Electricity transmission Ring-fencing Guideline

Explanatory Statement – Version 4, Draft

November 2022

AUSTRALIAN ENERGY REGULATOR

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Version	Date	Pages
1	15 August 2002	9
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4	4 November 2022 (*draft*)	70

Shortened forms

Shortened Form	Extended Form
ACCC	Australian Competition and Consumer Commission
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AEC	Australian Energy Council
AEO	Australian Energy Operations
AER	Australian Energy Regulator
AusNet	AusNet Transmission Group Pty Ltd
current guideline	Ring-fencing guideline – Electricity Transmission (Version 3), July 2022
DNSP	Distribution Network Service Provider
ENA	Energy Networks Australia
NECA	National Electricity Contractors Association
NEL	National Electricity Law
NEM	National Electricity Market
NEO	National Electricity Objective
NER or the rules	National Electricity Rules
RAB	Regulatory Asset Base
RESP	related electricity service provider
REZ	Renewable Energy Zone(s)
TNSP	Transmission Network Service Provider

Contents

Request for submissions

Interested parties are invited to make written submissions to the Australian Energy Regulator (AER) regarding this paper and our draft ring-fencing guideline for electricity TNSPs (version 4) by close of business, **16 December 2022.**

Submissions should be sent electronically to AERringfencing@aer.gov.au.

Alternatively, submissions can be mailed to:

General Manager, Strategic Policy and Energy Systems Innovation

Australian Energy Regulator

GPO Box 3131

Canberra ACT 2601

The AER prefers that all submissions be publicly available to facilitate an informed and transparent consultative process. Submissions will be treated as public documents unless otherwise requested.

Parties wishing to submit confidential information are requested to:

- Clearly identify the information that is the subject of the confidentiality claim; and
- Provide a non-confidential version of the submission in a form suitable for publication.

All non-confidential submissions will be placed on the AER's website at www.aer.gov.au.

For further information regarding the AER's use and disclosure of information provided to it, see the ACCC/AER Information Policy, June 2014 available of the AER's website.

Enquiries about this paper, our draft guideline, or about lodging submissions, should be directed to the Strategic Policy and Energy Systems Innovation branch of the AER on 1300 585 165 or AERringfencing@aer.gov.au.

Executive Summary

Australia's electricity market is undergoing a fundamental transformation, transitioning from a reliance on coal- and gas-fired power plants to renewable sources of energy (mainly wind and solar) to meet State and Federal renewable energy targets. This transformation presents significant challenges and opportunities for Australia's electricity transmission system (the interconnected networks of high voltage lines and infrastructure that carry electricity from generators to distributors and ultimately to consumers). The role of transmission network service providers (TNSPs) is expanding to connect this new generation and to manage system stability as our reliance on variable renewable energy increases.

At the same time, new contestable markets are being developed and technology is being deployed in new ways that increase the potential scope of TNSP operations outside of traditional transmission network services. New markets are being considered for essential system services (such as inertia). Technologies such as batteries and synchronous condensers that can provide both transmission and contestable market services are being deployed that can provide both transmission and contestable market services. These developments are opening new market opportunities, including for TNSPs.

There is also increasing appetite to explore or promote contestability in areas that have traditionally been provided by monopoly TNSPs. Amendments to the rules governing transmission connections arrangements have already expanded opportunities for third parties to provide elements of transmission connection services. Some jurisdictions have also adopted contestability in relation to the delivery and operation of major transmission projects within renewable energy zones.

It is in this context that we are reviewing the transmission ring-fencing guideline. Given TNSPs' monopoly role in planning, operating, and maintaining the transmission network[1] – the backbone of the electricity market – as well as in providing connections to their networks, it is timely to consider whether appropriate controls are in place to support competitive outcomes in markets within which TNSPs operate.

Ring-fencing seeks to prevent TNSPs from using their position as monopoly providers of prescribed transmission services[2] to distort outcomes in contestable markets. There are two types of harmful conduct by TNSPs that ring-fencing can address:

- **Cross-subsidisation**, where a TNSP uses revenues it earns in providing prescribed transmission services to subsidise its activities in other, contestable markets. Cross-subsidisation can have the effect of undermining or damaging competition and innovation in related contestable markets. In addition, it can result in consumers paying more than they should for regulated transmission services.

- **Discrimination**, where a TNSP is able use its monopoly position in regulated markets, or information obtained through the provision of those services, to favour itself (or an affiliated entity) or to discriminate against a competitor in contestable

[1] With the exception of Victoria, where AEMO performs some of these roles.

[2] Prescribed transmission services are shared services provided via the transmission network that are paid for by all end users. They do not include connection services, which are paid for by individual connecting parties.

markets. This harms consumers by distorting outcomes in competitive markets, reducing competition and so increasing prices and reducing innovation.

The AER's transmission ring-fencing guideline seeks to prevent these harms from occurring by requiring a TNSP to separate the provision of prescribed transmission services from contestable services that may be provided either by the TNSP (or its affiliates) or third parties. Ring-fencing obligations should evolve to remain a targeted, proportionate, and effective regulatory response to the potential harm consumers may face as the market context within which TNSPs operate changes.

The AER's current transmission ring-fencing guideline was first published in August 2002. While there have been minor amendments to the guideline over the years, the guideline has not changed substantively over the past 20 years, despite significant changes in the regulatory landscape and electricity market. By contrast, the ring-fencing guideline for distribution network service providers (DNSPs), which came into effect in November 2016 has been amended twice to respond to these changing market conditions. The distribution guideline differs in many respects to the current transmission ring-fencing guideline and we are mindful of the National Electricity Rules' (NER) direction that we try to make the two sets of guidelines consistent where practicable.[3]

With these matters in mind, we began a full review of the guideline in 2019 and resumed that review in 2022 following a temporary halt due to Covid-19, when we again invited submissions from interested stakeholders. We received 18 submissions from stakeholders, in response to our 2022 Issues paper (and 9 submissions in response to our 2019 Discussion paper).

Based on consideration and analysis of these submissions and our powers and obligations under the National Electricity Law and the NER, the AER has formed an initial view that changes to the current transmission ring-fencing guideline are required to ensure that it remains fit for purpose.

Addressing the potential for cross-subsidisation

Opportunities for TNSPs to cross subsidise contestable services using regulated revenues have expanded since the guideline was introduced in 2002. At that time, the distinction between generation, transmission, distribution and retail was clearer. TNSPs were prohibited from operating in other parts of the electricity supply chain except where revenue from those activities was no more than 5% of a TNSP's total revenue.

Since then, the boundaries between these activities have blurred, and the scope of services that a TNSP can provide that do not clearly fall into generation, transmission, distribution or retail has expanded. With the expected increase in transmission investment, the absolute value of the 5% revenue cap will increase significantly, expanding TNSPs' opportunities to operate in other, generally prohibited, markets. Furthermore, deployment of technologies that can provide both transmission services and contestable services makes it harder to monitor and control the potential for cross-subsidisation.

For these reasons, we are concerned that there is a risk of cross-subsidisation that is not adequately addressed under the current guideline.

[3] NER 6A.21.2(c)(2).

To address these concerns, we propose to strengthen TNSPs' legal separation obligations compared to the current transmission ring-fencing guideline in three main areas.

The draft guideline:

- Allows TNSPs to provide transmission services and regulated distribution services but generally prohibits them providing other services. In effect, this expands TNSPs' current legal separation obligations to capture all non-transmission contestable electricity services and non-electricity services (with some exceptions), rather than just generation, distribution and retail services. This approach will provide greater assurance to the AER and market participants that TNSPs are not cross-subsidising contestable services with regulated revenues. For clarity, TNSPs who do not provide any regulated distribution services could not provide contestable distribution services under the draft guideline as proposed (unless they obtain a waiver).
- Removes the 5% revenue cap exception to the current guideline's legal separation obligation but introduces the ability to apply for a waiver from this obligation, where there are consumer benefits from the TNSP providing a service that would otherwise be prohibited. We consider a revenue cap is no longer appropriate given the expected increase in TNSPs' revenue due to significantly increased investment in the transmission system. Further, we consider a waiver provides greater transparency and oversight over TNSP activities that could potentially impact contestable markets.
- Prevents TNSPs from leasing excess capacity from batteries without a waiver from the AER. This brings the transmission ring-fencing guideline into alignment with the distribution guideline. It also provides important protection for the development of competition in the grid-scale battery market, which is in an early stage of development.[4] Allowing TNSPs to operate without appropriate checks and balances could stifle smaller and less well-equipped participants in the battery services market. We are also concerned about TNSPs' abilities to influence operational outcomes in contestable markets within which batteries may operate.
- Provides for waivers other than from some core ring-fencing obligations relating to cost allocation, the obligation not to discriminate, and information access and sharing. Waivers will be granted on a case-by-case basis where the applicant has demonstrated a compelling case for a waiver where the benefit to consumers of the TNSP complying with the waiver would be outweighed by the cost to the TNSP of complying with the obligation. In addition, we propose to include a power to grant class waivers.

We are also proposing amendments to accounting separation and cost allocation requirements.

Addressing the potential for discrimination

As new, contestable electricity markets have developed, the potential for TNSPs to favour themselves or an affiliate operating in those markets has also increased. Discrimination

[4] There are presently only about 15 grid-scale batteries operating around Australia. See AusNet, *Response to Questions from the Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, pp 5-6. Another 91 grid-scale batteries are at varying stages of development, however, according to AEMO's August 2022 generation report. See AEMO, NEM Generation Information.

could potentially occur wherever a TNSP holds sensitive information obtained from providing regulated services or has the ability to discriminate in favour of itself or an affiliate in the provision of regulated services.

Stakeholders identified two areas of potential harm that they considered were not adequately addressed by the current guideline:

- TNSPs favouring themselves or an affiliate in providing the contestable component of transmission connection services, and
- TNSPs favouring themselves or an affiliate in relation to batteries, particularly favourable terms and conditions for connecting their own batteries to the transmission network.

In respect of contestable connections, concerns largely related to potential discrimination in the market as a result of a TNSP being the monopoly provider of negotiated transmission services – in this case services provided by the TNSP to facilitate connection to the transmission network. Specifically, there is a concern that TNSPs are using their monopoly position in the provision of negotiated transmission services to act in a discriminatory manner, impacting the market for contestable transmission connection services. The AER's transmission ring-fencing powers are limited to requiring accounting and functional separation of prescribed transmission services from other services. Our powers do not extend to requiring separation between negotiated transmission services and non-regulated (contestable) transmission services.

To the extent that stakeholders have concerns in respect of TNSPs' conduct in the provision of connection services, we encourage stakeholders to raise these matters with the AER. If any evidence is presented to us that TNSPs are not complying with their obligations under Chapter 5 of the NER, we may consider taking enforcement action where appropriate. In addition, we are seeking feedback from stakeholders on whether we should seek a change to the NER that would expand our ring-fencing powers to include the ability to, where appropriate, ring-fence TNSPs' negotiated transmission services from other services.

In respect of connecting batteries, where TNSPs are connecting batteries for the purposes of providing prescribed transmission services and can discriminate in favour of themselves or an affiliate to the detriment of a competitor, this would fall within the scope of the ring-fencing guideline.

To address this concern, and wider concerns we have about TNSPs being able to favour themselves or their affiliates participating in other contestable electricity markets, we propose to strengthen the current guideline's functional separation obligations. The draft guideline:

- introduces the concept of a 'related electricity service provider' which includes not only a TNSP's affiliates but parts of a TNSP that provide contestable electricity services,
- clarifies and strengthens obligations around information access and disclosure, including the establishment of an information sharing protocol, and
- requires TNSPs to establish, maintain and keep an information register about information that has been shared.

These obligations are intended to mitigate discrimination by the TNSPs in relation to the provision of prescribed transmission services, in favour of themselves or related electricity service providers.

We expect this approach will increase transparency, confidence and predictability for stakeholders and improve compliance with the guideline. This approach also better aligns the transmission and distribution ring-fencing guideline, while recognising differences.

Next, we propose to introduce a new obligation on TNSPs to require any agreements with third party service providers who provide services to the TNSP to contain provisions that mirror the guideline's non-discrimination and information access and disclosure provisions. This approach recognises that third parties that assist with TNSPs' provision of prescribed transmission services can also engage in discriminatory behaviour. Our initial view is that this provision would apply to 'new' or variations to existing third party service agreements executed after the commencement of this variation to the guideline. As such, the costs of compliance are, in our view, likely to be minimal.

At this stage we do not propose to amend the current guideline to add additional obligations in relation to staff and office separation or restrictions on cross-branding and promotions. Our initial view is that we do not have sufficient evidence at this time that the benefits of these functional separation obligations would outweigh the costs. This is due to the relatively small size of TNSPs and the nature of their customers, which are typically large, sophisticated corporate entities. However, we propose to retain the current guideline's provision requiring separation of marketing staff from related electricity service providers that provide contestable services and we have streamlined the wording of these requirements in accordance with updated terminology within the revised draft guideline.

Other proposed amendments

We have proposed several other amendments to the current transmission ring-fencing guideline in relation to compliance reporting, waivers, and transitional arrangements. All proposed amendments are summarised in the table below.

In addition, we are also seeking feedback on whether it is appropriate for the AER to begin a process to seek to introduce a civil penalty provision for non-compliance with the guideline in both the National Electricity Regulations and the NER.

Developing a transmission ring-fencing guideline that remains fit for purpose in a rapidly transforming energy market is an iterative process. New regulatory or market arrangements, new information, or new evidence may justify further amendments to the transmission ring-fencing guideline's obligations in the future. As with our distribution ring-fencing guideline, we intend to continue to review market conditions and to update the guideline when warranted while balancing the need for regulatory certainty.

Throughout this explanatory statement, we have identified specific issues on which we seek feedback from stakeholders, which we have highlighted in bold. To assist stakeholders, we have set out these issues in the table below. While certain issues in this explanatory document are highlighted for stakeholder feedback, we are seeking submissions from stakeholders on the entirety of this document and the draft guideline.

Table 1: Issues on which stakeholder feedback sought

Topic	Feedback sought	Page reference
Legal separation	We are seeking evidence from TNSPs regarding any electricity services that are currently provided by TNSPs	Page 15

	that do not fit the definition of a transmission service, but which could not practically be provided by any other party.	
Functional separation	If current arrangements for preventing discrimination are considered inadequate, we may consider a rule change request that would seek to expand our ring-fencing powers to include the ability to specifically ring-fence negotiated transmission services, in addition to prescribed transmission services. We welcome feedback on this issue.	Page 27
Functional separation	We welcome further feedback on our approach to functional separation.	Page 33
Functional separation	We are seeking feedback from stakeholders on the costs of functional separation where possible.	Page 34
Waivers	We are specifically seeking feedback from stakeholders on whether a streamlined process is appropriate for battery waivers and what criteria could be used to determine which applications qualify for a streamlined assessment.	Page 48
Transition to Version 4	We invite stakeholders to advise us if there are additional [existing] services that may require further consideration.	Page 53
Other matters	We are seeking stakeholder feedback on whether advocating for civil penalties in relation to guideline enforcement is an appropriate next step to follow the guideline review.	Page 54

Finally, we summarise our proposed amendments to the draft transmission ring-fencing guideline in Table 2.

