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AER Draft Ring-Fencing Guideline - Electricity Distribution

The Australian Energy Council (the Energy Council) welcomes the opportunity to make a submission to the Australian Energy Regulator's (AER) Ring-Fencing Guideline - Electricity Distribution (Draft Guideline).

The Energy Council is the industry body representing 21 electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. These businesses collectively generate the overwhelming majority of electricity in Australia and sell gas and electricity to over 10 million homes and businesses.

The Energy Council is supportive of the principles of AER's Draft Guideline in that it seeks to create a more level playing field by addressing the two harms created by ineffective ring-fencing: cross subsidy and discrimination.

Despite the progressive changes to the Draft Guideline, the Energy Council submit that they do not go far enough. The Energy Council remains concerned that the sharing of staff and physical offices is not subject to an absolute prohibition, and that the proposed \$500,000 materiality threshold that would allow Distribution Network Service Providers (DNSPs) to provide some limited non-network services directly is even being considered. We remain concerned that compliance monitoring is heavily reliant on complaints and so any compliance breaches by a DNSP will not be readily detectable and as a consequence that enforcement will be problematic.

Legal separation, cost allocation and separate accounts

The Energy Council supports the AER's contention that non-network services within a DNSP could be cross-subsidised through its network services, where inefficiencies would inflate its prices for Direct Control Services and regulated Transmission Services. In this regard we consider that the AER Draft Guideline has moved some way to addressing cross-subsidy concerns by introducing the obligations for legal separation of the DNSP from other entities, and requiring separate accounting and more transparent cost allocation. This will assist in improving industry confidence in ring-fencing as part of a suite of practical solutions to preventing cross subsidy in what should be the competitive delivery of an emerging class of energy services.

The Energy Council supports the adoption of the AER Draft Guideline in its current form, as it assigns obligations that explicitly prevent a DNSP allocating or attributing to distribution services costs those costs that properly relate to non-distribution services. This is of fundamental importance to

minimising cross-subsidisation concerns. However its effectiveness in achieving this goal is inherently linked to the terms of the supporting cost allocation guideline. Accordingly the Energy Council recommends a review of this guideline with a view to greater prescription in the means for allocating costs between different services. Whilst beyond the scope of the AER review, the Energy Council considers further complementary changes are still required in addition to those in the Draft Guideline that include but are not limited to the NER 6.2 (Classification) and 6.4.4 (Shared Assets), the Cost Allocation Guideline, the DNSPs' approved CAMs and the Shared Asset Guideline.

Legal separation of the DNSP from other entities should create clear boundaries between providers of prescribed distribution services and providers of other services. The Energy Council considers that this will be achieved if there are clear governance arrangements with ring-fenced DNSPs allowing the affiliate to operate completely independently and are able to maintain their own individual financial accounts. We note that this governance could only be achieved if senior executives also operate independently in strategic decision making and in contract negotiations with contestable participants. Accordingly, there should be no exception to functional separation which allows the sharing of senior executives between DNSPs and their ring-fenced affiliates. Further strength in governance arrangements are more likely to occur if functions such as internal audit do not span both the ring-fenced DNSP and the affiliate.

The requirement for DNSPs to maintain consolidated and separate accounts for standard control services, alternative control services and other services provided by DNSPs is also welcomed by the Energy Council.

The Energy Council supports the AER's restriction of waivers under the Draft Guideline. The Draft Guideline means that the AER will disallow waiver applications that apply to legal separation, cost allocation and information protection. We are concerned that waivers under the previous ring-fencing guidelines may have been applied too leniently in some jurisdictions. The current change provides more certainty.

Physical separation and staff sharing

The functional separation obligations contained in the Draft Guideline include physically separating a DNSP's offices from its service providers or related bodies corporate and preventing staff sharing between a DNSP and its related body corporate. The Energy Council strongly supports these measures.

The AER's revised approach to ring-fencing however will assess waiver applications that apply to the functional separation of either accommodation and or/employees. The Energy Council does not support waivers being granted for staff sharing or physical separation. An absolute prohibition is necessary given that the regulated entity is the entity that is ring-fenced from other activity, not the other way around.

