

Mr Chris Pattas
General Manager Networks Investment and Pricing
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Lodged (by online/email): ringfencingguideline2016@aer.gov.au

3 June 2016

Dear Chris,

Re: Electricity Ring-Fencing Guideline - Preliminary Positions

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

The Energy Council is the industry body representing 22 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 supports the AER's review of the existing jurisdictional ring-fencing regimes. We believe that it is important the guidelines continue to be developed in a manner that ensures clarity of purpose, predictability and the ability to be monitored and enforced ensuring competitive neutrality is achieved.

The intent of the guideline broadens the scope to address a range of new energy services, while also bringing these together in one consistent national guideline. Ring-fencing will allow customers to see the value and benefits that comes from competition, enhanced services and efficient cost. We support the proposed ring-fencing objectives and obligations, and welcome the commencement of robust compliance and enforcement activities.

If there are concerns about the ability of ring-fencing guidelines to protect customer interests or about the costs involved in pursuing a ring-fenced model, then structural separation is the first best solution for achieving the ring-fencing objectives. The Energy Council does note that structural separation is outside the remit of the AER however.

The submission that follows outlines the Energy Council's response to the AER's development of the updated guidelines and to the issues raised in the Positions Paper.

Objectives of Ring Fencing

Consumers benefit where they have access to competitive markets. Competitive markets develop and thrive where participants are able to compete on an equal footing in the provision of products and services. In order to achieve this, the concept of competitive neutrality is paramount. The objective of ring-fencing is to limit the ability of the regulated entity to confer an unfair advantage to itself or to an affiliate operating in a competitive market¹. Ring fencing is therefore key to the delivery of competitive neutrality and its consequent benefits to consumers.

¹ AER Preliminary Positions Paper Ring Fencing 2016

The Energy Council submits that the objective of ring-fencing should be to *prevent* the ability of the regulated entity from conferring *any* advantage to itself or to an affiliate operating in a competitive market. This objective is preferable to alternatives which require proof of unfair advantage (an intent) and replaces it with any advantage (an outcome).

Essential components of effective ring-fencing

The Energy Council submits that the guidelines must clearly set out the form and degree of separation required, and should also be accompanied by a strict monitoring and compliance program. Effective ring-fencing ensures that a level of confidence exists for new entrants to invest in these markets and for competition to improve. The Energy Council considers that effective ring-fencing requires:

1. Legal separation

Legal Separation creates clear boundaries between providers of prescribed distribution services and providers of other services. Some jurisdictions have made it compulsory for a Distribution Network Service Provider (DNSP) to legally separate the business that provides standard control services from the one it owns that supplies contestable services, although this is not applied nationally. Even where a jurisdiction has made it compulsory, the jurisdictional cost allocation guidelines have still allowed shared costs to be moved around to the benefit of a ring-fenced affiliate. This raises questions in relation to whether the objectives of legal separation have been achieved under the current guidelines.

The Energy Council believes that legal separation would enable clear governance arrangements whereby directors of ring-fenced affiliates would have specific duties to the affiliate company under the Corporations Law. Legal separation therefore makes the role of the regulator in policing the separation less onerous.

Ring-fenced affiliates should be completely independent and maintain their own individual financial accounts. The directors of ring-fenced affiliates have specific duties to the affiliate company under the Corporations Law.

2. Not permitting the ring-fenced entity to be a subsidiary of the regulated network business (even if it otherwise forms part of the same corporate group)

The network business should not be permitted to establish the ring-fenced entity as a subsidiary. This ensures Directors will act in the best interests of the ring-fenced entity and not a regulated parent business.

3. Accounting separation

The guidelines should make clear that the ring-fenced entity must maintain consolidated and separate accounts. These must clearly identify the extent and nature of transactions between the network business and ring-fenced entity.

4. Allocation of costs

DNSP cost allocation methodologies that clarify how costs may be allocated between contestable services and regulated services need to be developed further, with more detail in the guidelines regarding the basis of allocating shared costs.

The cost allocation principles in the NER and the guidelines that apply to DNSPs mean that appropriate allocation of shared costs between a DNSP and a ring-fenced affiliate cannot guarantee competitive neutrality. In order to preserve competitive neutrality it is important that the costs of supplying contestable services should only be recovered through the ring-fenced affiliate that supplies these services.