Table 2: Summary of amendments

Potential harm	Current guideline	Draft guideline amendments
Cross-subsidisation	**Legal separation** TNSP may not engage in related business (electricity generation, distribution or retail), except if total related business revenues ≤ 5% of total TNSP revenue	**Legal Separation** Expand to prohibit TNSP from providing contestable electricity and non-electricity services Remove 5% revenue cap exception and replace with waiver Allow TNSPs to provide regulated distribution services without a waiver Prevent TNSPs from entering into any new or varied agreements which lease excess capacity from batteries without a waiver
	Accounting and transactional separation TNSPs must: maintain separate accounts for ring-fenced services and separate amalgamated accounts for entire business and comply with any AER accounting guideline	**Accounting and transactional separation** Extend accounting separation and cost allocation requirements to include allocating costs between transmission services and non-transmission services per TNSP's cost allocation methodology and cost allocation principles Explicitly prevent TNSPs from allocating or attributing costs to transmission services that

	TNSPs must allocate costs between ring-fenced services and other activities per any AER approved TNSP guidelines	properly relate to other services and require allocation attribution to be consistent with NER 6A.19.2
Discrimination	**Obligation not to discriminate** Only considers discrimination regarding prescribed transmission services, not contestable services, and has less definition around 'discrimination'	**Obligation not to discriminate** Include a more comprehensive non-discrimination obligation which will address TNSP's misusing their monopoly position to discriminate unfairly in respect of the provision of prescribed transmission services and their dealings with related electricity service providers and their competitors in respect of contestable electricity services
	Functional separation – offices No obligation	**Functional separation – offices** No change
	Functional separation – staff TNSP must ensure its marketing staff do not work for an 'associate' taking part in a related business and that none of its staff are marketing staff of an associate taking part in a related business	**Functional separation – staff** Retain current obligation with some streamlining of wording.
	Functional separation – service branding, promotions No obligation	**Functional separation – service branding, promotions** No change
	Information access and disclosure TNSPs must ensure information regarding prescribed transmission services given to an affiliate taking part in a related business is available to others	**Information access and disclosure** Require TNSPs to keep information acquired in connection with provision of prescribed transmission services confidential, where it is not already publicly available Require TNSPs to only use such information for the purpose for which it was acquired or generated Require TNSPs to establish an information sharing protocol and maintain an information register about information shared with a related electricity services provider
	Third-party service providers No obligation on third parties providing prescribed services on behalf of a TNSP	**Third-party service providers** Require TNSPs to ensure that any new agreements with third party service providers who provide services contain provisions that mirror non-discrimination and information access and disclosure provisions applicable to TNSPs
	Compliance reporting TNSPs must report measures taken to ensure compliance; could include independent audit	**Compliance reporting** Require annual compliance reporting, subject to independent audit Extend breach reporting to 15 days from breach

	TNSPs must report any breaches immediately	
	Waivers After consultation, AER may waive any TNSP obligation if satisfied benefit to the public is outweighed by cost to TNSP of complying with the guideline	**Waivers** Maintain waiver process but expand to include a power for AER to issue class waivers Restrict the provisions for which waivers may be granted
Other matters	**Transitional arrangements** N/A	**Transitional arrangements** TNSPs will have 12 months to comply with Version 4 of the guideline. However immediate compliance with the guideline is required for: • breach reporting (i.e. 15 day breach reporting) • entering into any new or varied agreements relating to the leasing of excess battery capacity and service provider arrangements • annual compliance reporting for the period of commencement date to 31 December 2023. Reports should be submitted by 30 April 2024.
	Additional obligations After consultation, AER may impose additional obligations on TNSP if satisfied cost to TNSP and its affiliate of complying is outweighed by benefit to the public	**Additional obligations** By implementing more comprehensive and robust ring-fencing requirements the ability for the AER to impose additional ring-fencing obligations will no longer be required. Therefore our draft position is to remove this obligation.

Next steps

Following the release of our draft guideline and this explanatory statement, we will undertake further consultation before releasing our final guideline. Indicative timing is as follows.

Indicative date	Project milestone
4 November 2022	AER publishes draft guideline and explanatory statement
17 November 2022	AER public forum on its draft guideline and explanatory statement
16 December 2022	Submissions on draft guideline and explanatory statement close
March 2023 (publication)	AER publishes final guideline and explanatory statement
March 2023 (publication)	Guideline commences and takes effect
12 months post publication (draft position)	Guideline compliance begins

1 Background

Under the National Electricity Rules (NER), the Australian Energy Regulator (AER) is required to develop, and may amend from time to time, a transmission ring-fencing guideline (guideline).[5] The guideline provides for the accounting and functional separation of the provision of prescribed transmission services by transmission network service providers (TNSPs) from the provision of other services by TNSPs. Ring-fencing supports the development of competitive markets by placing restrictions around TNSP behaviour to prevent them from taking advantage of their status as a monopoly service provider.

Ring-fencing benefits consumers in two ways:

- by addressing the risk that consumers pay more than they should for regulated services because a TNSP uses regulated revenue to cross-subsidise unregulated services offered in competitive markets; and
- by supporting competitive markets, meaning that electricity consumers can benefit from lower long-term costs and greater consumer choice associated with strong competition.

The guideline was first published by the Australian Competition and Consumer Commission (ACCC) in August 2002. While there have been minor amendments to the guideline over the years,[6] the guideline has not substantively changed since that time, despite significant changes in the regulatory landscape and electricity market.

For this reason, we commenced a full review of our transmission ring-fencing arrangements with the release of a Discussion paper on 15 November 2019.[7] Following a pause due to disruptions associated with the COVID-19 pandemic, we recommenced the review with the release of an Issues paper on 31 May 2022.[8] We received 18 submissions in response to the Issue paper (as well as 9 submissions in response to the Discussion paper).[9] We held a public forum on 15 June 2022 attended by 17 stakeholders[10] and also consulted individually

[5] NER, 6A.21.2.

[6] The current version of the transmission ring-fencing guideline (Version 3) was recently published on 6 July 2022. Prior to that, the transmission ring-fencing guideline was republished by the AER in 2005 (Version 2). Version 2 of the guideline was substantially the same as Version 1.

[7] See AER, *Electricity transmission ring-fencing – a review of current arrangements, Discussion paper* , November 2019.

[8] See AER, *Ring-fencing guideline electricity transmission, Issues paper*, May 2022.

[9] We received 18 submissions on the Issues Paper from: AEC; AEO; AGL; Ausgrid, Endeavour Energy and Essential Energy (collectively, the NSW DNSPs); CitiPower, Powercor and United Energy (collectively CitiPower); CEIG; ENA; Iberdrola; Jemena; NECA; Network REZolution; Northern Beaches Council; Powerlink; Snowy Hydro; TasNetworks, Tilt Renewables; and Transgrid, In addition, we received 9 submissions in response to our 15 November 2019 Discussion Paper from the following: ENA, Australian Energy Operations, AusNet Services, CitiPower/Powercor/United Energy, Evoenergy, TasNetworks, Transgrid, Spark Infrastructure, and the Public Interest Advocacy Centre.

[10] The following sent one or more representatives to the 15 June 2022 public forum: AEMC, APA, AusNet Services, Clean Energy Council, Department for Energy and Mining, ElectraNet, Elliott Green Power, Electrical Trades Union of Australia (ETU), Incenta Economic Consulting, Marinus Link, NECA, Neoen, Nexa Advisory, Northern Beaches Council, Powerlink, TasNetworks, and Transgrid.

with various stakeholders. We thank all stakeholders for their constructive engagement to date.

This draft explanatory statement and accompanying draft guideline sets out our draft positions on updating the transmission ring-fencing guideline to ensure it remains fit for purpose and continues to support outcomes that are in the long-term interests of electricity consumers. We consider the proposed changes strike an appropriate balance, having considered the views of all stakeholders. However, this remains a draft guideline and we welcome feedback from interested stakeholders before we finalise the guideline.

1.1 Australia's rapidly transforming electricity market

Australia's electricity market is undergoing a fundamental transformation. Historically, the nation's electricity market depended on electricity generated from coal and gas fired power stations. The transmission system we have today was constructed based on the location of coal and gas resources used to fuel electricity generation.

The move to renewable generation sources, including wind and solar, represents a significant transformation that reinforces the role of transmission as the backbone of the national electricity market. This system consists of interconnected networks of high voltage lines and infrastructure that carry electricity from generators to distributors and ultimately to consumers. The shift from fossil fuels to renewables highlights the importance of the transmission network, and its role in connecting these new renewable generation sources into the electricity market.

As the industry transitions, new generators will need to be connected to the transmission network to replace retiring fossil fuel generation. Approximately 80 renewable power projects are either committed or being commissioned at present, while over 450 projects have been publicly announced.[11] TNSPs will play a critical role in facilitating these connections in their role as the monopoly operator of the transmission network.

The regulatory framework provides for the contestable provision of some elements of transmission connections. This is a nascent market that should be supported where possible. The development and implementation of each generation project may cost several hundred million dollars to complete. Each project is likely to require a new connection the cost of which is likely to be approximately 10% of the overall project cost.[12] As such, the potential benefits of improving competition and driving down the cost of connections are likely to be high, and these benefits will be passed through to consumers via lower wholesale prices.

The location of these new generators will also drive significant investment in the transmission network. The best sources of wind and solar are not always located close to the existing electricity network. This means new transmission infrastructure needs to be built, and existing assets strengthened and expanded, to enable new renewable generators to connect.

[11] AEMO, Generation information (as of August 2022). 'Renewables' in this regard includes solar and wind farms, hydro power stations, and batteries.

[12] See AEMC, *Transmission connection and planning arrangements, Rule determination*, 23 May 2017, Sydney, p ii.

The investment needed to expand and strengthen the transmission system is significant. The Australian Energy Market Operator (AEMO) predicts that at least 10,000 kilometres of new transmission lines will be required to accommodate the anticipated growth in renewable generation over the next 30 years, at an estimated cost of around $12.7 billion.[13] For context, the combined value of the regulatory asset bases of the 7 TNSPs is approximately $22.8 billion.[14] This will significantly increase TNSPs' revenue and geographic reach.

Building on contestable transmission connection services, there is an increasing appetite for allowing third party delivery of transmission services, with the overarching objective of lowering costs for consumers through competitive tensions. For example, some jurisdictions such as NSW are implementing the competitive provision of transmission services through renewable energy zones (REZs). Australia's transition to renewables also increases the importance of essential system services such as system strength, inertia[15] and fast frequency response. In the past, these physical properties were created as a by-product of synchronous fossil fuel and hydro generators and considered essentially 'free' services. In contrast, inverter-based generators – such as wind and solar – generally are not able to provide these services.

TNSPs currently have a role to play in planning to provide, and maintaining, a secure and reliable network. This role includes procuring inertia when directed by AEMO[16] and, from 1 December 2022, procuring system strength services.[17] However, a range of reform initiatives are currently under way that may change the regulatory framework for how essential system services are provided, including who is responsible for procuring them (where they are not mandated). In addition, the AEMC has received a rule change request proposing the development of a competitive spot market for inertia. The continued role of TNSPs in this space, and the role of ring-fencing to support newly competitive markets, will need to be carefully considered.

Finally, some TNSPs have deployed assets such as batteries and synchronous condensers that can provide both contestable and network services. The opportunities for using such assets for multiple purposes are expanding, with new markets being implemented for fast frequency response and being considered for other essential system services. While 'value stacking' these services may provide benefits to consumers, the opportunities for cross-subsidisation and discrimination are also increased where TNSPs own, operate and/or lease such assets.

We note the critical role batteries can play in supporting the shift to a generation mix that is dominated by variable renewable generators. AEMO anticipates that by 2050, approximately

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[13] AEMO, *2022 Integrated system plan*, June 2022, p 15.

[14] AER, *State of the energy market 2022*, p 59.

[15] Inertia is a physical resistance that slows the impact of a sudden disturbance to the system. The large rotating mass of a plant's turbine and alternator create this inertia as they rotate in synch with system frequency. A system with low inertia has a higher risk that frequency deviations will cause generators to disconnect from the power system. AER, AER, *State of the energy market 2021*, p. 43.

[16] Under NER 5.20B.4, a TNSP that is an Inertia Service Provider must make inertia network services available if AEMO assesses that there is or is likely to be an inertia shortfall in a particular area.

[17] AEMC, *Efficient management of system strength on the power system*, Rule determination, 21 October 2021.

46 GW/640 GWh of dispatchable storage capacity will be required.[18] TNSPs will have an important role in connecting utility-scale storage to the transmission network. TNSPs can also support the deployment of storage by purchasing network services from third party providers. However, it is important that TNSPs are not able to distort the development of the utility scale battery market or contestable markets in which the battery may be operated, particularly at a time when many of these new markets (including, for essential system services) are developing and where innovation from new service providers is occurring.

Ring-fencing goes hand-in-hand with these regulatory, market and technology developments to support both competitive market outcomes, and innovation through the energy transition and to ensure consumers realise the benefits of these. Ring-fencing is an essential tool for levelling the playing field between TNSPs and third-party providers, helping them compete on an equal footing. The ring-fencing arrangements must therefore evolve to complement, and not obstruct, policy and market developments.

1.2 What is Ring-fencing?

Ring-fencing involves the separation of business activities, costs, revenues, and decision-making for delivering regulated (monopoly) network services, from the delivery of other, unregulated services that are subject to competition. In the context of electricity transmission, ring-fencing refers to the separation of prescribed transmission services provided by a TNSP (e.g., the installation, operation and maintenance of high voltage towers, poles, conductors and associated switching and protective equipment), from the provision of contestable services (such as electricity generation or retail services). The objective of ring-fencing is to provide a regulatory framework that promotes competitive markets, generally by seeking to ensure a level playing field for providers in markets for contestable services while promoting the long-term interests of consumers.

There are two key harms that ring-fencing seeks to prevent:

- Cross-subsidisation. This can occur where a TNSP uses revenue that it earns from providing prescribed transmission services to subsidise its activities in other, contestable markets.
- Discrimination. This can occur where a TNSP is able to favour itself or an affiliated entity, or discriminates against a competitor, as a result of providing a monopoly service.

Both cross-subsidisation and discrimination can have the effect of undermining or damaging competition and innovation in related contestable markets. In addition, cross-subsidisation can result in consumers paying more than they should for regulated transmission services.

TNSPs are subject to ring-fencing requirements under Chapter 6A of the NER. These rules require the AER to develop ring-fencing guidelines for the accounting and functional separation of TNSPs' prescribed transmission services from other services provided by the TNSP. The rules also provide that the AER's transmission ring-fencing guidelines may include other matters, such as:

[18] AEMO, *2022 Integrated system plan*, June 2022, p 50.

- legal separation of the entity through which a TNSP provides network services from any other entity through which it conducts business;
- limitations on the flow of information between the TNSP and any other any other person; and
- limitations on the flow of information between those parts of the TNSP that provide "prescribed" transmission services and parts of its business that provide any other services where there is the potential for a competitive disadvantage.

Finally, the rules allow the AER to add to, or waive, a TNSP's obligations under the ring-fencing guidelines.

1.3 Challenges in assessing the transmission ring-fencing requirements

Each TNSP, and the market within which it operates, is very different from one another. There is considerable disparity among TNSPs, for example in terms of their regulated revenues and the extent of infrastructure they operate and manage.[19]

Similarly, while all TNSPs' operations are focused primarily on providing transmission services, some TNSPs provide other electricity and non-electricity services, either themselves or through an affiliated entity. For example, TasNetworks provides both transmission and distribution services in Tasmania from within the same business entity[20] while AusNet's affiliate provides distribution services for the eastern half of Victoria. Other TNSPs have separate legal entities that provide contestable services. For example, Transgrid provides contestable connection services through a separate legal entity, Lumea.

In Victoria, where AusNet operates, AEMO is responsible for planning the transmission network and procuring contestable network and non-network services where augmentations are required. AEMO also has a role in facilitating connections to the shared transmission network. This means that AusNet's role and the context within which it operates is different to other jurisdictions.

Jurisdictions are transitioning to renewable energy at different paces and in different ways, impacting on factors such as the expected level of connections that will need to occur.

These differences mean it is challenging to balance the costs and benefits of ring-fencing tools across all TNSPs. For example, while a stronger approach may be justified for one TNSP, the same approach may be excessive for another TNSP due to differences in scale, scope or market context. We have approached this issue by adopting draft positions that are appropriate for the majority of TNSPs, noting that TNSPs will be able to apply for a waiver

[19] In terms of gross, regulated revenues in 2020-21, TNSPs ranged from large providers Transgrid, Powerlink, Transgrid and AusNet ($783, $781, and $622 million, respectively), to mid-sized ElectraNet ($320 million), to quite small TNSPs TasNetworks ($143 million) and smaller Murraylink and Directlink (about $15 million each). See *AER, Electricity Networks Performance Reporting*. The transmission networks operated by TNSPs also vary widely, from 63 km (Directlink), the smallest, to 14,534 km (Powerlink), the largest (with the average being about 6,200 km). AER, State of the Energy Market 2022, p 61 Figure 3.2.

[20] TasNetworks currently has a waiver from the transmission ring-fencing guideline to enable this to occur.

from several of the proposed obligations where appropriate. In practice, this means we have generally erred on the side of having a lighter-touch approach.

1.4 Alignment with distribution ring-fencing requirements

In reviewing the guideline, the NER require us to consider consistency with the distribution ring-fencing guideline.[21] However, we are mindful of the differences between distribution and transmission markets. For example:

- DNSPs are considerably larger than TNSPs, both in terms of revenues, operating expenditures and infrastructure. For example, average operating expenditures allowed for DNSPs over the five years ending 30 June 2026 are $3.2 billion. Over the same period, operating expenditures for TNSPs averaged $812 million – or a little less than one-quarter of the DNSPs' expenditures.[22]
- DNSPs serve nearly 11 million connections via 755,429 km of lines, most of which are residential and small business customers. In contrast, TNSPs serve a few hundred customers over 43,411 km of high voltage lines, most of whom are large and well-resourced.[23]

Despite these differences, there are areas where we consider alignment between the two guidelines to be appropriate, particularly where divergence in policy could distort market outcomes.

