer a simpler approach. It may be sufficient for the auditor to be contracted either by the licensee or the Commission, since the general compliance auditing licence obligation outlined in section 2.1 above arguably provide sufficient powers to ensure that the audit will be undertaken, and results reported, in the manner required by the Commission.

Prior to the commencement of the audit, and regardless of the manner of appointment of the auditor, the Commission will brief the auditor in the presence of the licensee about its expectations concerning the conduct of the audit.

(iii) Conduct of audit

The compliance reporting scheme specified in Guideline No. 4 is intended to provide assurance to the Commission that each licensee has in place a compliance system that is effective in itself and that the system is being applied in a rigorous manner. This includes effective means of monitoring and dealing with any non-compliances. A compliance audit might be expected to review similar matters, at least in relation to the obligations that are the subject of the audit. It would be expected that a sample of cases would be reviewed to establish a level of compliance with the particular obligations.

ESCV Guideline No. 9 specifies certain minimum requirements that must be incorporated into the compliance audit methodology employed in Victoria. These include:

- Analysis of documented procedures that provide guidance to staff in complying with the obligation;
- Interviewing responsible staff to establish level of understanding of the documented procedures;
- Analysis of quality controls to identify whether or not non-compliance is detected and reported for correction;
- Analysis of a sample of cases to establish the extent to which the obligations have actually been delivered; and
- Assessment of the licensee's plans to ensure compliance in cases of significant non-compliance. The Commission expects that these requirements would also be met in the conduct of compliance audits in South Australia.

An important aspect of the audit involves forming a view as to the degree of compliance of the licensee with the regulatory obligations that have been the subject of the audit. In some cases, it may be possible to assess the degree of compliance with a particular obligation and produce a compliance grading. In other cases, it may be possible to review compliance issues and produce an appropriate grading. Under ESCV Guideline No. 9, the compliance grading is underpinned by statistical confidence levels that vary between 90% and 95% depending on the obligation under examination. The Commission proposes to take a similar approach, to be reviewed with the auditor and discussed with the licensee, as required, prior to the commencement of an audit.

If the licensee appoints the auditor, then the contract between the auditor and the licensee must provide that:

- The audit is to be conducted in accordance with any requirements of the Commission as specified by Guideline No. 4; and
- The auditor must provide a draft report of the audit to the licensee for comment, but the licensee must not unreasonably withhold payment to the auditor or seek to terminate the contract over a disputed audit finding.

(iv) Reporting the results of the audit

The external auditor would be required to prepare a detailed report outlining the scope of the audit, the methodology used in the conduct of the audit, and the degree of compliance identified by the auditor for each regulatory obligation considered in the audit. The report should also detail any significant non-compliances identified in the audit and the actions being taken by the licensee to rectify such non-compliances. The report should be accompanied by a statement from the leader of the team conducting the audit that provides certification to the Commission regarding these matters.

The report should be provided as a draft to both the licensee and the Commission for initial comment. Any dispute between the licensee and the auditor concerning an audit finding is to be referred to the Commission for consideration and resolution. A final report is to be provided by the auditor to both the Commission and the licensee. The Board of the licensee must consider the final report and provide a statement to the Commission regarding action it is taking in relation to any non-compliances identified in the report.

The Commission seeks comments on the general approach to compliance auditing, using an independent external auditor, as encompassed in the four steps outlined above. With reference to the appointment of the auditor, the Commission also seeks comments on the appropriateness of a tripartite agreement between the relevant parties (as required by ESCV Guideline No. 9) or any other alternative.


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3. APPLICATION OF THE COMPLIANCE FRAMEWORK

This section of the paper discusses, and seeks comment on, the potential application of the general framework for compliance audits, as outlined in the previous section, to the conduct of audits of compliance by relevant licensees with specific regulatory obligations.