The importance of restricting the inappropriate allocation of costs between the DNSP and its ring-fenced affiliate in supplying contestable services cannot be understated, and is essential to the development of competitive markets.

5. *Restrictions on the flow of information*

Unrestricted flows of information between the DNSP and its ring-fenced affiliate must be prohibited. The Energy Council believes that there should be procedures in place which govern the sharing of information (including customer information and energy data and intellectual property) between the regulated network business and the ring-fenced entity. This would be in addition to compliance processes for obligations under applicable energy market rules. The results of any trials or pilot projects undertaken by a network business that may benefit a contestable entity must be made freely available to all contestable parties, to ensure the market as a whole is able to benefit from this work.

This position would be strongly complemented by legal separation and would promote competition in the market. We do not support DNSPs getting access to any commercial information that would give its affiliate any advantage over other market players.

6. *Physical, staffing and functional separation*

The Energy Council supports locational, staffing and functional separation. This would include no shared operational staff, separate office locations and separate IT systems. We believe that significantly improved compliance monitoring would be required to ensure that this occurs and guard against the normal flow of information between DNSPs and their affiliates providing contestable services.

7. *Non-discrimination obligations, possibly assured by precluding the ring-fenced entity from offering services in the related network business' franchise service area*

The guidelines should include clear non-discrimination obligations that prevent DNSPs from favouring a ring-fenced affiliate operating in a contestable market. A DNSP ring-fenced affiliate should not be able to access the shared network on more favourable terms and conditions than a competing third party service.

The standard terms and conditions imposed by the regulated business on all parties operating in the emerging market (e.g., batteries beyond the meter; solar PV) will influence the types of services and technologies able to be introduced into that competitive market. In these circumstances, the regulated network business has an incentive to impose terms and conditions that favour the services and technologies it is seeking to sell in the contestable market via its affiliated business, as opposed to the services and technologies that the market might prefer and that could be provided by its competitors.

A means of achieving the non-discrimination objective would be to exclude a ring-fenced entity from operating in the franchise service area of the affiliated network business. While this wouldn't prevent the flow of information such as intellectual property, it would reduce the incentive for the network business to discriminate in favour of the ring-fenced affiliate in regards to matters relevant to a specific group of customers. This is a mechanism that would promote a higher degree of confidence in the contestable market.

8. *No shared assets and minimisation of shared costs (with more prescription regarding the basis for allocating shared costs)*

The Energy Council submits that asset sharing should be restricted between regulated services and contestable services and agrees with the AER that functional separation allows for the enforceable separation of assets. Given the relative infancy of the market, allowing DNSPs to provide Distributed Energy Resources (DER) behind the meter may impact the competitiveness and efficiency longer term of the market for contestable services. We support clear obligations which provide the AER with the ability to identify compliance and enforce penalties for any non-compliance.

The inappropriate allocation of costs between regulated and other services allows regulated business to subsidise the provision of non-regulated services. The Energy Council believes that the effectiveness of the current Cost Allocation Principles outlined in the Rules should be reviewed, and more prescriptive guidelines regarding the basis for allocating shared cost provided.

Ring-fencing waivers

The Energy Council submits that all ring-fencing waiver applications must only be provided on an exceptions basis and assessed carefully case by case. The AER needs to develop a clear and transparent set of assessment criteria which includes stakeholder consultation for every individual waiver application. Previous decisions of the AER have applied little assessment of these costs and benefits and waivers from the current ring-fencing guidelines have been applied too leniently in some jurisdictions. For example, the decision to grant Energex a waiver for its Battery Energy Storage System project had no mention of the costs to consumers arising from the broader market outcomes likely to eventuate.

It is important to understand that the potential for competition to impact a developing services market may vary depending on different geographical areas, customer sectors and applications. Market stakeholders are well placed to identify these differences, and provide insight into business developments. In fact it is unclear how the AER could make an informed decision without such feedback. It would therefore be inappropriate for an AER approval or rejection of a waiver application to set a firm precedent for future applications without the opportunity to consider these factors.