We also note that the distinction between distribution and transmission is less sharp today than it was previously. Some DNSPs – such as Ausgrid – provide services via 'dual function assets.' Dual function assets operate at distribution level voltages (between 66 kilovolts (kV) and 220 kV), meaning services provided by these assets might be prescribed transmission services but for the fact that the NER specifically deems them to be distribution services.[24] Similarly, in Victoria, AusNet provides transmission services at voltages typically associated with distribution system voltages (33 kV and possibly lower). As such, we consider aligning the guidelines where appropriate is less likely to result in loopholes or distortions.

As noted in the Issues paper, we consider the distribution guideline to be a modern and flexible regulatory instrument that reflects the challenges and opportunities of the current and future market for network businesses in distribution. We also conducted extensive consultation on the distribution ring-fencing guideline, covering a range of issues that are relevant to transmission, and have drawn on learnings from that process.

Since 2016, we have been actively monitoring DNSPs' compliance with the guideline through annual reporting. We have amended the distribution ring-fencing guideline twice since 2016, with the latest version of that guideline issued in 2021.[25] We have incorporated our learnings

[21] NER, 6A.21.2(c)(2).

[22] See AER, *State of the energy market 2022*, p 86 Figure 3.5.

[23] See AER, *State of the energy market 2022*, p 61 Figures 3.2 and 3.3.

[24] NER, 6.24.

[25] AER, Ring-fencing Guideline - Electricity Distribution - Version 2, October 2017; AER, Ring-fencing Guideline – Electricity Distribution – Version 3, November 2021.

from developing the distribution ring-fencing guideline over the past five years in our review of the current transmission ring-fencing guideline.

1.5 Ring-fencing in Renewable Energy Zones

Renewable Energy Zones (REZs) are being developed in New South Wales, Victoria and Queensland, with the NSW framework most progressed.[26] The purpose of REZs is to cluster new wind and solar projects in renewable hubs so that transmission investment can be made efficiently – in terms of time and cost. Clustering renewable generation in REZs reduces the amount of transmission investment that would otherwise be needed if new renewable power sources are widely dispersed.

The role of ring-fencing within REZs will likely be determined by individual state governments and will depend on the framework they adopt. In NSW, the Government has appointed the AER as a regulator to oversee development of the state's REZs and conferred a number of functions on us under the *Electricity Infrastructure Investment Act 2020* (NSW). These functions include making five-year revenue determinations for authorised network operators, determinations for contributions from the state's DNSPs, and developing a risk management framework.[27] In addition, the AER will be developing ring-fencing guidelines that are specific to network operators who operate in NSW's REZs. Our transmission and distribution ring-fencing guidelines will likely inform development of similar guidelines for NSW REZ.

1.6 Structure of this draft explanatory statement

The remainder of this draft explanatory statement is structured as follows:

- Chapter 2 sets out our draft position on how we propose to amend the current ring-fencing obligations to address issues in relation to cross-subsidisation.
- Chapter 3 sets out our draft position on the appropriate mix of tools to address discriminatory behaviour.
- Chapter 4 sets out the proposed obligations in relation to compliance and reporting.
- Chapter 5 explains our draft position on waivers.
- Chapter 6 sets out our draft position on transitional and grandfathering arrangements.
- Chapter 7 addresses other issues including our position on additional ring-fencing obligations, whether the addition of a civil penalty provision is appropriate and further reviews to the guideline.

Our draft guideline (Version 4) should be read in conjunction with this explanatory statement. To assist stakeholders, a list of guideline clauses that we have amended or deleted, together with new clauses, is provided in Appendix A.

[26] For a discussion of REZs, see AER, *State of the Energy Market Report*, 2021, p 58.

[27] See AER, *NSW Renewable energy zones* and NSW Government, *Electricity-infrastructure-roadmap*.

2 Preventing cross-subsidies

This Chapter explains the content and rationale for our proposed amendments to the guideline that further reduce the risk of cross-subsidisation by a TNSP. Cross-subsidisation occurs where TNSPs use revenue earned through providing prescribed transmission services to subsidise its activities in other markets. This can cause harms in two ways. First, consumers pay more than they should for regulated services. Second, TNSPs can gain an unfair advantage in a contestable market by recovering some of their costs from consumers of regulated services, allowing them to undercut their competitors in the contestable market for reasons other than cost efficiencies.

There are two tools we can use to address the risk of cross-subsidisation:

- legal separation; and
- account separation and cost allocation.

While both tools are currently in place, we consider their application should be strengthened, for the reasons discussed below.

2.1 Legal Separation

Legal separation provides transparency in the way costs are allocated between different services. Legal separation goes further than separate accounting and cost allocation measures which, alone, are not sufficient to prevent cross-subsidisation if a TNSP was to provide non-transmission services. Legal separation gives an added layer of transparency and assurance about separation arrangements, including the ways costs are allocated, increasing the robustness of ring-fencing arrangements.[28] For example, each legal entity is required to comply with the *Corporations Act 2001* (Cth) and the relevant requirements for the preparation of financial statements and company accounts.

Legal separation also supports the non-discrimination ring-fencing provisions, discussed in Chapter 3, by reinforcing the requirements for the TNSP and its affiliate entity to deal with each other at arms-length. For example, the TNSP must enter into separate transactions with its affiliates and we may request details of those transactions.

TNSPs are currently prohibited from carrying on a related business, being the activities of generation, distribution, and retail electricity supply. However, TNSPs are permitted to carry on these activities, if the total revenue from them does not exceed 5% of their total annual revenue. There is no restriction on TNSPs providing other types of services from the same legal entity.

In the Issues paper we asked whether the guideline should be amended to define the services that TNSPs may provide, rather than the activities they cannot engage in and, if so, the appropriate scope of services. We did not propose to amend the general restriction on the ability of TNSPs to provide generation or retail services but asked whether TNSPs should

[28] The NER allows a ring-fencing guideline to include provisions defining the need for and extent of "legal separation of the entity through which a TNSP provides network services from any other entity through which it conducts its business". See NER 6A.21.2(b)(1)(i).

be able to provide distribution services, new and emerging electricity services (including leasing batteries) and non-electricity services. We also asked whether the ability to carry on generation, distribution, and retail electricity supply services up to a 5% cap remained appropriate or whether it should be removed and instead allow TNSPs to apply for a waiver.

2.1.1 Submissions

Submissions from ENA and individual TNSPs generally opposed extending legal separation requirements on the basis that the AER had not provided evidence of harms occurring that would justify this requirement. They also considered that existing cost allocation obligations provide sufficient transparency to demonstrate that no cross-subsidisation is occurring, and that the possible harms from TNSP legal entities providing other services (excluding generation and retail) is very low. Similarly, Network REZolution considered that the competition benefits of requiring legal separation do not outweigh the costs to TNSPs, and therefore did not support it.[29]

AusNet considered that legal separation is not required in Victoria due to the contestability framework adopted in that jurisdiction, whereby AEMO has a role in procuring transmission services on a contestable basis.[30]

Other stakeholders supported extending legal separation requirements on the basis it would improve transparency, support the non-discrimination ring-fencing provisions and appropriately align transmission and distribution.[31] The Australian Energy Council (AEC) considered legal separation of transmission services from other services was required because accounting separation and cost allocation are not sufficient to prevent cross-subsidisation since they simply require cost assignment and provide too much flexibility on how costs are assigned.[32] Iberdrola acknowledged that TNSPs may incur initial costs in legally separating transmission and non-transmission services, but noted that they "expect this to be small and balanced by subsequent competition benefits".[33] CitiPower/Powercor/United Energy (collectively, CitiPower) generally supported stronger ring-fencing arrangements, as did Snowy Hydro and Tilt Renewables.[34]

2.1.1.1 Distribution services

Submissions from TNSPs argued that they should be permitted to provide distribution services for consistency with distribution. In their joint submission, Ausgrid, Endeavour Energy and Essential Energy (collectively, the NSW DNSPs) also supported TNSPs

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[29] Network REZolution, *AER Electricity Transmission Ring Fencing Review – Issues Paper* submission, 22 July 2022, p 8.

[30] AusNet, *Response to Questions from the Ring-fencing Guideline Electricity Transmission Issues Paper*, 22 July 2022, p 2.

[31] AEC, *Issues Paper: Ring-Fencing Guideline Review (Electricity transmission)* submission, 22 July 2022, p 2; AEO, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 2; AGL, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, pp 1-2; Iberdrola, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 2.

[32] AEC, *Issues Paper: Ring-Fencing Guideline Review (Electricity transmission)* submission, 22 July 2022, p 2.

[33] Iberdrola, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 2.

[34] CitiPower, *Transmission ring-fencing guideline review* submission, 22 July 2022, p 1; Snowy Hydro, *Issues Paper: Ring-Fencing Guideline Review (Electricity transmission)* submission, 22 July 2022 p 1; Tilt Renewables, *Response to Ring-fencing Guideline Electricity Transmission – Issues Paper* submission, 22 July 2022, p 1.

providing distribution services on the basis that, without mirroring the distribution guideline, it could be problematic for DNSPs who want to provide transmission services and become a TNSP because they would then be subject to the transmission guideline preventing them from providing distribution services.[35]

On the other hand, Jemena cautioned against TNSPs being able to offer contestable distribution services without any functional separation.[36] Jemena stated that there is a degree of substitution between transmission and distribution, and it would give TNSPs an unfair advantage as compared with DNSPs who would be required to functionally separate these contestable activities. Iberdrola considered TNSPs should not be permitted to provide distribution services, with the exception of TasNetworks.[37] Australian Energy Operations (AEO) supported TNSPs only providing transmission services.[38]

2.1.1.2 New and emerging electricity services

ENA considered that the possible harms from a TNSP providing contestable electricity services were very low.[39] They also considered the guideline should not regulate services that do not exist yet, and that the potential for harms to arise is unique to each service. They noted that changes to the scope of contestable services generally occurs through the NER, and it is appropriate to consider ring-fencing issues via that process.[40]

Similarly, Transgrid suggested that existing approaches to managing cross-subsidies (namely cost allocation methodologies) are working, and that since TNSPs are already providing contestable services there may be more harm than benefit to requiring legal separation.[41] Transgrid also noted that TNSPs that do not provide prescribed transmission services should not be caught by any new legal separation obligations.

TasNetworks noted that competition for some services can be limited, so removing the ability of a TNSP to provide that service may be detrimental. Further, having to apply for a waiver in this situation would be administratively burdensome.[42]

As noted above, other stakeholders consider that TNSPs should not be permitted to provide services other than transmission services within the same legal entity. For example, AGL stated that TNSPs should not be able to provide contestable electricity services on the basis that 'any encroachment by a TNSP in a contestable market will…decrease efficiency in that market or an associated market to the detriment of the consumer'.[43]

2.1.1.3 Non-electricity services

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[35] NSW DNSPs, *Ring-fencing Guideline Electricity Transmission: Issues Paper* joint submission, 22 July 2022, pp 2-3.

[36] Jemena Electricity Networks, *Ring-fencing guideline (electricity transmission) review* submission, 22 July 2022, p 2.

[37] Iberdrola, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 2.

[38] AEO, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 4.

[39] ENA, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 3.

[40] ENA, *Transmission Ring-fencing Guideline Response to AER Issues Paper* submission, 22 July 2022, p 11.

[41] Transgrid, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 2.

[42] TasNetworks, *Ring-fencing Guideline Electricity Transmission – Issues Paper* submission, 22 July 2022, p 2.

[43] AGL, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 1.

As for other types of services, TNSPs considered they should be able to provide non-electricity services without legal separation because there is no evidence of harm from doing so and no ability for them to discriminate. Further, the cost of legal separation would outweigh the benefits of them providing the service, leading to them withdrawing from the market with consequent loss of competition.

Other stakeholders that commented specifically on this issue, specifically AEO and Iberdrola, supported legal separation of non-electricity services.[44]

2.1.1.4 Defining services

Stakeholders were generally supportive of updating the guideline language from regulating "activities" to regulating the "services" TNSPs can provide.

Stakeholders had mixed views on whether service definitions in the rules are sufficiently clear. ENA, Ausnet and Iberdrola considered there is no need to provide further prescription.[45] Transgrid and CitiPower considered them to be less clearly defined than for distribution.[46] Transgrid suggested the AER provide examples of services that may or may not be provided by TNSPs.

2.1.1.5 Exceptions to legal separation

TNSPs and Network REZolution considered the 5% revenue cap should be maintained.[47] They considered waivers are an administrative burden, time consuming and impose unnecessary costs. There was also concern about the potential need to apply for a waiver and the regulatory uncertainty this would create, imposing a barrier to innovative solutions. ENA indicated that while few TNSPs have used this cap to provide generation services to date, they may do so in the future as the system transitions rapidly.

The NSW DNSPs considered the revenue threshold should be reviewed and updated, noting that it was much higher than the 'equivalent' threshold provided for stand-alone power systems in the distribution ring-fencing guideline and the two sets of guidelines should be aligned.[48]

Other stakeholders were supportive of adopting a waiver regime in place of the 5% revenue cap on the basis that TNSP revenues are expected to increase, providing TNSPs with

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[44] AEO, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 2; Iberdrola, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 2.

[45] AusNet, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 3; ENA, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 2; Iberdrola, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 2.

[46] Transgrid, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 2; CitiPower, *Transmission ring-fencing guideline review* submission, 22 July 2022, p 2.

[47] AusNet, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 6; ENA, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 4; Network REZolution, *AER Electricity Transmission Ring Fencing Review – Issues Paper* submission, 22 July 2022,p 9; TasNetworks, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 3; Transgrid, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 3.

[48] NSW DNSPs, *Ring-fencing Guideline Electricity Transmission: Issues Paper* joint submission, 22 July 2022, p 3. The revenue threshold for stand-alone power systems is not, however, equivalent to the 5% revenue cap in the current transmission ring-fencing guideline, given the very narrow application of the distribution guideline.

significant scope to increase generation and retail activities under the current cap.[49] Iberdrola argued there should be neither a cap nor a waiver for legal separation of non-transmission services on the basis that doing so would 'materially weaken the effectiveness of ring-fencing requirements'.[50]

2.1.1.6 Leasing batteries

In relation to battery services, TNSPs, ENA and Network REZolution considered they should be able to lease spare capacity without the need for a waiver.[51] ENA however noted that some oversight may be warranted, suggesting a reporting framework that potentially sits alongside the regulatory investment test (transmission) process, rather than a waiver. The NSW DNSPs also held the view that TNSPs should be able to lease batteries without a waiver, and that this approach should be extended to distribution.[52]

AusNet considered that TNSPs do not have a competitive advantage in utility-scale battery storage, noting that of 16 batteries currently operating or under construction, only 3 have involved a TNSP. AusNet also noted differences in the Victorian regime which it considers means there is no scope for cross-subsidisation or discrimination.[53]

Other stakeholders generally considered that TNSPs should require a waiver to lease spare capacity given the significant harms to the market of a TNSP being able to directly earn unregulated revenue without the appropriate checks and balances.[54] The AEC considered TNSPs should not be able to own batteries or lease the spare capacity, arguing it is almost impossible to allocate the costs between different services due to the speed at which a battery can switch between providing different services, and so it is not possible to prevent cross-subsidies from occurring.[55] Similarly, Iberdrola considered TNSPs should not own and operate batteries, but rather work closely with other parties to develop them and contract for services.[56]

2.1.2 Draft position

Our draft position is that the current legal separation requirements should be extended so that a TNSP may provide transmission services and may not provide other services. This retains the existing prohibition on a TNSP providing generation, contestable distribution

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[49] AEC, *Issues Paper: Ring-Fencing Guideline Review (Electricity transmission)* submission, 22 July 2022, p. 2; AGL, *Issues Paper: Ring-Fencing Guideline Review (Electricity transmission)* submission, 22 July 2022 p 2, NECA, *Issues Paper: Ring-Fencing Guideline Review (Electricity transmission)* submission, 22 July 2022 p 2.

[50] Iberdrola, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 3.

[51] AusNet, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 4; ENA, *Transmission Ring-fencing Guideline Response to AER Issues Paper* submission, 22 July 2022, p 10; Network REZolution, *AER Electricity Transmission Ring Fencing Review – Issues Paper* submission, 22 July 2022, pp 7-8; TasNetworks, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 3; Transgrid, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, pp 2-3.

[52] NSW DNSPs, *Ring-fencing Guideline Electricity Transmission: Issues Paper* joint submission, 22 July 2022, p 2.

[53] AusNet, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, pp 4-6.

[54] AEO, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 2; AGL, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, pp 1-2; Citipower, Powercor, United Energy, *Transmission ring-fencing guideline review* joint submission, 22 July 2022, p 3.

[55] AEC, *Issues Paper: Ring-Fencing Guideline Review (Electricity transmission)* submission, 22 July 2022, p 3.