> ***A decision to proceed with a compliance audit program in a specific area would not be undertaken in advance of a risk assessment as outlined in this paper. Nevertheless, the Commission believes that the public consultation process being initiated through this discussion paper will assist in highlighting areas that should be subjected to such a risk assessment.***

It is noted that the framework might be applied to an individual licensee, perhaps as a result of customer complaints regarding certain practices of that licensee, or be applied to a group of licensees of the same type, perhaps because of the critical nature of the regulatory obligations under scrutiny.

3.1 Performance Data Quality Assurance

A potential area of application of the audit framework detailed in this paper relates to the accuracy of performance data provided to the Commission by relevant licensees.

An important aspect of the Commission's regulatory functions in the electricity sector involves monitoring the performance of regulated businesses and of the markets in which those businesses are operating. Licensees are required, as a condition of licence, to provide to the Commission such information as the Commission may require to undertake its performance monitoring role and to perform other functions (e.g. price and access regulation). The Commission has developed Guidelines outlining its performance information requirements for relevant distribution, transmission and retail licensees[13]. For example, ETSA Utilities is required to provide annual regulatory accounts and quarterly non-financial performance data concerning reliability and quality of supply, customer service and other matters in accordance with Guideline No. 1. Service standards for ETSA Utilities in relation to some of these measures are specified in the Electricity Distribution Code. Retailers selling electricity to small customers[14] are required to provide quarterly data, in accordance with Guideline No. 2, concerning market sales to various

[13] Refer to the Electricity Industry Guidelines: No. 1, "Electricity Regulatory Information Requirements – Distribution"; No. 2, "Electricity Regulatory Information Requirements – Retail Code Retailer"; and, No. 3, "Electricity Regulatory Information Requirements –Transmission and System Control". These Guidelines are all available from the Commission's website.

[14] A reference in this paper to "small customers" refers to those with an annual electricity consumption of less than 160 MWh, as defined under s.4 of the Electricity Act.

customer groups, customer service matters and implementation of various customer protection measures as specified in the Energy Retail Code.

The Commission believes that it is essential that the performance information provided by licensees is accurate and is compiled in accordance with the relevant Guideline. The information is used by the Commission in a variety of areas, including its assessment of performance of licensees against specified Code obligations and service standards, and in its review of the state of competition in retail markets. Furthermore, the information is also fundamental to the operation of the Performance Incentive Scheme for the South Australian monopoly distributor, ETSA Utilities (as contained within the Electricity Distribution Code) and for pricing determinations of the Commission. The integrity of the regulatory regime is placed at risk if the Commission cannot have a high degree of confidence about the accuracy of the performance data supplied by licensees.

It is for this reason that the Commission has already implemented a number of quality assurance measures in relation to licensees' performance data. Pursuant to the relevant performance reporting Guideline, data must be submitted under the signature of the Chief Executive Officer and contain a certification that data has been submitted fairly in accordance with the requirements of the Guideline. In addition, both ETSA Utilities and AGL have been required to provide internal audit assurance as to the accuracy of performance data. Guideline No. 1 also requires ETSA Utilities to provide independent audit assurance in relation to regulatory accounts submitted in accordance with the Guideline.

Nevertheless, the Commission does have concerns about the accuracy of certain performance data submitted by licensees. Notwithstanding the current level of assurance being provided by licensees, the Commission's own reasonableness checks of performance data frequently reveal errors in the compilation of performance data. Furthermore, with an increasing number of retailers now being required to submit performance data in accordance with Guideline No. 2, the potential for data errors to corrupt the Commission's assessment of market performance is increasing.

Therefore, the Commission believes it may be appropriate to institute a program of audits to review the adequacy of certain of the systems developed by certain licensees to compile and report performance data to the Commission pursuant to relevant performance reporting Guidelines. Such an audit program would use the compliance audit framework outlined in section 2 of this paper. The Commission notes that the audit framework specified in ESCV Guideline No. 9 has been applied to the conduct of such data quality assurance audits. Indeed, that Guideline makes explicit reference to this application of the audit framework.

The Commission seeks comments on the application of the audit framework outlined in this paper to provide assurance regarding the quality of performance data supplied by licensees.