The Energy Council does not agree to fast-track and bulk waiver approval processes. We understand the AER's desire to mitigate against unwarranted ring-fencing costs. However, short-circuiting the application assessment process has the potential to lead to hindering the development of the competitive market. The Energy Council believes that the AER needs to develop a waiver process that is transparent and robust.

It is appropriate for the costs of ring-fencing to be borne by the customers of ring-fenced services. Engaging in ring-fenced services represents a commercial decision made by network businesses that is quite separate from its role as monopoly network service provider. The costs of ring-fencing are in principle comparable to the costs of a contestable provider establishing their business.

The AEMC's recommendations from the Integration of Storage paper² released late last year represents a reasonable starting point in terms of the issues that the AER should consider when considering granting a waiver. The AER still needs more analysis to determine how appropriate each specific issue is before deciding on which items to use to determine whether a waiver from the guidelines is warranted.

If waiver applications are granted too easily it could impact the supply of contestable services in these emerging markets, to the ultimate detriment of consumers.

Reporting, compliance and enforcement

The Energy Council welcomes the AER's preliminary views on the need for robust compliance and enforcement of ring-fencing obligations. Independence and transparency in the AER's compliance and enforcement activities is important to support market confidence that network businesses are operating fairly and in accordance with their obligations.

The Energy Council is concerned that breaches of the ring-fencing guideline may in some circumstances be very difficult to identify and prove. It is unlikely that the AER or participants will have the resources to pursue suspected breaches in all cases. This difficulty inadvertently maintains the monopoly advantage and power of the NSP. We believe that structural separation is the first best solution for achieving the ring-fencing objectives and ensure customers' interests are protected.

² Australian Energy Market Commission, 2015, "Integration of Energy Storage – Regulatory Implications", << <http://www.aemc.gov.au/Major-Pages/Technology-impacts/Documents/AEMC-Integration-of-energy-storage,-final-report.aspx> >>

We support the AER's proposal to place the onus on network businesses to demonstrate compliance with their obligations, and believe the proposed annual reporting requirements will provide an appropriate level of market transparency. Nevertheless we recommend that annual audits are undertaken by an independent auditor appointed by the AER. This will strengthen public perceptions of independence and AER accountability for audit outcomes.

Ring-fencing services

The Energy Council is concerned that it will be difficult to categorically classify services as regulated or contestable service and therefore suggest that DNSP's be excluded from supplying any potentially competitive service. One way to achieve this would be for the AER to prohibit DNSPs from acquiring and using certain assets like energy storage services beyond the meter, consistent with the AEMC's recommendation in their Integration of Storage paper.

The AER has indicated that it considers it unlikely that assets can be ring-fenced. This is a concern. The Energy Council submits that it is likely that some asset types, such as energy storage devices and load control devices, should always be ring-fenced because of the potential to crowd out alternative service providers.

We believe this will guarantee that DNSPs were unable to distort competition in these emerging markets. Although the AER has argued that the outright prohibition of DNSPs supplying contestable services would not be compliant with the current NER. Hence, as part of this process we need to put forward ring-fencing and service classification options that meet the NER.

The Energy Council supports the AER determining ring-fenced services that would be subject to the guideline at the beginning of a regulatory period. The AER framework and approach to rate reviews currently classifies services at the beginning of every price review. Where there is scope for the competitive provision of a service by a third party then that service will be supplied to the market in a competitively neutral manner.

Once the AER has determined the classification of a service in terms of whether it should be a direct control service or otherwise, all contestable services determined would be captured under the proposed guideline and would need to be ring-fenced.

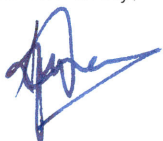
Moving forward

We understand that the AER must implement a timeframe which enables both compliance and an opportunity for DNSP's to put in place alternative arrangements in respect of legacy service offerings. To this end the Energy Council suggests a two phased approach, involving a commencement date for the ring fencing guidelines of 1 December 2016. This would mean that new initiatives and pilots by DNSP's should fall under the ring fencing guideline from 1 December 2016 and for existing pilots and initiatives the AER should provide a transitional implementation timeframe of 12 months.

The Energy Council looks forward to participating in the AER's process as it develops its Draft Guidelines.

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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