[56] Iberdrola, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, pp 2-3.

services and electricity retail supply services within the same legal entity and extends it to capture other types of contestable electricity services and non-electricity services (with some exceptions). The draft guideline does not prevent an affiliated entity of a TNSP from providing other services, subject to certain constraints. This is broadly consistent with the approach taken for distribution.

Transmission services include prescribed, negotiated and non-regulated transmission services. For clarity, under the draft guideline, TNSPs will continue to be able to provide non-regulated transmission services, including contestable transmission connections, within the same legal entity. In drafting this guideline, it is our intention that network services being provided in respect of a REZ will fall within the definition of transmission services and could therefore be provided within the same legal entity. The strengthened legal separation requirements will not impact any TNSP that only provides transmission services.

We consider that the proposed, strengthened legal separation obligations represent a targeted and proportionate approach to address concerns about the potential for cross-subsidisation between revenue obtained from providing prescribed transmission services and the provision of other services. This approach updates the guideline to reflect the current electricity market, which is very different from when the guideline was written two decades ago. Since then, the division between generation, network and retail services have blurred, and new contestable electricity services have been introduced. The scope of services that a TNSP could potentially provide extends well beyond the transmission services envisaged in 2002. Consequently, the opportunities for TNSPs to cross-subsidise other services using revenue from providing prescribed transmission services, and so the need for transparency has increased.

As noted in the Issues paper, there are three developments in the NEM that are particularly relevant to our consideration of the potential for cross-subsidisation:

- The size of transmission investment is expected to increase significantly over the coming years, with an associated increase in revenue. In turn, this would increase the absolute value of the cap under which TNSPs could offer generation, distribution and retail electricity services if the revenue cap approach in the current guideline were to be maintained.
- New contestable electricity markets are being developed that were not envisaged when the current guidelines were written and do not clearly fit into the definition of a generation, transmission, distribution, or retail service.
- Technologies are now being used to provide prescribed transmission services that can also be used to provide contestable electricity services, such as batteries and synchronous condensers.

The role of TNSPs is also changing. As noted in Chapter 1, TNSPs were previously responsible for high voltage electricity network assets, which were relatively well defined. New connections occurred infrequently and tended to be limited to very large generators or large consumers. The need for significant new transmission investment was limited. TNSPs are now expected to deliver 10,000 km of new transmission lines by 2050.[57] Connecting

[57] AEMO, *2022 Integrated system plan*, June 2022, p 12.

generators are typically much smaller but are expected to occur in greater numbers than historically. TNSPs also have a responsibility to maintain a secure and reliable grid as the generation mix becomes dominated by variable renewable energy. This includes being responsible for procuring some essential system services, such as inertia and system strength, as the synchronous generators that traditionally provided these services retire.

The distinction between transmission and distribution is also becoming less clear. Some large users or generators may have the option of connecting at the transmission or distribution level. There may be a mix of high voltage and low voltage assets needed to provide connection services which, under the NER, could be defined as providing a mix of transmission and distribution services. We recognise that it is important to ensure this consumer choice is not distorted by differences in the approach to transmission and distribution regulation if efficient outcomes are to be achieved.

We are concerned that without appropriate controls and oversight, there is a risk of cross-subsidisation that is not adequately addressed under the current guideline. The current guideline does not capture the full suite of non-transmission services a TNSP may provide and permits generation, distribution, and electricity retail supply activities up to a 5% revenue cap.

Accounting separation and cost allocation methodologies alone are not sufficient to address concerns about cross-subsidies. Legal separation provides greater transparency into how costs are allocated to the TNSP before the cost allocation methodology is applied to allocate costs between transmission services.

Improving the transparency of cost allocation through legal separation will provide greater certainty and confidence for other market participants that they are competing with TNSPs on a level playing field. As noted above, while the main purpose of legal separation is to address concerns about cross-subsidisation, it also has the added benefit of reinforcing non-discrimination requirements for the TNSP and affiliates to operate at arms-length. Addressing cross-subsidisation also removes any unfair advantage to the TNSP in contestable markets due to cross-subsidies.

We acknowledge there will be some costs involved for TNSPs in separating out their existing non-transmission services (to the extent they currently provide such other services), which will ultimately be passed through to consumers. These include: the costs associated with setting up a new legal entity; possible tax impacts from moving activities into a new legal entity; one-off costs of establishing new commercial agreements, licences and other regulatory obligations; and ongoing costs associated with preparing and auditing separate financial accounts.

We note that a number of TNSPs already have associated separate legal entities, such as Transgrid (Lumea) and TasNetworks (42-24 and Marinus Link), suggesting the costs of setting up another legal entity are not prohibitive.

TNSPs have also said they may stop providing non-transmission services if required to legally separate, because the costs of legal separation may outweigh the benefit to them of continuing to provide the services. If there is a competitive market for the provision of those services, it is not clear there would be significant harm to electricity consumers from TNSPs no longer operating in those markets. On the other hand, there is potential risk that

consumers could be cross subsidising the provision of those services were TNSPs permitted to continue offering those services from the same legal entity.

There may be some instances where there may be undesirable consequences if a TNSP withdrew from providing a service, such as where the TNSP is the only provider of an electricity service, even where that service is contestable. **We would welcome evidence from TNSPs where any electricity services are currently provided by TNSPs that do not fit the definition of a transmission service, but which could not practically be provided by any other party**.

In respect of AusNet's view that legal separation should not apply in Victoria due to the contestable transmission arrangements in that jurisdiction, we note that legal separation already applies to AusNet under the current guideline in relation to generation, distribution and retail electricity supply activities. We do not propose to relax these obligations for Victoria. AusNet receives regulated revenue to meet its responsibilities to maintain and operate the existing shared network. Without transparent and robust cost allocation requirement, strengthened through legal separation, there is still an opportunity for AusNet to use its regulated revenue to cross-subsidise contestable services.

On balance, we consider that if TNSPs wish to provide services other than transmission services for commercial reasons, this should be done from a separate legal entity to provide transparency and assurance about separation arrangements. We consider this approach is more likely to be in the long-term interests of consumers by ensuring they are not subsidising services from which they do not benefit and providing other market participants with greater confidence that they are competing on a level playing field, enhancing competition.

Further reasoning for our draft position not to allow TNSPs to provide unregulated distribution services, other electricity services and non-electricity services is set out in the sections below.

For completeness, in the Issues paper we expressed the preliminary view that the general restriction on the ability of TNSPs to provide generation or retail services would remain. No submissions disagreed with this view, noting that ENA raised the possibility of TNSPs providing generation under the current revenue cap. This is discussed in Section 2.1.2.5.

2.1.2.1 Distribution services

One of the key areas of focus for ring-fencing under the NER[58] is on separating contestable electricity services from non-contestable electricity services. In principle, we are comfortable with a single legal entity providing different types of regulated services on the basis that those services are subject to regulatory oversight and a cost allocation methodology. Requiring a business to separate two regulated businesses would impose significant costs, which would be passed on to consumers. In the case of transmission and distribution services, it may also reduce the efficiencies that can be achieved from economies of scale from operating two regulated electricity networks. As such, we consider there is case to allow TNSPs to provide regulated distributions services.

[58] See NER 6.17.2 and 6A.21.2 for distribution and transmission, respectively.

The case for TNSPs providing contestable distribution services is less clear.

There may be benefits from permitting TNSPs to offer contestable distribution services by increasing competitive tension in those markets. In turn, this could lower costs and increase innovation.

On the other hand, we hold concerns about TNSPs generally being able to provide unregulated, non-transmission services due to the risk of cross-subsidisation. Contestable distribution services are not subject to regulatory oversight or a cost allocation methodology.

Further, as discussed in Chapter 3, we are not proposing to impose the same degree of functional separation on TNSPs as for DNSPs meaning that unlike a DNSP, a TNSP could trade on its regulated brand in offering contestable distribution services. While the level of brand recognition of a TNSP is likely to be lower than for distribution, some TNSPs have relatively strong relationships with their communities.

We have not been provided with any evidence supporting a need for TNSPs to be able to provide distribution services, other than for TasNetworks, which already has a waiver to provide both distribution and transmission services.[59] TNSPs have not suggested that they intend to start offering contestable distribution services should the current restriction be removed.

While the distribution ring-fencing guideline permits DNSPs to provide transmission services within the same legal entity, the associated explanatory statement indicates this was primarily done to recognise that some DNSPs own both distribution and transmission assets to provide regulated network services. At the time the distribution ring-fencing guideline was drafted there was a very limited market for contestable transmission services, and so the ability of DNSPs to provide contestable transmission services was unlikely to have been a serious consideration.

Our draft position is that the guideline should be amended to permit TNSPs to provide regulated distribution services (that is, direct control services) within the same legal entity, but not contestable distribution services on their own. Where a TNSP is also a regulated DNSP providing direct control services, then we consider it appropriate that the TNSP/DNSP should also be able to provide any other distribution services, so long as they are complying with the distribution ring-fencing guideline. If a TNSP is not a regulated DNSP under Chapter 6 of the NER (that is, it does not provide direct control services), but wishes to provide contestable distribution services, then it will need to seek a waiver from the legal separation requirements, to ensure that the risks of cross-subsidisation are appropriately mitigated.

In practice, this approach means that TasNetworks would no longer require a waiver from the transmission ring-fencing guideline to continue to provide distribution services within the same legal entity as it is a DNSP who provides direct control services, and therefore, is

[59] Ausgrid also owns transmission assets, which are deemed to provide distribution services for the purposes of economic regulation. The current transmission ring-fencing guideline introduced a similar approach for ring-fencing, clarifying that the guideline does not apply to services provided via dual function assets see the definition of ring-fenced services).

required to comply with the distribution ring-fencing guideline with respect to any distribution services it provides.

We consider this approach is in keeping with the original policy intent of the distribution ring-fencing guideline. It strikes an appropriate balance between reducing administrative burden for those TNSPs that are already subject to appropriate regulatory oversight and preventing potential harms associated with cross-subsidisation.

However, we consider this to be a nuanced issue and would welcome further feedback from stakeholders on whether the draft guideline appropriately balances the various potential costs and benefits of allowing TNSP to provide distribution services, as well as any additional evidence that would help inform our assessment.

2.1.2.2 New and emerging electricity services

Under the current guideline, TNSPs are permitted to provide any services, other than generation, distribution, and retail electricity supply, within the same legal entity. This means there is currently no restriction on TNSPs providing a range of electricity-related services that were not envisaged when the guideline was drafted, such as demand management services, constructing private microgrids, consulting services, laboratory and testing services and leasing batteries. Further, new contestable markets are being considered for essential system services such as inertia.[60]

For reasons discussed above, we consider that legal separation is important to provide transparency of costs to ensure there is no cross-subsidisation from revenue earned from prescribed transmission services. Requiring legal separation will help prevent this from occurring.

Further, there is an added risk that TNSPs could potentially discriminate in favour of themselves or an affiliate providing contestable electricity services. This could occur in circumstances where a TNSP is able to use information it holds due to providing prescribed transmission services to favour itself or an affiliate in providing the contestable electricity services.

While legal separation is targeted more towards preventing cross-subsidisation than discrimination, as noted above it reinforces the requirement for a TNSP and its affiliate entity to deal with each other at arms-length. In doing so, there is greater transparency of related party charges, allowing us to consider whether these appear reasonable compared to market costs.

We are not persuaded that the benefits to electricity consumers of TNSPs being able to provide contestable electricity services within the same legal entity outweigh the potential costs and risks. As such, the draft guideline proposes prohibiting the provision of contestable electricity services (to the extent that these are not transmission services) within the same legal entity.

[60] See AEMC and AEMO, *Essential system services and inertia in the NEM*, joint paper, June 2022.

2.1.2.3 Non-electricity services

As noted above, the current guideline permits TNSPs to provide any services, other than generation, distribution and retail electricity supply, within the same legal entity. We understand that some TNSPs are currently providing non-electricity services such as telecommunications and fibre optics.

We agree there is limited scope for TNSPs to discriminate in favour of itself or an affiliate in providing non-electricity services. However, we remain concerned about the ability of TNSPs to cross-subsidise the provision of these services.

For this reason, the draft guideline prohibits TNSPs from providing non-electricity services within the same legal entity without a waiver, with some exceptions discussed below. This is consistent with our approach to distribution, and we have not been presented with evidence to suggest this approach is not also appropriate in transmission.

2.1.2.4 Defining services

The draft guideline updates the language from regulating "'activities' to regulating the 'services' TNSPs are able to provide.

This approach relies on clear definitions of the different services categories, without which the guideline will be difficult to apply in practice.

Overall, we consider the definitions of "transmission services" and the different types of transmission services recognised in the NER to be adequate. However, there are some services that may not clearly fit into an existing definition.

We generally expect services that are delivered for the purposes of, or in the course of, providing transmission services will be permitted to be provided within the same legal entity. For example, consulting services that are provided in delivering a non-regulated transmission service (e.g., the contestable component of a connection to the transmission network) would be considered a transmission service. However, consulting services for the provision of a private microgrid would not be considered a transmission service.

Generation may be deployed as an input into providing a prescribed transmission service if it is deployed solely for network support services. However, if a TNSP owns generating units that are registered with AEMO as market generating units and so receiving revenue from the wholesale market, we consider this to be a generation service and so would not be permitted to be provided within the same legal entity under the draft guideline without a waiver.

Further examples are provided below.

2.1.2.5 Exceptions to legal separation

Revenue threshold versus a waiver approach

TNSPs are currently permitted to engage in generation, distribution, and retail electricity supply activities up to a cap of 5% of their annual revenue. In the Issues paper we canvassed removing the cap but introducing the ability to apply for a waiver from this obligation, similar to distribution.

Given the changing role of TNSPs and the importance of their role in supporting the transition of the electricity industry towards net zero emissions, TNSPs need to have the

flexibility to invest in and procure services efficiently and provide prescribed transmission services at a low cost to consumers. During this transitional phase, TNSPs may also need flexibility to be innovative in the way that they meet their regulatory obligations to provide greatest value to consumers. We do not want to restrict TNSPs' activities to the extent that this would inhibit improved outcomes for consumers. For this reason, we do not consider it prudent to remove avenues to provide these services altogether.

On the other hand, we are concerned that without appropriate controls and oversight, there is a risk of consumers paying for assets or additional capacity that is used to provide contestable services without a commensurate benefit being passed back to consumers. As discussed further in Chapter 3, we are also concerned about the potential for discriminatory behaviour and the impact on competition, particularly in new and emerging markets. Unlike a revenue cap, waivers have the added benefit for the market of providing greater transparency over the activities being conducted by a TNSP and allow the AER to impose conditions over the provision of services to enable greater regulatory oversight.

We consider that permitting TNSPs to offer non-transmission services up to a cap based on a percentage of revenue is no longer fit for purpose and that a waiver approach is a more appropriate tool. There are several reasons for this:

- As noted previously in this document and by some stakeholders, TNSPs' annual revenue is expected to increase over coming years, driven by significant transmission investment under the Integrated System Plan. Transmission investment of $12.7 billion is required to deliver 10,000 km of new transmission lines.[61] Revenue will also increase due to expected increases in interest rates and so the permitted rate of return.
- There is a risk that TNSPs could breach their cap since revenues change over time. There is no clear process to monitor this.
- There is currently no oversight of TNSP activities within the revenue cap, or process to monitor whether the cap is being complied with. It is therefore difficult for the AER to monitor any risks or potential harms associated with the TNSP conducting those activities, as well as compliance. For example, investing up to the full cap in a single service (such as generation) could have quite different harms from using the cap to provide a mix of services.
- Waivers provide greater transparency over the services being provided and allow conditions, such as reporting, to be attached. This allows the AER to monitor any potential risks and harms and also provides greater confidence to other market participants that TNSPs are not cross-subsidising or using their monopoly power to gain an advantage in a contestable market.

The approach is consistent with distribution, which we consider appropriate. We have not been presented with strong evidence as to why TNSPs require a revenue cap approach, particularly given its limited current use. While certain DNSPs can provide stand-alone power

[61] AEMO, *2022 Integrated system plan*, June 2022, p15. This compares to current combined RAB for TNSPs of approximately $22.8 billion.

systems up to a revenue cap, TNSPs have not identified a similar circumstance which could apply in the context of transmission.

The only TNSP to inform us that it is currently using the 5% cap is Transgrid, which recently acquired two diesel generators as a back-up supply to Broken Hill when there is a transmission outage. While ENA suggests use of generation could become more common in the future, this situation appears relatively unique and we consider a waiver would be an appropriate approach to address this scenario. Given concerns about the ability of TNSPs to affect generator access to the wholesale market, we consider an added layer of scrutiny is appropriate where TNSPs are providing a generation service. However, where a TNSP is using a generator solely to provide network services a waiver would not be required. We consider that if a TNSP is earning generation market revenue from running a generator, then it is providing a generation service.