3.2 FRC Compliance

A further possible area of application of the compliance audit framework proposed in section 2 of this paper is to regulatory obligations of licensees involved in the sale and supply of electricity to small customers connected to the main electricity distribution network in South Australia. Since 1 January 2003, with the commencement of Full Retail Contestability ("FRC") in South Australia, such customers have been able to choose their own electricity retailer. Licensees that might be the subject of an FRC compliance audit program are retailers selling electricity[15] to such customers, and ETSA Utilities, the monopoly distributor in South Australia.

The Commission has established a significant consumer protection framework for customers in the FRC environment, in particular through relevant Codes[16] made under Part 4 of the ESC Act, as summarised in Table 2 below:

Table 2: Codes made by the Commission pursuant to the ESC Act that impose significant FRC regulatory obligations on certain licensees.

The *Energy Marketing Code* ensures appropriate standards for the marketing of electricity by retailers to small customers, including the provision of a written disclosure statement to a customer at the time the customer enters into a market contract with the retailer. The Code therefore deals with matters that precede the establishment of such a contract.

The *Energy Retail Code* establishes a comprehensive consumer protection regime associated with the sale of electricity by retailers to small customers, including service standards to be met by such retailers. The Code specifies the terms of the standing sale contract required to be offered by AGL, and certain mandatory provisions for market contracts. It also establishes cooling-off requirements for market contracts.

The *Energy Customer Transfer and Consent Code* governs the conditions under which consumers may be transferred from one retailer to another retailer, limits the grounds on which a customer transfer may be prevented, and sets standards for explicit informed consent. The Code is applicable to both retailers and ETSA Utilities.

[15] As at 31 March 2004, five retailers were selling electricity to small customers in South Australia under market contracts – *viz.* AGL, Origin Energy Electricity, TXU Electricity, Energy Australia, and Powerdirect. AGL is the so-called first-tier retailer in South Australia, and is obliged to sell to any small customer (who requests such sale and meets specified pre-conditions) under standing contract terms and conditions as approved by the Commission. About 5% of small customers had transferred to market contracts by 31 March 2004.

[16] It is noted that, in March 2004, the Commission established Marketing, Retail, and Customer Transfer and Consent Codes to apply to both electricity and gas retailers. This was done in preparation for gas FRC, due to commence in the 3rd quarter of 2004. The earlier Codes, which had applied only to electricity retailers, were revoked at that time. The new Energy Codes did not significantly change the nature of regulatory obligations applying to electricity retailers.

The *Electricity Metering Code* regulates the installation, maintenance and testing of meters for specified groups of customers. The Code is applicable to both retailers and ETSA Utilities.

In the broadest sense an FRC audit program would seek to assure the Commission and the wider community that small customers are receiving appropriate consumer protection as is intended by the regulatory framework. Such assurance could assist in improving consumer confidence in the operation of the still embryonic electricity retail market in South Australia.

However, the Commission does not believe that there is a case for widespread compliance auditing of FRC regulatory obligations at the present time. Any such program should be carefully targeted at critical obligations that have been the subject of customer complaints, and where the Commission believes that there may be underlying compliance issues that remain undetected through the normal compliance reporting process.

If any FRC regulatory obligations are to be the subject of an early compliance audit, it is likely that they would be associated with the establishment of market contracts between retailers and customers, the nature of those contracts, and the transfer of customers between retailers at the time of commencement of those contracts. It is important to the future development of the electricity retail market in South Australia that consumers have confidence in the integrity of the processes related to the establishment of market contracts between customers and retailers.

The impact, adverse or otherwise, that marketing conduct can have on small customers suggests that the Marketing Code could be an appropriate starting point in auditing retailers' compliance from a consumer protection perspective. In addition, audit of a small number of requirements in the Customer Transfer and Consent Code may be important, while certain requirements in the Retail Code related to the content of market contracts, the handling of customer disputes, and ensuring the customer's rights and obligations are known to the customer may also be important from an audit perspective.