The Energy Council is concerned that the test for harm to contestable markets will be based on the information submitted by the DNSP. Not all applications will be subject to consultation and we consider that this is important to ensure harm to competition is tested and exposed through a consultation process. The degree of procedural transparency proposed is also concerning as it is unclear whether it will be up to the AER's discretion whether to publish waiver applications, decisions or reasons.

Materiality threshold

The Energy Council does not support the proposed \$500,000 threshold that would allow DNSPs to provide some limited non-network services directly. The AER argues that on balance the \$500,000 dollar materiality threshold is necessary *“to allow a DNSP to do the minimum necessary to support its network services, without having a materially adverse impact on competition in the market for non-network services”*.

Evidence is required as to why the threshold is necessary. The AER currently provides a threshold for *“DNSP to provide limited non-network services that are incidental to, but necessary to support the provision of, its network services”*. The Energy Council is concerned that the materiality threshold of \$500,000 could potentially have an adverse effect on the market for Behind the Meter (BTM) contestable energy services. DNSPs will likely establish services in contestable fields knowing that the likely costs are to exceed \$500,000 and will only have ring-fencing imposed once they exceed that threshold. By this time the damage to potential contestable markets has already been realised.

If a service is *“necessary”* to support network services then by definition it is a network service and should be classified as such during the AER’s classification of services. If it is not classified as a network at this time then it is a non-distribution service and must be treated as such. There should be no materiality threshold as this appears contrary to the National Electricity Rules (NER).

If a materiality threshold does remain in the Draft Guideline then it should at least be subject to a condition that the contestable services in question *‘are incidental to, but necessary to support the provision of, the DNSP’s network services’*. That is a caveat should at least be written into the guideline.

The Energy Council agrees that the AER should have the right to review this decision if it emerges that it undermines the ring-fencing policy objectives in any way.

Reporting, compliance and enforcement

The Energy Council considers that the reporting and compliance requirements on DNSPs applied under the Draft Guideline are not robust. We support a comprehensive compliance framework which will ensure that the development of all contestable energy services is not undermined by cross subsidies or discrimination which will require DNSPs to engage independent third parties to annually assess their compliance with ring-fencing obligations. The Energy Council submits that the issues are:

- Lack of clarity on how compliance will be measured;
- Lack of resources to enforce, there is too much reliance on complaints rather than assurance auditing against a defined tests from annual audit;
- Need restrictions on the auditors, no more than 2 audit terms to ensure no conflicts;
- Waivers validity should be tested in audit as conditions may have changed, and;
- Substantial fines commensurate with damage to competition (similar to Australian Competition & Consumer Commission (ACCC) fines).

The Energy Council is concerned that compliance breaches by the DNSP will not be enforced properly. The AER reports that *“with respect to compliance breaches by a DNSP, we may seek enforcement of the Draft Guideline by a court in accordance with the NEL”* and *“any interested party may make a complaint to us about a possible breach of the Draft Guideline by a DNSP. We will*

investigate complaints in accordance with our compliance and enforcement policy.” We believe the AER’s enforcement explanation is not rigorous or detailed enough which could exacerbate the number of breaches if it is not handled correctly.

Ring-fencing arrangements will only be effective to the extent that there is a robust compliance assessment regime with credible penalties for non-compliance. This needs to be made clear by the AER as it is unclear whether they will have the resources to pursue suspected breaches in all cases. We support the AER writing up a separate compliance and enforcement policy which would provide more detailed information. Such a policy document would provide certainty and clear guidance to participants, as to the enforcement practices the AER will follow in addressing identified breaches.

The AER Draft Guideline includes a static obligation on DNSPs to provide third parties competing with any ring-fenced body corporate of the DNSP equivalent access to any information. The Energy Council supports this proposal although we note that this does not place a positive obligation on DNSP’s to provide all necessary information (network performance data, load data, value of constraints etc.) to all competitors that will enable decisions to invest in generation or storage as an alternative to transmission or distribution capacity. Rather, it relies on the related body corporate seeking that information, and the DNSP then being required to make that information available to third parties.

Any questions about our submission should be addressed to Panos Priftakis, Policy Adviser by email to panos.priftakis@energycouncil.com.au or by telephone on (03) 9205 3115.

Yours sincerely,



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