For these reasons, the draft guideline replaces the revenue cap with the ability of TNSPs to seek a waiver from legal separation obligations where the costs of legal separation are likely to outweigh the benefits to electricity consumers. We consider this appropriately balances flexibility for TNSPs with necessary oversight and monitoring to ensure any non-transmission services provided within the same legal entity as a TNSP will ultimately benefit consumers.

Leasing assets

Some TNSPs are currently leasing out transmission assets to third parties, such as using poles and wires to mount telecommunications cables and leasing spare office space. Generally, we consider this is appropriate and likely to benefit consumers where it is in accordance with the shared asset rules and guideline, by reducing the cost of providing prescribed transmission services. As such, the draft guideline clarifies that leasing assets to a third party, with the exception of batteries, is permitted.

Batteries

For the purpose of the transmission ring-fencing guideline, we consider there are two general categories of battery services: those that are related to a network business' role in supporting the network and all other services, including those that are supplied into contestable markets, such as wholesale energy.

The grid-scale battery market for contestable services is in development and ring-fencing is particularly important given the nascent and emerging status of battery services markets. Allowing TNSPs to operate without checks and balances could stifle smaller and less well-equipped market participants, harming competition and ultimately resulting in consumers paying more for services.

Currently the guideline allows a TNSP to provide contestable services using batteries as long as any revenue from generation, distribution or retail services is less than 5% of the TNSP's overall revenue.

Given our proposed position is to remove the cap and instead introduce a prohibit and waive approach, a TNSP would not be able to provide contestable services directly from batteries and would need a waiver to lease excess capacity of a battery to a third party to provide those services. We consider this approach provides an appropriate balance between

encouraging competition in the battery services market, while allowing TNSPs to apply for a waiver and have their proposals considered on a case-by-case basis.

It is important to note that grid-scale batteries in transmission are not comparable to smaller batteries being rolled out by DNSPs, which include community batteries. While the distribution guideline also uses a prohibit and waive approach to battery services, we have granted waivers for battery services that mitigate the ring-fencing risks, and which demonstrated benefits to consumers from the granting of a waiver.

More discussion about battery waivers and their operation can be found in Section 5.2.7.

Synchronous condensers

Synchronous condensers are similar to batteries (although more limited) in that the same asset is capable of providing more than one service, such as system strength and inertia. [62] As such, we considered whether restrictions should also be placed on leasing synchronous condensers. The only stakeholder to comment specifically on this issue was AGL, which considered investment in these assets should be driven by contestable market signals rather than TNSP investment.[63]

From 1 December 2022, TNSPs are required to provide system strength as a prescribed transmission service.[64] TNSPs may do this by building new network infrastructure, including the use of synchronous condensers, or contracting with existing synchronous generators. TNSPs are also currently responsible for procuring other system services such as inertia and reactive power that can also be provided by synchronous condensers.

In making the system strength rule, the AEMC considered that 'TNSPs are best placed to consider what mix of solutions will maximise operational efficiency'.[65] It also noted that the proliferation of individual system strength remediation schemes, including synchronous condensers owned by third parties, created complexity and system security risks. Synchronous condensers may therefore be an important part of a TNSP's toolkit to meet its obligations to provide these types of services.

In theory, synchronous condensers could be leased to third parties to provide contestable services, such as frequency control ancillary services markets (noting that TNSPs cannot operate in these markets). Synchronous condensers could also potentially be used to supply a new market for inertia if this was to develop, which is actively being considered by the AEMC and AEMO.[66]

While we have some concerns about TNSPs leasing these assets for third parties to provide contestable electricity services, at this stage we consider there is still significant uncertainty about how these markets will develop. On balance, we consider it appropriate not to specifically prohibit leasing of these assets at this stage. However, if contestable markets are to develop for which synchronous condensers could be used, we may revisit this decision

[62] For a description of how synchronous condensers work, see AER, *State of the energy market 2022*, p 53.

[63] AGL, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, pp 2-3.

[64] AEMC, *Efficient management of system strength on the power system*, October 2021.

[65] AEMC, *Efficient management of system strength on the power system*, October 2021, p 36.

[66] See AEMC and AEMO, *Essential system services and inertia in the NEM*, joint paper, June 2022.

(noting the AEMC is currently looking to introduce such a market)[67]. We also note that if this decision was reviewed in future, grandfathering existing services may be appropriate where TNSPs have already invested in synchronous condensers in good faith to meet existing regulatory obligations.

Other exceptions

The draft guideline carves out a number of exceptions from the obligation to legally separate transmission and non-transmission services, consistent with distribution. These carve-outs include:

- providing corporate services (such as general administration, accounting, payroll, human resources, legal or regulatory, or information technology support services) to a related electricity service provider or other legal entity;[68]
- providing staff or to a related electricity service provider or other legal entity where doing so is not prohibited under the guideline;
- providing electricity information to another legal entity where doing so is not prohibited under the guideline;
- providing assistance to the extent necessary to respond to an event (such as an emergency) that is beyond a Network Service Provider's reasonable control; and
- providing any other services authorised in accordance with the waiver process set out in the guideline.

2.2 Accounting separation and cost allocation

Accounting separation and cost allocation help provide transparency in the way in which TNSPs are allocating costs between different services. Combined with a requirement for an independent audit, these tools help provide confidence that TNSPs are appropriately allocating costs according to the services for which they are incurred, including between a TNSP and its affiliates.

There is currently a gap in the cost allocation requirements, whereby TNSPs are only required to allocate transmission costs according to their cost allocation methodologies. In the Issues paper we flagged that there is no existing reporting mechanism or enforceable obligation that requires correct cost allocation between transmission and non-transmission services.[69]

[67] See AEMC, *Operational security mechanism, Draft rule determination*, 21 September 2022.

[68] We discuss 'related electricity service provider' and our proposal to adopt a definition of that term in more detail in Section 3 of this explanatory statement.

[69] In the Issues Paper (at p 22), we suggested that this gap had been addressed by an update to the current guideline. However, this was not the case as the guideline was not amended in this regard.

2.2.1 Submissions

ENA submitted that in practice TNSPs already apply the cost allocation methodologies consistent with the distribution approach.[70] ENA also noted that existing cost allocation arrangements were working well.

Other stakeholders supported strengthened accounting separation on the basis it would improve transparency and appropriately align transmission and distribution. CitiPower supported stricter accounting separation between regulated and competitive services, particularly to prevent cross-subsidisation that might give a TNSP a competitive advantage in a contestable market.[71]

Jemena submitted that cost allocation accountabilities and requirements should be similar to distribution 'to give greater confidence that the appropriate consumers are charged for the costs incurred; both for incumbent and new TNSP services'.[72]

2.2.2 Draft position

Our draft position is that:

- The separate accounting obligations should be strengthened by requiring TNSPs to establish and maintain appropriate accounting procedures to ensure they can show the extent and nature of transactions between themselves and their affiliated entities.
- The cost allocation obligations should be strengthened by explicitly preventing TNSPs from allocating or attributing costs to transmission services that properly relate to other services. The allocation attribution must be consistent with the cost allocation principles in the national electricity rules (cl. 6A.19.2).

While TNSPs may already effectively be separating accounts and allocating costs between network and non-network services consistent with the stronger requirements for distribution, the AER has no other power to enforce these requirements. Further, unlike for distribution, there is no enforceable requirement for TNSPs' accounts and cost allocation between transmission and non-transmission services to be independently audited for ring-fencing purposes.

For this reason, the draft guideline extends the existing accounting separation and cost allocation requirements to include allocating costs between transmission services and non-transmission services as though the cost allocation methodology and cost allocation principles apply, mirroring the arrangements for DNSPs. We consider the costs to TNSPs are likely to be outweighed by the improved transparency, particularly to the extent that TNSPs already have systems in place to allocate costs in this way. The next two sub-sections further explain our draft position in respect of accounting separation and cost allocation.

2.2.2.1 Accounting separation

The legal separation requirements in the draft guideline prevent a TNSP from providing non-transmission services, but do not prevent an affiliate from providing such services. The

[70] ENA, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 2.

[71] CitiPower, *Transmission ring-fencing guideline review* joint submission, 22 July 2022, p 3.

[72] Jemena, *Ring-fencing guideline (electricity transmission) review* submission, 22 July 2022, p 2.

separate accounting obligation is targeted at preventing cross-subsidisation between transmission services and other services. The requirement to establish and maintain internal accounting procedures enables a TNSP to:

- isolate its costs associated with transmission services; and
- make transparent transactions between the TNSP and any affiliated entities.

The draft guideline also prohibits a waiver from these obligations. We consider this is appropriate because account separation is essential to give effect to the objectives of transparency and accountability. Permitting waivers could undermine confidence and certainty in markets for other electricity services and confidence that consumers are not cross-subsidising contestable services.

This approach strengthens the current guideline, which simply requires a separate set of accounts for the provision of prescribed transmission services and a separate amalgamated set of accounts for the entire business and does not prevent a TNSP from applying for a waiver from this obligation.

2.2.2.2 Cost allocation

The draft guideline strengthens the cost allocation provisions in the current guideline by:

- requiring a TNSP to allocate or attribute costs in a way that is consistent with its approved cost allocation methodology and with the cost allocation principles in NER cl. 6A.19.2, including between transmission and non-transmission services;
- preventing a TNSP from allocating or attributing the costs of providing other services to transmission services; and
- removing the ability for a TNSP to apply for a waiver from the cost allocation obligations.

Together, these obligations target the prevention of cross-subsidisation between transmission and non-transmission services. These obligations will improve certainty and confidence in the attribution and allocation of costs and complement the legal separation and separate accounting provisions.

As for accounting separation, we consider that not permitting a waiver from this obligation will improve certainty and confidence for stakeholders operating in competitive markets and ensures consumers do not pay for the provision of contestable services.

3 Preventing discrimination

This Chapter explains the content and rationale for our proposed amendments to the guideline that further reduce the risk of discrimination by a TNSP. Discrimination can occur where a TNSP is able to favour itself or an affiliate to the detriment of a competitor to gain an advantage in a contestable market. This could be through the provision of favourable (or unfavourable) terms and conditions or taking advantage of the use of confidential information gained in providing regulated services. Where such behaviour reduces competition in a market, consumers will be harmed through higher costs and less innovation.

In the Issues paper we identified four tools we can use to address the risk of discrimination to limit a TNSP's ability to discriminate in favour of its own, or an affiliate's, business, to the disadvantage of competitors:

- a general obligation not to discriminate;
- functional separation of offices, staff, branding and cross promotions;
- restrictions on sharing of confidential information and information sharing obligations to promote information symmetries; and
- application of non-discrimination measures to third party service providers.

After providing a summary of the harms identified by stakeholders in their submissions, and our ability to address them, we discuss each of these tools in turn.

3.1 Potential harms raised and AER's scope of power

3.1.1 Submissions

In submissions and consultation, stakeholders raised two key areas where TNSPs have the potential to discriminate against competitors: first, with respect to contestable transmission connections and second, with respect to batteries and particularly connecting batteries.

In respect of connections, stakeholders were concerned about both information sharing and the potential for TNSPs to use their position to favour themselves or an affiliate when providing contestable connections. CitiPower provided an example, suggesting that where a connection requires terminal station work, the relevant TNSP should provide consistent offers in respect of both price and non-price (e.g., timeframes for delivery, quality of service and variations) conditions. They noted these offers should be consistent irrespective of whether the customer is an affiliated entity, a distributor, or the TNSP itself. [73]

CitiPower also suggested that TNSP connection offers should include a clear breakdown of costs between the regulated components and unregulated works.[74] They considered this would assist consumers in comparing offers and reduce the risk of cross-subsidisation by a TNSP.

AEO also considered that the ring-fencing framework should be strengthened to support the contestable framework, particularly in Victoria where it considers the nature of the framework

[73] CitiPower, *Transmission ring-fencing guideline review* joint submission, 22 July 2022, p 2.

[74] CitiPower, *Transmission ring-fencing guideline review* joint submission, 22 July 2022, p 2.

is more conducive to competition but where more can be done to encourage it.[75] AEO raised similar concerns to CitiPower, noting that the incumbent TNSP could favour an affiliate through favourable timing and cost in relation to 'cut-in' work on the shared network. It also raised concerns about the TNSP's ability to discriminate in respect of the price, terms and conditions associated with the operation and maintenance of an identified user shared asset.

Jemena noted that 'TNSPs continue to hold a competitive advantage in the development of transmission networks and are increasingly leveraging this advantage in down-stream and other related markets.'[76] It raised concerns in relation to connections, where TNSPs and DNSPs compete to connect large customers. Jemena considered strengthened controls are necessary to prevent TNSPs and their affiliates bundling their products and jointly marketing to consumers.

With respect to batteries, Iberdrola raised concerns about TNSPs discriminating against third party battery providers in their connection arrangements, since TNSPs have access to information such as land and infrastructure availability that is not available to third parties.[77]

Tilt Renewables shared similar concerns, particularly since 'the grid connection study and connection agreement negotiation process for a battery is the most time consuming and expensive part of the development process'.[78] It notes that third party developers are at a disadvantage if a TNSP can expedite or connect their battery at a lower cost (such as by relaxing technical requirements). The Clean Energy Investor Group raised similar issues.[79]

In contrast, ENA considered there are sufficient constraints in the NER and general competition law, combined with the current guideline, to prevent discriminatory behaviour from occurring.[80] As discussed further below, TNSPs pointed to the connections framework in the NER as providing sufficient protections to address discriminatory behaviour. In addition, AusNet noted that the nature of the contestability framework in Victoria means that it does not have the ability to discriminate due to the role of AEMO in facilitating connections and, in the case of contestable augmentations, assessing competitive tenders.[81]

3.1.2 AER's scope of power

In developing our draft position on obligations to prevent discrimination, we are mindful of the limitations on our current ring-fencing powers under the NER. The NER limits the AER's transmission ring-fencing powers to requiring accounting and functional separation of prescribed transmission services provided by a TNSP from other services.[82] We do not have the power to require accounting and/or functional separation of negotiated transmission

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[75] AEO, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 5.

[76] Jemena, *Ring-fencing guideline (electricity transmission) review* submission, 22 July 2022, p 1.

[77] Iberdrola, *Ring-fencing Guideline Electricity Transmission – Issues Paper* submission, 22 July 2022, p 4.

[78] Tilt Renewables, *Response to Ring-fencing Guideline Electricity Transmission – Issues Paper* submission, 21 July 2022, p 2.

[79] Clean Energy Investor Group, *Response to Ring-fencing Guideline Electricity Transmission – Issues Paper* submission, 21 July 2022, p 1.

[80] ENA, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022.

[81] See e.g., AusNet, *Response to Questions from the Ring-fencing Guideline Electricity Transmission Issues Paper* submission p 8.

[82] NER 6A.21.2(a).

services (most commonly the non-contestable components of a transmission connection) from non-regulated transmission services (including the contestable components of connections).

Since TNSPs have the exclusive ability to provide negotiated transmission services, there is a risk that TNSPs can use this monopoly power to achieve favourable outcomes in providing transmission connection services. Given the scale and cost of connections required over the coming years, we consider there are significant benefits from ensuring connections are completed as efficiently as possible, and that connecting parties should be able to benefit from lower cost connection services driven by a competitive market. While the NER provide a number of protections in relation to information sharing, given the concerns raised by stakeholders it is not clear that the framework is functioning as well as intended.

We note that the AEMC also considered the nature of negotiated transmission services in its decision on the Transmission Connection and Planning Arrangements Rule Change, noting:[83]

> The Commission considers that negotiated transmission services are more akin to alternative control services than negotiated distribution services. This is because, under the final rule, the Primary TNSP is required to provide certain negotiated transmission services (connection services) on an exclusive basis. This is not the case for negotiated distribution services (where the DNSP is not required to provide the service). Imposing a form of separation at the transmission level similar to that imposed at the distribution level (i.e. between direct control services and other services) may therefore not be appropriate. The Commission is of the view that a more appropriate division would be between a TNSP's provision of prescribed transmission services and negotiated transmission services, and its non-transmission or other contestable transmission services.

We will consider, based on stakeholder feedback, whether the current obligations for preventing discrimination go far enough to address harms particularly in the provision of contestable connections services. **If current arrangements are considered inadequate, we are minded to pursue a rule change request that would seek to expand our ring-fencing powers to include the ability to specifically ring-fence negotiated transmission services, in addition to prescribed transmission services. We welcome feedback on this issue.**

We note that TNSPs are required to comply with the negotiating principles for negotiated transmission services.[84] This includes that TNSPs must:

[83] AEMC, *Transmission connection and planning arrangements, Rule determination*, 23 May 2017, pp 167-168.

[84] The negotiating principles are set out in NER S5.11. Clause 5.3.8 (2) provides TNSP must not use information provided to it in the provision of non-contestable services for purpose of tendering for, or negotiating, contestable services in the connection process in which data or information was given or in future connection processes without consent of Connection Applicant. However this is not a civil penalty provision.