The Commission believes that non-compliance with these conditions could have potentially serious implications for the affected customers. Marketing practices, customer transfer issues, and the content of market contracts, have all been the subject of customer queries and complaints to retailers and to the Energy Industry Ombudsman of South Australia ("EIOSA") since the commencement of FRC in this State, although the Commission acknowledges that the level of these complaints is not such as to suggest that there are systemic compliance issues arising in these areas at the present time.

Table 3 below summarizes certain provisions from the Marketing Code, Customer Transfer and Consent Code and the Retail Code that might potentially be included in an early FRC compliance audit program. As stated previously, all of these conditions are associated with the process of inducing customers to enter into market contracts, the

nature of those contracts, the transfer of such customers from one retailer to another, and ensuring that customers are informed about rights and obligations.

Words highlighted in bold and italics in Table 3 are defined in the "Definitions" section of the respective Codes. A reference in this table to a contract means a market contract.

Table 3: Obligations from the Energy Marketing Code (MC), Retail Code (RC), and Consumer Transfer and Consent Code (CTCC) that might be included in an early FRC compliance audit program.

Clause No.	***Obligation***
MC: Clause 3	Statement of Compliance ▲ A r***etailer*** is required to use its best endeavours to obtain a written statement from ***non-regulated marketers*** confirming that the latter comply with the *Energy Marketing Code*. This requirement applies where ***non-regulated marketers*** have introduced a ***customer*** to a ***retailer***, or arranged or facilitated a ***contract*** on behalf of a ***retailer***. This clause seeks to promote a level of assurance about the nature of the marketing activities of non-regulated entities, for which retailers have some responsibility
MC: Clauses 4 - 12	Conduct Standards ▲ While engaged in ***marketing***, ***marketers*** or ***salespersons*** are required to comply with relevant conduct standards set out in these clauses (e.g. time of contact, identification, termination of contact, marketing in person, by telephone and by electronic means). This is of particular importance given the developing nature of the competitive market in South Australia and the effects that marketing practices may have on consumer choice.
MC: Clause 13	Record Keeping Standards ▲ ***Marketers*** are required to use ***best endeavours*** to keep records related to their ***marketing contacts*** for the purposes highlighted in this clause, for at least one year from the date of such contacts. Records of market contacts are an important means of ensuring the integrity of the marketing process.
MC: Clause 14	Disclosure Statement ▲ ***Marketers*** are required to provide to ***customers*** a written disclosure statement under the circumstances and containing the information as set out in the clause. The written disclosure statement provides fundamental information to the customer about the nature of the market contract.
MC: Clause 16	Consent ▲ Whenever ***marketers*** are required to obtain the consent of a ***customer*** (e.g. consent to enter into a market contract), they are required to obtain ***explicit informed consent*** (as defined in the clause 2 of the Customer Transfer and Consent Code), obtained only after a process of disclosure to the ***customer*** related to the consequences of providing such consent. ***Marketers*** are further required to retain consent records for a period of 2 years, in an appropriate format for the purposes highlighted in this clause. Obtaining explicit informed consent is fundamental to ensuring that the customer has knowingly entered into a contract.

RC: Clause 1.3.1 – 1.3.2	Market Contracts ▲ ***Contracts*** offered to ***customers*** must comply with at least the provisions of Part A of the Code that are not permitted to be varied under this clause. The minimum provisions of Part A of the Code represent an important consumer protection for small customers.
RC: Clause 1.3.3	Cooling-off ▲ A r***etailer*** must ensure that a ***contract*** entered into with a ***customer*** confers on the ***customer*** the right to rescind the ***contract*** within 10 ***business days*** of receipt by the ***customer*** of the ***disclosure statement*** for the ***contract***, in accordance with the criteria set out in the clause. The cooling-off clause is a further important consumer protection for small customers.
RC: Clause 2.1	Customer Charter ▲ A ***retailer*** is required to provide a copy of its ***Customer Charter***, containing items as specified in clause 2.1.4, to a ***customer*** with whom it has entered into a ***market contract*** as soon as possible after it has entered into that contract. The Customer Charter is an important document setting out the rights and obligations of the customer. Failure to provide this document to the customer may leave the customer seriously uninformed about those matters.
RC: Clause 3.1.2 (refer also to MC: Clause 15)	Customer Complaints and Dispute Resolution ▲ A ***retailer*** is required to implement approved procedures for dealing with customer complaints and disputes. The approved procedures must also deal with customer complaints relating to marketing matters. These procedures are an important part of the customer protection regime.
CTCC: Clause 2	Consent ▲ A ***retailer*** must not initiate or effect the transfer of a ***customer*** without obtaining the ***explicit informed consent*** of that ***customer***, as specified in this clause. Further, ***retailers*** are required to retain transfer consent records for a period of at least 2 years, in an appropriate format for the purposes highlighted in this clause. It is vital to ensure that customers are not transferred without relevant consent. This is considered to be a major area of risk

It is important to stress that the Commission has not yet formed a view about whether or not the obligations listed in Table 3 should be the subject of compliance audits. However, the Commission believes that non-compliance with certain FRC regulatory obligations poses particular risks for consumers, and that it is therefore appropriate to consider the need for such a compliance audit program at this time.

The Commission seeks comment on the application of the audit framework outlined in section 2 of this paper to FRC regulatory obligations of electricity licensees. Is it necessary at the present time to initiate a program of compliance audits relating to FRC obligations? If so, should the audits, at least in the first instance, be restricted to the indicative list of obligations contained in Table 3 above?

3.3 Other

From time to time the Commission has been urged by certain interest groups to adopt a more rigorous approach to the conduct of compliance audits in relation to specific regulatory obligations. This section of the discussion paper highlights two examples in which this has occurred.

- Chapter 3 of the Electricity Distribution Code ("Chapter 3") deals with procedures to be followed by ETSA Utilities for establishing connections to the electricity distribution network in cases where network extension and/or augmentation is required. These procedures are complex, and deal not only with the process by which ETSA Utilities responds to a connection enquiry from a customer but also the method of charging for such work and the extent to which the work associated with such connections is contestable. The Commission has been reviewing the Chapter 3 provisions over the past two years. During this review, the Commission has received comments alleging non-compliance by ETSA Utilities with the provisions of Chapter 3. Such allegations, concerned, for example, the processes followed by ETSA Utilities in responding to connection enquiries from customers. In a position paper on the Chapter 3 Review, released in June 2003[17], the Commission commented that:

  > "ensuring that ETSA Utilities complies with the provisions of Chapter 3 is essential if those provisions are to be regarded as credible and effective. ESCOSA will continue to rely on compliance reporting under Electricity Industry Guideline No. 4 as the basic element of its compliance regime for Chapter 3 provisions. However, this will be supplemented by audits commissioned by ESCOSA as required to ensure continuing compliance."

- In June 2003, the Commission introduced a Guideline outlining certain requirements to be met by ETSA Utilities concerning operational ring fencing (separation) between the licensed distribution business of ETSA Utilities and other activities it might conduct in contestable markets (e.g. the design and construction of extensions to the distribution network)[18]. During the consultation process associated with preparation of this Guideline, the Commission received a small number of submissions (mostly from competitors of ETSA Utilities in such markets) arguing that it would be important to ensure that ETSA Utilities complied with the requirements of the Guideline, and that compliance auditing should be used in the achievement of

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[17] ESCOSA, "Review of Distribution Code, Chapter 3: Connections Requiring Network Extension and/or Augmentation", Position Paper, June 2003. Refer also to the Final Determination on the Review of Chapter 3, released in December 2003. These papers are available from the Commission's website.