- on request, identify and inform a connection applicant of the reasonable costs and/or the increase or decrease in costs (as appropriate) of providing a negotiated transmission service; and
- on request, demonstrate to a connection applicant that the charges for providing a negotiated transmission service reflect those costs and/or the cost increment or decrement (as appropriate).[85]

To the extent that stakeholders continue to have concerns in respect of TNSP conduct in the provision of connection services, we encourage stakeholders to raise these matters with the AER. If any evidence is presented to us that TNSPs are not complying with obligations under Chapter 5 of the NER, we may consider taking enforcement action where appropriate.

Potential harms raised by stakeholders that relate to prescribed transmission services can be addressed through strengthened measures and are discussed below. The ability of a TNSP to favour its own battery when it is operated in contestable markets is addressed in Section 5.2.7 below.

3.2 Strengthening the obligation not to discriminate

In the Issues paper, we noted that there is a gap in the current guideline because the obligation not to discriminate does not explicitly capture a TNSP providing a competitive advantage to, or otherwise favouring, an affiliated entity in their supply of contestable services. We also noted that the definition of discrimination has less prescription than the distribution guideline.

Our initial view was therefore that we would broaden the obligation not to discriminate in the same way we set out non-discrimination obligations applying to DNSPs and that similarly TNSPs would not be able to apply for a waiver from this obligation.

3.2.1 Submissions

Most stakeholders were supportive of, or did not oppose, broadening TNSPs' obligation not to discriminate.[86] While not opposing the measure, TNSPs suggested that general competition law is sufficient to address any actual discriminatory conduct by TNSPs.[87] ENA noted that the definition of discrimination should be drafted to recognise legitimate transmission reliability issues or national security concerns associated with third party access

[85] NER 5.2A.6(b)(1) and (2).

[86] AEC, *Issues Paper: Ring-Fencing Guideline Review (Electricity transmission)* submission, 22 July 2022, p 4; AGL, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022 , p 2; CitiPower, Powercor, United Energy, *Transmission ring-fencing guideline review* joint submission, 22 July 2022, p 3; ENA, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 4; Jemena, *Ring-fencing guideline (electricity transmission) review* submission, 22 July 2022, p 2; Network REZolution, *AER Electricity Transmission Ring Fencing Review – Issues Paper* submission, 22 July 2022, p 9; Transgrid, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 4.

[87] Ausnet, *Issues Paper: Ring-fencing Guideline Electricity Transmission* submission, 22 July 2022, p 1; Transgrid, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 4.

to the network.[88] AusNet Services considered an obligation not to discriminate is unnecessary in Victoria due to that State's unique contestability arrangements.[89]

3.2.2 Draft position

We propose to amend the transmission ring-fencing guideline to replicate the same form of non-discrimination obligations which apply to DNSPs under the distribution ring-fencing guideline. The guideline's general non-discrimination obligations seek to mitigate the risk of a TNSP providing a competitive advantage to a related electricity service provider in the supply of contestable electricity services. Also consistent with the distribution ring-fencing guideline, we propose to extend this obligation to mitigate a TNSP's risk of discriminatory conduct in respect of any 'related electricity service provider,' any customer of a related electricity service provider, or their own customers, consistent with the approach in the distribution guideline.

A related electricity service provider is defined in the draft transmission ring-fencing guideline and includes any affiliated entity of a TNSP and the part of the TNSP that provides contestable electricity services. However, as defined the term excludes a part of an affiliated entity that provides prescribed transmission services, negotiated transmission services or direct control services.

This approach provides for a clearer, more targeted approach to achieving the objectives of our draft guideline.

In the absence of the general non-discrimination obligations, there is a risk of a TNSP's related electricity service provider gaining an advantage over its competitors (including a potential new competitor) in contestable markets for energy-related services by reason of its relationship with the TNSP. Without limitation, the general non-discrimination obligations are targeted at preventing a TNSP from:

- giving its related electricity service provider a financial benefit that is not available to its competitors;
- giving customers of its related electricity service provider a financial or non-financial benefit that would not be available to them if they were customers of a competitor of the related electricity service provider; or
- using its position as a TNSP to advantage its related electricity service provider in competing to provide contestable services.

The general non-discrimination obligation also prohibits a TNSP from providing recommendations or providing information in favour of a related electricity service provider.

We consider that the cost of extending the general obligation not to discriminate as described above, is relatively low – mainly the cost of establishing processes and procedures and

[88] ENA, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 5.

[89] AusNet, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, pp 8-9.

reporting compliance, and the limited opposition from TNSPs suggests these costs will not be high.[90]

We disagree with stakeholder submissions that general competition law alone adequately addresses potential discrimination against providers of services in competition with TNSPs or their related entities. As we noted in the Issues paper, unlike general competition law, the guideline is industry-specific and is designed and enforced specifically to promote the national electricity objective. This has a different focus from general competition law, with its emphasis on end-use consumers.

Further, given the scale and speed of investment associated with connecting new generation to the transmission network, we consider it is not advisable to place too much reliance on general competition law rather than being able to proactively monitor and enforce non-discrimination obligations. We consider any issues raised under the draft guideline will be able to be resolved more quickly, which is more likely to be in the long-term interests of consumers.

Without limiting its scope, under the general prohibitions we also propose to include a non-exhaustive list of instances where the general obligations not to discriminate apply, including that TNSPs be required to:

- deal with a related electricity service provider as if it were not a related electricity service provider;
- deal with a related electricity service provider and its competitors in the same way
- provide the same quality, reliability and timeliness of service to a related electricity service provider and its competitors; and
- avoid providing information to a related electricity service provider that the TNSP has obtained through its dealings with a competitor of that provider that may advantage the provider.

Again, the above approach reflects the approach taken in the distribution ring-fencing guideline.

We expect TNSPs to deal with their related electricity service providers on an arm's length basis. We expect a TNSP to contract with its related electricity service providers on a commercially efficient basis, as if it were dealing with a non-related third party. The requirement to deal at arm's length does not restrict efficient purchasing policies. The Guideline does not prevent a TNSP from purchasing from a related electricity service provider so long as there is no cross subsidy or discrimination in favour of a related electricity service provider. It also does not prevent bulk procurement and passing on those savings or lower prices to related electricity service providers. However, the TNSP should be prepared

[90] With respect to ENA's concern about TNSPs' actions to dealing with national security, system reliability issues, we note that providing assistance to the extent necessary to respond to an event (such as an emergency) that is beyond a Network Service Provider's reasonable control would not be considered as 'discrimination' in contravention of the guideline. See ENA, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 5.

to deal on similar terms with competitors, including offering the benefits of these economies of scale, where possible.

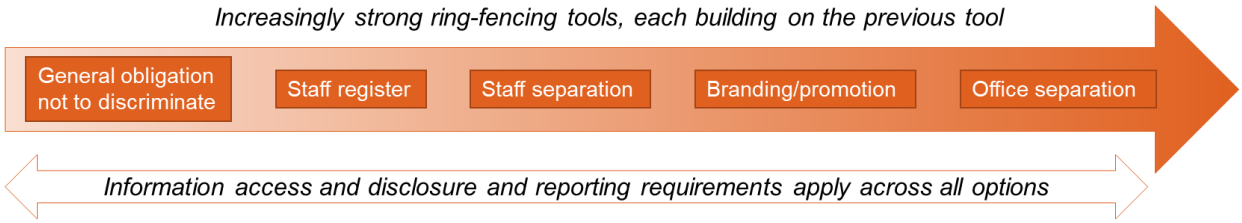
Finally, a TNSP must avoid providing to its related electricity service provider information that it has obtained from a competitor of its related electricity service provider. This is intended to avoid a related electricity service provider receiving an advantage in contestable energy-related markets in which it competes by reason of its relationship with the TNSP, and the access the TNSP has to information from many parties.

We propose that TNSPs will not be able to apply for a waiver from these obligations. Waivers could undermine the intent of this obligation to create a level playing field and encourage competition in the provision of contestable services.

3.3 Functional separation

Functional separation is a step beyond a general non-discrimination requirement. It reinforces the general obligation not to discriminate and controls on information flows by requiring physical and branding separation between the part of a business providing regulated services and the parts of the business or its affiliate providing contestable services. Figure 1 provides a summary of these tools.

Figure 1: Functional separation tools



Currently the only functional separation requirements applying to TNSPs relate to separation of marketing staff. In the Issues paper we noted we would consider strengthening functional separation obligations but recognised that differences in operating environments between TNSPs and DNSPs meant that the arrangements for distribution may not be appropriate.

3.3.1 Submissions

TNSPs, Network REZolution and ENA opposed functional separation to varying degrees.

ENA stated the transmission connection framework adopted by the AEMC in 2017 protects against cross-subsidisation and a TNSP performing its monopoly functions in a way that advantages its non-regulated activities without requiring functional separation.[91] Under this framework, ENA noted, TNSPs can provide both non-regulated, contestable connection services while providing certain elements of connection services as a monopoly service.

[91] ENA, *Transmission Ring-fencing Guideline Response to AER Issues Paper* submission, 22 July 2022, p 8.

Most TNSPs supported ENA's submission.[92] AusNet submitted that the division of the TNSP functions in Victoria between AEMO and declared transmission system operators means that TNSPs are already subject to functional separation.[93] AusNet noted that TNSPs must provide AEMO with information and assistance both to plan and prepare tender documents for contestable augmentations, meaning AEMO 'is the arms-length purchaser of the majority of services and controls all aspects of the contestable process'.[94] As a not-for-profit organisation, AusNet stated, AEMO has no commercial incentives in determining the successful tenderer and may require assurances from a TNSP that appropriate ring-fencing arrangements will apply to each procurement on a case-by-case basis.[95]

Network REZolution and the NSW DNSPs opposed extending the distribution ring-fencing guideline's functional separation obligations to TNSPs due to differences between the two markets.[96] They noted that strengthened functional separation is not appropriate because the transmission market is characterised by very different customers, namely entities involved in large scale projects who are well resourced and able to protect themselves from discriminatory behaviour. Network REZolution further noted that some TNSPs – particularly interconnectors – are not connected to regional reference nodes and have very limited opportunity to discriminate.

Stakeholders supporting functional separation noted their concerns about the potential for TNSPs to use offices and staff shared with unregulated affiliates to discriminate against competitors.[97] For example, the AEC and AEO expressed support for full functional separation to reduce the risk of TNSPs passing commercial information to unregulated affiliates.[98] AEO noted that full functional separation prevents a TNSP from advantaging its affiliate in terms of the timing and cost of 'cut-in' works, or through the price, terms and conditions of agreements for the operation and management of contestable components of identified user shared assets.

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[92] AusNet, *Response to Questions from the Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 9; Powerlink, *Submission on AER Issues Paper – Electricity Transmission Ring-Fencing Guideline*, 22 July 2022, p 3; TasNetworks, *Ring-fencing Guideline Electricity Transmission - Issues Paper* submission, 22 July 2022, p 1.

[93] AusNet, *Issues Paper: Ring-fencing Guideline Electricity Transmission* submission, 22 July 2022, p 2; AusNet, *Response to Questions from the Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, pp 2-3, 9-10.

[94] AusNet, *Response to Questions from the Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 2.

[95] AusNet, *Response to Questions from the Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 8, citing AEMO, Tender and evaluation process for contestable augmentations in Victoria, 13 June 2014.

[96] Network REZolution, *AER Electricity Transmission Ring Fencing Review – Issues Paper* submission, 22 July 2022, p 5; NSW DNSPs, *Ring-fencing Guideline Electricity Transmission: Issues Paper* joint submission, 22 July 2022, p 3.

[97] See, e.g., Iberdrola, *Ring-fencing Guideline Electricity Transmission – Issues Paper* submission, 22 July 2022, p 3; Iberdrola, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 5; NECA, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 4; AGL, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 3; CitiPower, *Transmission ring-fencing guideline review* joint submission, 22 July 2022, pp 2-3.

[98] AEC, *Issues Paper: Ring-Fencing Guideline Review (Electricity transmission)* submission, 22 July 2022, p 4; AEO, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 4.

CitiPower also supported full functional separation, including separation of staff, separation of office locations and a prohibition on branding and cross-promotion with affiliates that provide contestable electricity services.[99] CitiPower considered full functional separation is required because the potential for discrimination, including the use of privileged information, 'remains a real threat to the efficient and prudent delivery of transmission services'.

3.3.2 Draft position

As discussed above, our ring-fencing powers are limited to requiring functional separation between prescribed transmission services and other services. They do not currently extend to requiring separation between negotiated transmission services and other services. In this respect, we note the difference between transmission and distribution from a ring-fencing regulatory perspective. Unlike transmission, the NER authorises us to require functional and accounting separation between all regulated distribution services (i.e., direct control services) and other distribution services. Direct control services include 'alternative control services' that are similar to negotiated transmission services and, unlike transmission, distributors are not required to provide negotiated distribution services. Our distribution head of power therefore allows us to address where harm occurs meaning the costs of full functional separation are proportional to the benefits.

Given that many of the identified harms for transmission relate to the potential for discrimination in relation to a TNSP's monopoly position in providing negotiated transmission services (as part of delivering transmission connections), we wish to be clear that greater functional separation of prescribed transmission services cannot address these issues. Partly for this reason, we consider the benefits of strengthening staff, office and brand separation do not outweigh the costs at this time. The sections below provide further reasoning for this draft position.

We note that this is the first full review of the guideline in twenty years, and that many of the measures we have proposed will assist both in leveling the playing field for competitors as well as improving reporting requirements from TNSPs (discussed below). However, we also note that these measures may not go far enough to address the concerns about discriminatory behaviour suggested in submissions. **We welcome further feedback from stakeholders, including evidence that would support the need for a rule change to strengthen our ring-fencing powers.**

We will continue to monitor the market to ensure that our ring-fencing guideline remains fit for purpose. We expect our knowledge from increased compliance reporting and monitoring of TNSPs' provision of regulated and non-regulated services, particularly in association with network connections, will grow and may justify revisiting our proposed approach. We will also monitor further regulatory changes that may be adopted by the AEMC and other regulatory bodies that affect both the evolving energy market and the considerations underlying our proposed approach, including any rule changes amending our ring-fencing powers.

3.3.2.1 Additional staff and office separation

As previously noted, the current transmission ring-fencing guideline provides for limited functional separation of TNSP staff, requiring TNSPs to ensure their marketing staff do not

[99] CitiPower, *Transmission ring-fencing guideline review* joint submission, 22 July 2022, p 1.

work for an 'associate' taking part in a 'related business' and also requiring them to ensure TNSP staff are not marketing staff of such an associate. We propose to retain this provision, updating the language to reflect other amendments to the draft guideline, such as replacing 'associate' with 'related electricity service provider'.

However, based on the evidence available to us, we consider that the costs of requiring additional staff and office separation to restrict information flows between staff providing prescribed transmission services and those providing other services is likely to outweigh the benefits.

Physically separating offices and staff who work across prescribed transmission services and other services provided by the TNSP or its related electricity services provider is likely to be relatively more costly for TNSPs than DNSPs. TNSPs have a smaller and more highly specialised staff, meaning that the cost of duplicating positions is likely to be relatively high, particularly for smaller TNSPs. While a stronger approach may be justified for larger TNSPs that employ more staff and process more connections, the same approach may be excessive for other TNSPs due to differences in scale, scope or market context. We have approached this issue by adopting draft positions on functional separation that are appropriate for the majority of TNSPs, noting that in practice, this means we have generally erred on the side of having a lighter-touch approach.

While we consider there is the potential for discriminatory behaviour due to a TNSP having access to sensitive information gained as a result of providing prescribed transmission services, at this stage we consider the associated costs are likely to be lower than the cost of enforcing staff and office separation. Instead, we propose these potential harms will be addressed through the general obligation not to discriminate and information access and disclosure requirements, discussed below.

Nevertheless, there was minimal information provided on what the costs of office separation, and staff separation might be, and **we are therefore seeking feedback from stakeholders on the costs of functional separation where possible.**

In addition to staff and office separation we also considered requiring TNSPs to provide a public staff register which would contain any staff shared between the non-regulated and prescribed transmission parts of the business. However, it is unlikely that the registers would provide useful information to stakeholders since it would not capture information about staff shared between non-regulated and negotiated transmission services, where concerns about competition were raised. We therefore considered the costs of implementing this option would not outweigh the benefits, and so have not included staff registers in the draft guideline.

3.3.2.2 Restrictions on branding and cross-promotion of services

As for staff and office separation, we have formed a draft view that requiring separate branding between the regulated and unregulated parts of the business, coupled with restrictions on cross-promotion of services by such entities, are not warranted at this time.