[18] ESCOSA, "Operational Ring Fencing Requirements for the SA Electricity Supply Industry", Final Determination, June 2003. Refer also to Electricity Industry Guideline No. 9 issued at the time of the final determination. These papers are available from the Commission's website.

this objective. In its final determination concerning the form of the Guideline, the Commission commented that it was:

> "appropriate that the Electricity Industry Guideline No. 4 approach be given a chance to operate in relation to ring fencing obligations. However, Electricity Industry Guideline No. 4 does provide for external, independent auditing under specific circumstances. Therefore, ESCOSA may, as necessary, decide to require such auditing of some or all of the ring fencing obligations as the need arises".

- Reference has been made in section 2.3 of this paper to a review, undertaken by the Commission in 2003, of the compliance by AGL with the billing requirements of the Electricity (now Energy) Retail Code. The need for this review arose as a result of a significant number of customer complaints regarding estimated bills produced by AGL. Customer representatives have expressed a general view to the Commission that the billing and other provisions of the Energy Retail Code that are designed to provide important protections to customers, should be subject to frequent compliance auditing by the Commission, not only in relation to AGL but also other retailers selling to small customers.

- A matter of concern to some customers, particularly in rural areas of the State, is the level of reliability of electricity supply, as defined, for example, by the frequency of supply interruptions and time taken to restore supply. Customers often urge the Commission to audit the practices of ETSA Utilities in operating and maintaining the network in such areas. The supply reliability obligations of ETSA Utilities are principally those contained in Chapter 1 of Part A of the Electricity Distribution Code[19], in which "best endeavours" standards (frequency and duration of supply interruptions) are specified. These targets are expressed as averages across broad geographic regions (urban, rural, and remote) in the distribution network. An auditing task in relation to compliance with such standards principally involves consideration of whether or not ETSA Utilities has used "best endeavours" (in terms of its operating and maintenance practices) in seeking to meet the standards. From time to time the Commission has itself initiated independent reviews of specific aspects of the reliability performance of ETSA Utilities[20].

These are four examples of recent situations in which the Commission has been urged by stakeholders to undertake an active program of compliance auditing concerning specific regulatory obligations. In relation to these examples, the Commission's current approach is generally to require that compliance with the specific obligations be audited through the

[19] Refer particularly to clause 1.2.2.1 of the Electricity Distribution Code, available from the Commission's website.

[20] For a discussion of a review of weather impacts on reliability performance in 2002/03, refer, for example, to section 4.2.3 of ESCOSA, "Performance of Regulated Electricity Businesses In South Australia - 2002-2003", Annual Performance Report, November 2003, available from the Commission's website.

internal audit function of the licensee. . Should the Commission itself initiate compliance audits of these obligations, it would adopt the framework for compliance audits as outlined in section 2.3 of this paper.

The Commission seeks comment on the application of the audit framework outlined in this paper to the regulatory obligations associated with the three examples described above as well as to any other regulatory obligations of particular licensees. The Commission stresses again that it intends to use the Guideline No. 4 compliance reporting approach as the cornerstone of its overall compliance framework, and that the use of compliance audits would be restricted to key obligations as determined by means of a risk assessment approach.


ESSENTIAL SERVICES COMMISSION
OF SOUTH AUSTRALIA

4. NEXT STEPS

The Commission seeks submission on the issues raised in this discussion paper by 11 June 2004. The "Request for Submissions" section at the front of this paper provides details regarding the making of such submissions.

In particular, the Commission would welcome submissions on the general framework for compliance audits as proposed in section 2.3 of this paper, as well as the possible application of this framework to certain regulatory obligations as set out in section 3 of the paper.

Following receipt of such submissions, the Commission will consider any issues raised before making a final decision on the matters discussed in this paper. Subject to any comments received during this public consultation process, it is the Commission's intention to apply the compliance audit framework as outlined in section 2.3 to the conduct of future compliance audits deemed necessary by the Commission.

It is also envisaged that the proposed compliance audit framework will be applied to the gas industry and other industries, as required. However, such an application will not take place until after the implementation of a compliance reporting framework that mirrors the existing framework for the electricity industry under Guideline No. 4[21].

[21] The Commission initiated its public consultation process on this issue by writing to all gas licensees in December 2003.