As noted in submissions, the profiles of transmission customers differ considerably from distribution customers. Generators and large customers seeking to connect to transmission networks are generally large, well-capitalised firms with their own regulatory and technical staff, capable of addressing complex network and legal issues. In contrast, customers

accessing distribution services are typically residential or small business consumers that are more likely to be susceptible to, or confused by, shared branding and cross-promotions.

3.4 Information access and disclosure

The current transmission ring-fencing guideline requires a TNSP providing prescribed transmission services to ensure that information relating to those services, which is provided to any associate taking part in a related business, is available to any other party.

In our May 2022 Issues paper, we questioned whether the current guideline adequately protects against TNSPs and their affiliates potentially gaining an unfair advantage in contestable services markets from information obtained from the TNSP's provision of prescribed transmission services. We indicated that our initial view was to align the transmission guideline with the distribution guideline by:

- introducing a new obligation to protect ring-fenced information;
- introducing a new obligation to address the circumstances under which ring-fenced information may be disclosed;
- strengthening the obligation that requires ring-fenced information to be shared where it is disclosed to an affiliate; and
- introducing a new obligation to establish, maintain and keep an information register to facilitate information sharing.[100]

3.4.1 Submissions

Stakeholders were divided on whether the current transmission ring-fencing guideline ought to be strengthened as proposed in our Issues paper. Several DNSPs, AGL, AEO, Iberdrola, AEC and NECA expressed support for stricter rules prohibiting the sharing of information between TNSPs and related entities, aligned with the current distribution ring-fencing guideline's provisions.[101] For example, CitiPower noted that, in Victoria, where a connection to the distribution network involves terminal station works (i.e., upgrades to the transmission network), the DNSPs inform AusNet of the connection. According to CitiPower, AusNet has 'the ability to freely pass on that information to its unregulated affiliate or, use the information themselves to offer an alternate connection to the transmission grid.'[102] The AEC suggested that where a TNSP discloses private electricity information to a ring-fenced affiliate, then it must also be made clearly available to all other potential competitors.[103]

[100] AER, *Ring-fencing Guideline Electricity Transmission Issues Paper*, May 2022, pp 30-31, Table 1.6.

[101] Iberdrola, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, pp 5-6; AGL, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 21 July 2022, p 2; AEO, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 5; AEC, *Issues paper: Ring-Fencing Guideline Review (Electricity transmission)* submission, 25 July 2022, p 4; NECA, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 26 July 2022, p 4.

[102] CitiPower, *Transmission ring-fencing guideline review* joint submission, 22 July 2022, p 3.

[103] AEC, *Issues paper: Ring-Fencing Guideline Review (Electricity transmission)* submission, 25 July 2022, p 4.

In contrast, TNSPs, ENA and Network REZolution suggested that no change to the current guideline is necessary because robust information protection arrangements already exist in the rules in all jurisdictions for TNSPs.[104]

3.4.2 Draft position

Our draft position is that the guideline should be amended to strengthen obligations around information access and disclosure. We propose to mirror the obligations in the distribution ring-fencing guidelines so that TNSPs will be required to:

- keep information that is acquired by a TNSP in connection with its provision of prescribed transmission services confidential, where it is not already publicly available; and
- only use such information for the purpose for which it was acquired or generated.

We propose to clarify the circumstances under which such information may be disclosed. We also propose to clarify the circumstances under which information must be shared, and to require TNSPs to establish an information sharing protocol. Finally, we propose to require a TNSP to establish, maintain and keep an information register to provide transparency about information that has been shared.

This approach complements (rather than duplicates) the information sharing requirements in Chapter 5 of the NER that relate to contestable connections. We note that the Chapter 5 requirements provide a reasonably robust set of information access and sharing obligations for negotiated transmission services in the jurisdictions in which they apply. This guideline complements these measures by addressing information access and disclosure requirements for prescribed transmission services.

Increasing the transparency of information flows between a TNSP and its related electricity service provider will reduce any competitive advantage TNSPs or their affiliates derive from such information. This helps put competitors on a more equal footing with the TNSP or its affiliate, by increasing transparency, predictability, and confidence for stakeholders. We consider that the information access and sharing provisions we propose to adopt in the draft guideline will help to prevent such use of information to the disadvantage of firms that compete with a TNSP's affiliate.

This approach may not address all the harms we have identified (especially those that relate to negotiated services). However, it will address circumstances where a TNSP may share sensitive information received while providing prescribed transmission services with its related electricity service provider to its advantage. For example, a related electricity service

[104] ENA, *Transmission Ring-fencing Guideline - Response to AER Issues Paper* submission, 22 July 2022, p 16; ENA, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, pp 5-6; AusNet, *Response to Questions from the Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 10; TasNetworks, *Ring-fencing Guideline Electricity Transmission - Issues Paper* submission, 22 July 2022, p 1; TasNetworks, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 5; Transgrid, *Transmission Ring-fencing Issues Paper* submission, 22 July 2022, pp 7-8; Transgrid, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 5; Network REZolution, *Electricity Transmission Ring Fencing Review – Issues Paper* submission, 22 July 2022, p 8.

provider could use information about planned transmission investments or future transmission constraints that are not yet public to advise its customers on investment decisions. It could also use short-term or real-time information on network congestion to inform operational decisions.

Consistent with our initial view, our draft position is that TNSPs will not be able to apply for a waiver from this obligation.

3.5 Requirement for service providers to comply with the guideline

The current guideline does not contain a requirement for a TNSP's third party service providers (i.e., contractors) to follow certain provisions of the guideline as if they were operating as the TNSP. In the absence of this requirement, there is a risk that certain provisions of the guideline could be circumvented.

In the Issues paper we noted our initial view was we would amend the guideline to align with the distribution guideline to recognise that discrimination and information leaks can also come from third party providers.

3.5.1 Submissions

All stakeholders who provided submissions on this issue supported ensuring that the guideline applies to service providers of TNSPs.[105] For example, Iberdrola expressed concern that TNSPs can use affiliates to discriminate to their advantage by having unregulated affiliates of TNSPs tender for new transmission lines, which are then delivered by the TNSP.[106] The AEC suggested that waivers should not be available for third party service providers, as discrimination and information leaks can still be a function of third parties.[107]

3.5.2 Draft position

Our draft position is to introduce a new obligation on TNSPs to require any agreements with third parties who provide services to the TNSP to contain provisions which mirror the non-discrimination and information access and disclosure provisions of the guideline. This provision aligns the transmission and distribution guidelines.

Our intention is that this provision will apply to 'new' third party service agreements and will not require TNSPs to vary existing agreements. As such, the costs of compliance are likely to be minimal.

While the AEC's submission regarding waivers has been considered, our initial view is that waivers from this requirement should be permitted. In our experience with DNSPs, there are

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[105] NECA, *Ring-fencing Guideline Electricity Transmission Issues Paper Stakeholder feedback* submission, 26 July 2022, p 5. Iberdrola, *Ring-fencing Guideline Electricity Transmission Issues Paper Stakeholder feedback* submission, 22 July 2022, p 4; ENA, *Ring-fencing Guideline Electricity Transmission Issues Paper Stakeholder feedback* submission, 22 July 2022, p 7. AEC, *Issues Paper: Ring-Fencing Guideline Review (Electricity transmission)* submission, 25 July 2022, p 4.

[106] Iberdrola, *Ring-fencing Guideline Electricity Transmission Issues Paper Stakeholder feedback* submission, 22 July 2022, p 4.

[107] AEC, *Issues Paper: Ring-Fencing Guideline Review (Electricity transmission)* submission, 25 July 2022, p 4.

circumstances which warrant a waiver for some arrangements with service providers and waivers provide the AER with the flexibility to consider arrangements on a case-by-case basis.

4 Compliance and reporting

In our 2016 explanatory statement to the distribution ring-fencing guideline, we stated 'we consider a robust ring-fencing regime requires rigorous monitoring and reporting arrangements. In the absence of these measures the development of contestable markets may be undermined by lack of confidence and predictability.' We consider this statement remains relevant and is also applicable to the transmission sector.

As noted in our Issues paper, we have limited oversight of TNSP compliance with the current guideline. We can require TNSPs to report on compliance, including an independent audit, however the AER has not exercised this power in recent years.

In developing an updated reporting and compliance framework, we consider that an effective arrangement should encourage compliance, and detect any areas of non-compliance. We also consider that the compliance and reporting requirements in the draft guideline are consistent with the AER's Compliance and Enforcement Policy.[108]

4.1 Submissions

Most stakeholders who commented on compliance and reporting arrangements, supported strengthening the framework in a similar manner to the distribution ring-fencing guideline.[109] Stakeholders commented this would drive transparency and accountability. However, submissions from ENA and Network REZolution noted that increasing obligations on TNSPs would increase costs to businesses that could outweigh the benefit, and that these costs could be material for smaller TNSPs.[110] Transgrid noted that reporting and compliance obligations should be focused on where greatest harms may occur.[111]

On breach reporting, stakeholders were supportive of extending the timeframe to 15 days, in alignment with the distribution sector.

Stakeholders also commented on the ability of external parties to report non-compliance and the AER's processing of these reports. Iberdrola commented that the AER should develop a process for external parties to report breaches.[112] NECA proposed that the AER should enhance investigative powers to allow it to forensically examine a TNSP business when reports of non-compliance are received.[113]

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[108] AER, Compliance and Enforcement Policy, 13 July 2021, p 1.

[109] AEC, *Issues Paper: Ring-Fencing Guideline Review (Electricity transmission)* submission, 22 July 2022, p 4; AEO, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 6; Iberdrola, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 5; Jemena, *Ring-fencing guideline (electricity transmission) review* submission, 22 July 2022, p 2; NECA, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 5.

[110] ENA, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 4; Network REZolution, *AER Electricity Transmission Ring Fencing Review – Issues Paper* submission, July 2022, p 10.

[111] Transgrid, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 5.

[112] Iberdrola, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 7.

[113] NECA, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 5.

4.2 Draft position

We consider that the scope of reporting should be expanded to provide both the AER and the market with greater transparency and evidence that a TNSP is complying with ring-fencing obligations.

4.2.1 Annual compliance reporting framework

The draft guideline requires a TNSP's compliance with ring-fencing obligations to be independently verified by a suitably qualified auditor and reported to the AER annually. This means that a TNSP will submit two reports. One authored by the TNSP and a second report authored by an independent assessor. All reports will be published on the AER's website in the interest of transparency.

Annual compliance reports will be due within 4 months of the end of the calendar year to which the compliance report relates. This means that all TNSPs must submit compliance reports on 30 April each year. We consider this to reduce the burden created by other reporting requirements under the NER due following the end of financial year, which was an item of feedback during the review for Version 3 of the distribution guideline.[114]

For the first year of compliance TNSPs will report on a period of March 2023 (date of commencement) to 31 December 2023.

4.2.1.1 Auditing

Our draft position includes a new requirement for TNSPs to demonstrate via their annual independent third-party assessment that their compliance with the guideline's obligations has been independently reviewed. This provides stakeholders with the necessary confidence in a TNSPs compliance. Generally, the standard of audit that will be expected is 'reasonable assurance'.[115] However the transitional arrangements discussed in Chapter 6 provide a one-off exception to this.

To assist TNSPs with their compliance functions under Version 4 of the guideline the AER proposes to provide a *Compliance Reporting Best Practice Manual* similar to the one provided for distribution.[116] This manual will provide further information on the auditing standards required for an independent assessment of a TNSP's annual compliance with the guideline.

4.2.2 Reporting on breaches

The 15-day reporting timeframe is consistent with the distribution ring-fencing guideline. We consider this timeframe to provide sufficient time for a TNSP to compile any necessary information and submit it to the AER, while limiting the time available for harms to occur before the AER may act in relation to the breach. We note stakeholders' concerns regarding breach reporting and we consider that self-reported breaches are appropriate at this time. Other parties are still able to contact the AER if they have concerns or complaints about a

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[114] ENA, *Electricity Distribution Ring-fencing Guideline Issues Paper submission*, 18 December 2020, p 16.

[115] Auditing and Assurance Standards Board -- *Standard on Assurance Engagements ASAE 3000 Assurance Engagements Other than Audits or Reviews of Historical Financial Information* – June 2014.

[116] AER, Distribution ring-fencing, Compliance reporting best practice manual.

TNSP which the AER can further investigate. We consider this provides an appropriate balance to breach reporting and compliance.

4.2.3 Record-keeping

In addition to regular reporting, under the draft guideline a TNSP is required to establish and maintain appropriate internal procedures to ensure it complies with its obligations to establish, maintain and keep up to date records relating to:

- separate accounts;
- cost allocation and attribution;
- information sharing protocol; and
- information and waiver registers.

An independent assessor must verify a TNSP is appropriately maintaining these records. We may require a TNSP to demonstrate the adequacy of these procedures in addition to those already provided to us. These new compliance obligations will be included in the best practice manual for compliance processes noted above.

5 Waivers

Waivers provide the AER with flexibility to respond to circumstances as they arise, including those which we are currently unable to foresee. Under the current guideline, the AER can waive any of the TNSP ring-fencing obligations contained in clause 7, provided we are satisfied the benefit, or any likely benefit, to the public is outweighed by the administrative cost to the TNSP.

In our Issues paper, we noted that our experience with the distribution guideline has shown that waivers provide useful flexibility in applying ring-fencing provisions.[117] Where certain activities or services are broadly prohibited, waivers provide a mechanism to exempt a network service provider from having to comply where the costs of compliance with a specific provision(s) outweighs the benefits to consumers. The Issues paper noted several issues with the waiver mechanisms in the current guideline, such as:

- while waivers are permitted, the process for applying for waivers and the way in which we assess waiver applications is not well specified; and
- waivers can be granted for any transmission ring-fencing obligation.

With respect to criteria and processes governing applications for, and assessment of, waiver applications, the Issues paper expressed our initial view that we should apply the same waiver assessment criteria for TNSPs as apply for DNSPs. We also indicated we would give further consideration to the application of other aspects of the distribution guideline waivers provisions, including:

- the length of time for which a waiver may be granted, particularly in light of the fact that the service classification framework for TNSPs is less flexible; and
- whether class waivers may be appropriate.[118]

5.1 Submissions

Stakeholders who addressed the issue of waivers were generally supportive of a waiver process, similar to that which currently exists for DNSPs, being adopted for a revised transmission ring-fencing guideline.[119] For example, while ENA expressed the view that relying on waivers is not an appropriate means of addressing excessive regulatory intervention, it acknowledged that where circumstances make waivers appropriate, the same assessment criteria should be applied for TNSPs as apply to DNSPs.[120]

Similarly, NECA was supportive of a waiver process that aligned with distribution but suggested that the public must see that there was an independent review of the waiver

[117] AER, *Ring-fencing Guideline Electricity Transmission Issues Paper,* May 2022, p 26.

[118] AER, *Ring-fencing Guideline Electricity Transmission Issues Paper,* May 2022, p 34.

[119] AEO, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 6; AGL, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 2; AEC, *Issues Paper: Ring-Fencing Guideline Review (Electricity transmission)* submission, 22 July 2022, pp 3-4.

[120] ENA, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 8.

request prior to approval, as well as an independent review of the works undertaken to assess whether the waiver was appropriate and conforms to the original request.[121]

While Iberdrola generally opposed a waiver mechanism, if such a mechanism was adopted, it suggested that waivers should not be available for legal and functional separation obligations, the obligation to not discriminate, obligations relating to information access and disclosure, and compliance and reporting obligations.[122]

Other stakeholders were less receptive to the AER placing any reliance on a waiver mechanism.[123]

5.1.1 Duration of waivers

ENA, AusNet, TasNetworks and Transgrid supported the granting of 'evergreen' waivers on grounds that long duration waivers are important for ensuring sufficient regulatory certainty for transmission projects.[124,] In addition, Transgrid submitted that waivers should not be revocable.[125] In contrast, NECA suggested that the duration of a waiver should be set through a separate consultation process once the considerations regarding whether to grant a waiver have been addressed.[126] Waivers associated with high impact issues, like transitioning to the new ring-fencing guideline, should have a limited duration, according to Iberdrola.[127]

5.1.2 Class waivers

Most stakeholders who made submissions on the availability of class waivers for TNSPs were supportive of the concept.[128] This was largely due to the flexibility of being able to deal with class issues in an efficient and timely manner, triggered by the AER.

However, some stakeholders expressed opposition to class waivers. For example, NECA and Iberdrola noted that they cannot identify any circumstances in which class waivers may be appropriate for transmission.[129,] Iberdrola suggested that ring-fencing waivers should only be granted in exceptional circumstances and all waiver applications should be assessed on a case-by-case basis on their individual merits.[130]

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[121] NECA, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 6.

[122] Iberdrola, *Ring-fencing Guideline Electricity Transmission – Issues Paper* submission, p 6; Iberdrola, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, pp 7-8.

[123] See Network REZolution, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, pp 9-10; Transgrid, *AER Transmission Ring-fencing Issues Paper* submission*, 22 July 2022,* p 3; AusNet, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 6.

[124] AusNet, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 12; TasNetworks, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 7.

[125] Transgrid, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 6.

[126] NECA, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 6.

[127] Iberdrola, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022 p 8.

[128] AEO, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022 p 7.

[129] NECA, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022p 6; Iberdrola, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022 p 8.

[130] Iberdrola, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022 p 8.

5.2 Draft position

Our draft position is generally to mirror the waiver framework in the distribution ring-fencing guideline, including having some key clauses that are not able to be waived. We propose that core ring-fencing obligations relating to cost allocation, the obligation not to discriminate, and information access and sharing will not be able to be waived. We think this strikes an appropriate balance between providing regulatory certainty, with enough flexibility that, where warranted, exemptions may be granted from certain obligations.

Our intention by including a waiver option in the guideline is that this will only be used where appropriate, and a waiver would only be granted in limited circumstances on a case-by-case basis that demonstrates a compelling case for a waiver. A TNSP may apply for a waiver from the following clauses in the proposed guideline:

- clause 3.1 – legal separation obligations with respect to the provision of other services;
- clause 4.3 – staff separation relating to sharing of marketing staff between the TNSP and related electricity service providers; and
- clause 4.4.1(a) – new agreements with service providers must comply with guideline requirements.

From time to time, where appropriate, the AER may publish updated guidance on the information required in a waiver application to allow the application process to remain fit for purpose and responsive to changing market conditions and emerging services.

5.2.1 Assessment criteria for consideration of waiver applications

A waiver application must include all necessary information and materials to enable us to assess the application, including:

- the guideline obligation(s) and service(s) subject to the waiver application;
- reasons for the waiver application including the likely benefits to consumers of granting the waiver;
- details of the costs associated with the TNSP complying with the obligation if the waiver were refused;
- the proposed commencement date for the waiver, the proposed expiry date (if any) and the reasons for requesting those dates; and
- the regulatory control period(s) to which the waiver would apply.

In considering whether to grant a waiver, we will consider a range of criteria, not limited to:

- whether granting a waiver would better achieve the National Electricity Objective, including how granting a waiver is likely to benefit the long-term interest of consumers;
- whether the potential for cross-subsidisation and discrimination are suitably addressed or outweigh the likely benefits of the waiver;
- the costs to the TNSP of complying with the obligation; and

- the likely impacts that granting a waiver would have on markets for contestable electricity services.

These criteria have been developed based on the National Electricity Objective. In addition, we have considered lessons learnt from our development of the distribution ring-fencing guideline. From 2016 to 2021, we published three versions of this guideline. The significant stakeholder feedback received through that process is important to shaping our waiver process for the transmission sector.

There may also be circumstances where there are overlapping and inconsistent legal or regulatory requirements. For example:

- where regulatory requirements of a state or territory overlap with the AER's guideline; or
- where other services provided by a TNSP are also regulated services, whether regulated by us or by another economic regulator.

We will also consider these factors when assessing waiver applications.

In providing all the above criteria, we aim to make our decision-making process more transparent for TNSPs and other market participants.

5.2.2 Consultation process

The current transmission guideline requires the AER to consult when deciding whether to grant a waiver. However, we expect some waivers will be inconsequential in nature (such as extensions of time to existing waivers), while others may have further reaching implications in contestable markets. It is important that we have flexibility in how we choose to assess an application, to ensure that we do justice to each application, while minimising unnecessary administrative and compliance burdens.

Our draft guideline has been updated so that minor matters can adopt a simple approval process with limited or no public consultation. Matters we consider likely to attract stakeholder interest or to have the potential to impact on the provision of contestable services will require formal consultation. We consider this strikes the appropriate balance on consultation and is similar approach to the distribution guideline.

5.2.3 Decision-making timeframes

We will endeavour to make a final decision on each waiver application within 90 days of the application being lodged. If we consider that the waiver application, as lodged, does not fully comply with guideline (for example does not provide sufficient information for the AER to assess the application), we will notify the TNSP accordingly within 10 business days of receiving the application. Where a TNSP would be non-compliant with the guideline if we are unable to make a decision within 90 days, we may decide to grant an interim waiver, as discussed below.

5.2.4 Publication of waiver decisions and related materials

Many stakeholders indicated in the distribution review that any waiver decision should be accompanied by published reasons for the decision. We intend to publish the terms, conditions and reasons of any waiver we grant (other than an interim waiver) in some form.

5.2.5 Duration of waivers

We consider it remains appropriate for the AER to have the discretion to determine the duration of a waiver, irrespective of the purpose of the waiver. However, in line with our approach of providing more detail and guidance on the waiver process under a new guideline, we will provide more detailed guidance on duration.

Longer duration waivers may cross over market developments that warrant re-consideration of the grounds on which the waiver was granted. It is possible that over time the basis upon which we grant any waiver application is no longer valid. However, we acknowledge that longer duration waivers provide greater certainty for the market participant and that, in some cases, it may be appropriate to grant a waiver without an end date.

Under clause 5.3.4 of the distribution guideline, the AER can only grant a ring-fencing waiver up until the end of the next regulatory control period. This approach may require DNSPs to reapply for a waiver if the DNSP intends to continue the activity after the waiver end date. There is an exception for stand-alone power systems and energy storage devices (such as batteries), where the AER may grant a waiver for a different term which is generally linked to the expected operational life of an asset that is intended to provide a specific service.

In the transmission sector, where there is demonstrable benefit to granting a TNSP an evergreen waiver, this would be considered. While it is more likely that, due to the risk of market changes, waivers will be granted with sunset dates or a condition to review the appropriateness of the waiver after a reasonable period, we will consider evergreen waivers where it is appropriate to do so on a case-by-case basis.

If an end date is included, our initial position is that it will be linked to a TNSP's regulatory control periods on the basis that, if the waiver expires, it enables the TNSP to consider the treatment of any cost implications in its revenue proposal. Also, the regulatory determination process provides a sensible trigger to review any waivers.

As with the distribution sector, an end date for waivers relating to the leasing of capacity from energy storage devices will be linked to the expected operational life of the relevant asset unless there is evidence that it should not be (e.g., that a service from a battery is not expected to be required after a shorter period of time).

Regarding the assessment and decision process for a waiver, although we see merit in including independent reviews as proposed by NECA at various points of the waiver process, overall we consider the time and costs involved does not provide any additional rigour to our assessment process and introduces regulatory uncertainty. We consider that the AER's internal assessment and decision processes strike an appropriate balance.

5.2.6 Reviewing and revoking a waiver

While network businesses have argued previously that the ability of the AER to revoke waivers would lead to uncertainty for networks and deter investment,[131] we consider that the ability to review and revoke a waiver under reasonable circumstances is necessary. We should be able to review a waiver at any time to assess its continued appropriateness, such

[131] CitiPower, Powercor and SA Power Networks, *Ring-Fencing Guideline Exposure Draft* joint submission, 16 November 2016, p 2.

as where new information has come to light or circumstances have changed that would likely have changed our views on the original need for the waiver.

If we propose to vary or revoke a waiver (including any conditions that we have imposed in relation to a waiver) we will:

- give the TNSP to whom the waiver was granted at least 40 days' notice of our proposed action before making any decision to vary or revoke the waiver; and
- give consideration to the same matters as we consider for the assessment of a waiver application.

We will usually publish our reasons for varying or revoking a waiver and publish any conditions that are varied.

5.2.7 Waivers for batteries

We acknowledge the important role that batteries have in a market that will be increasingly dominated by variable renewable energy. For example, AEMO's current Integrated systems plan estimates that 16 GW of utility-scale storage and pumped hydro will be required by 2050.[132]

While TNSPs have a role in connecting batteries, we do not consider they have a role in owning and/or operating them for purposes other than as an input into providing prescribed transmission services. Therefore, we consider it appropriate to explicitly restrict the leasing of spare capacity from batteries without a waiver. We consider this approach provides an appropriate balance between allowing batteries to be fully utilised and providing appropriate regulatory oversight.

The potential harms we are looking to mitigate through ring-fencing are cross subsidisation and discrimination. Where a battery is leased to a third party, cross subsidisation may occur where the lease payments to the TNSP do not accurately reflect the cost (capital and operational) of the battery, and regulated revenue is being used to 'top up' the battery's economics without a commensurate benefit to consumers. While costs can be apportioned between regulated and unregulated revenue streams initially, based on estimated usage, there is no mechanism to reapportion the costs if the battery is used differently than expected and so the cost allocation becomes inaccurate over time.

Discrimination may occur where a TNSP discriminates in favour of the party leasing the battery, such as by over-investing in network infrastructure and managing congestion in real time to improve wholesale market access, or by providing transmission network information to a partner that can be used to modify bidding strategies.

We consider a waiver approach particularly appropriate while the industry is still developing and learning about battery operations and services. There are trials being run by network businesses to explore the potential of energy storage devices for network and other purposes that will inform our understanding of how consumers can benefit and the appropriate allocation of costs. The AER has provided waivers to DNSPs to use battery assets for multiple services. There are also batteries currently being trialled by TNSPs, including ElectraNet's Dalrymple ESCRI-SA Battery Project and Transgrid's Wallgrove Grid Battery).

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[132] AEMO, *2022 Integrated systems plan*, June 2022, p 10.

In developing the distribution guideline, we first proposed a prohibition on providing contestable services from a battery (whether the supply of excess capacity to third parties, or the provision of contestable services by DNSPs themselves) without a waiver. In response, several stakeholders raised concerns that this approach was too strict and that it could risk slowing the deployment of batteries, particularly community-scale batteries. Both DNSPs and other potential providers of batteries emphasised the importance of the regulatory framework encouraging efficient investment in and deployment of batteries, particularly for community-scale batteries.

We understand the push for a clear pathway for deploying batteries. For the protection of competitive markets, there need to be robust safeguards to mitigate the potential risks of discrimination and cross-subsidisation. The AER's final position in the 2021 distribution guideline provided for a 'streamlined process' for battery applications that demonstrate there is unlikely to be a risk of cross-subsidisation, and as such, are 'lower risk' projects. We also included an additional requirement in the distribution guideline (clause 4.1(d)) to address potential discriminatory behaviour in favour of a battery that a DNSP owns, operates or otherwise controls in some way.

In the Issues paper we did not consult on whether a streamlined process for battery waivers would be appropriate for the transmission sector. We propose not to include a streamlined process for waivers for battery projects from the transmission ring-fencing guideline. For distribution, our primary concern was related to DNSPs cross-subsidising competitive services via a battery. Discriminatory behaviour, while an important issue, was of secondary concern and addressed via a combination of existing ring-fencing obligations and new waiver conditions.

While cross-subsidisation remains a concern for transmission, we also hold greater concerns about a TNSP's ability to discriminate in favour of itself or an affiliate in relation to batteries than we did for DNSPs. There has been a long-held acceptance that TNSPs should be prohibited from owning and operating generation because of their ability to influence wholesale market outcomes via the way in which they operate their networks. For this reason, we consider a higher threshold to be appropriate for TNSPs, and that applications from TNSPs to provide 'other services' using grid scale batteries should be considered through a full waiver process. However, we acknowledge that batteries are a nascent technology in transmission and there may be benefits to allowing TNSPs to lease batteries to allow the full potential value of batteries to be realised. **We are specifically seeking feedback from stakeholders on whether a streamlined process is appropriate for batteries in the transmission network and what criteria could be used to determine which applications qualify for a streamlined assessment.**

On waiver conditions, our initial view is that, if a waiver were to be granted, we are likely to impose conditions that aim to ensure there is transparency over the leasing arrangements between the TNSP and the third party. Our conditions may include submitting information on contractual terms, conditions and payments for other services, and for energy storage devices, on the uses (volume and frequency) that confirms any non-network usage. Non-network market participants have also argued that if a waiver is granted for the purposes of a

trial, details of that trial should be made public. Even small-scale trials will generate important learnings and information that networks can apply in other contexts and on a larger scale.[133]

5.2.8 Class waivers

We also propose including a power for the AER to grant class waivers. Some stakeholders noted that they cannot identify any circumstances in which class waivers may be appropriate and suggested that waivers should only be granted in exceptional circumstances on a case-by-case basis.[134] Our experience from administering the distribution guideline has shown that in a rapidly evolving energy transition, class waivers provide the AER with additional, and necessary flexibility to address unforeseen issues that could have a significant effect on the market in a timely manner.

5.2.9 Interim waivers

We propose to include the option to grant interim waivers in the draft guideline because, in our experience, it is sometimes reasonable to provide a temporary exemption from obligations, either in anticipation of a more fulsome waiver decision or of a business becoming compliant.

It is likely that interim waivers will be granted in exceptional circumstances, such as where:

- we are unable to make a final decision about the waiver application before the date on which the TNSP would be non-compliant with our guideline; or
- it is reasonable to allow the TNSP a transitional period to reach compliance where we have decided either not to grant a waiver or to vary or revoke an existing waiver.

In deciding whether to grant an interim waiver we will consider, amongst other things:

- the likely impact on the TNSP and on other parties of our decision;
- where we have not yet made a final decision on the waiver application, whether there is a reasonable possibility that we will grant a final waiver at a later date; and
- any other issues we consider relevant.

An interim waiver will include an expiry date. If we grant an interim waiver to allow the TNSP a transitional period to becoming compliant with the guideline, we will also make a final decision on the underlying waiver application at the same time.

5.2.10 Existing waivers

There is only one active waiver under the current transmission ring-fencing guideline (held by TasNetworks), related to the merger of the Tasmanian transmission and distribution network businesses. This waiver was issued in 2014 and did not include a sunset date. As discussed earlier, TasNetworks remains both a regulated TNSP and a regulated DNSP and we have prepared the draft guideline to permit TasNetworks to continue these activities within the same legal entity without requiring a waiver.

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[133] Energy Australia submission to distribution ring-fencing position paper p 9.

[134] NECA, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 6; Iberdrola, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 8.

6 Transition to Version 4

Immediate implementation of the updated guideline's obligations would create costs for TNSPs as they amend their corporate structures to comply with the new arrangements. In our view, most implementation costs are likely to be associated with achieving legal separation. Those costs are likely to be passed on to electricity consumers.

With TNSPs being required to legally separate services, and establish appropriate accounting and compliance reporting mechanisms, full compliance with the updated guideline will take some time. Failing to provide a sufficient transitional period would result in regulatory inefficiencies, whereby many TNSPs would find themselves in breach, and the AER would be required to consider waiver applications.

In the Issues paper, we identified that a relatively short transition is our preferred approach, but that would depend on the nature of the final guideline, where the time required to transition to full compliance would depend on the extent of changes to the previous guideline.

As well as costs, we recognise that TNSPs are likely to face difficulties transitioning current projects or business activities in line with the updated guideline. Accordingly, we sought submissions addressing how existing services ought to be treated.

6.1 Submissions

On the issue of transitional arrangements, Transgrid, AusNet, and AEO each supported implementing a transitional period to mitigate costs and immediate regulatory burden, particularly in the context of achieving legal separation.[135] While Transgrid and AEO did not suggest a specific length, in their submissions, AusNet suggested a two-year transitional period would be appropriate.[136]

6.2 Draft position

We note that stakeholders have relied on the experience of DNSPs adapting to the Distribution guideline in support of a two-year transitional period. While these views have been considered, the experience of DNSPs can be distinguished. With the introduction of the first distribution guideline, DNSPs were provided with over 12 months to comply with the guideline.[137] The distribution ring-fencing guideline included not only legal separation, but functional separation. It was acknowledged at that time by the AER and stakeholders that most implementation costs would be associated with obligations for functional separation and, to a lesser extent, legal separation.[138]

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[135] AEO, *Ring-fencing Guideline Electricity Transmission Issues Paper Stakeholder feedback* submission, 22 July 2022, p 3; Transgrid, *Ring-fencing Guideline Electricity Transmission Issues Paper Stakeholder feedback,* submission, 22 July 2022, p 3. AusNet, *Response to Questions from the Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 3.

[136] AusNet, *Response to Questions from the Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 3.

[137] AER, *Ring-fencing Guideline Electricity Distribution,* November 2016, p 24.

[138] AER, *Electricity distribution Ring-fencing Guideline Explanatory statement,* November 2016, p 73.

In circumstances where TNSPs are already subject to some ring-fencing obligations a transitional period of 18 months to two years is unlikely to be necessary. Unlike the distribution guideline, the draft guideline does not include a functional separation requirement.

Our draft position is therefore to require that TNSPs comply with all obligations in Version 4 of the guideline within 12 months from the commencement date. However, the instances listed below will require immediate compliance with the guideline:

- 15-day breach reporting of all breaches is required from the commencement date.
- Entering into any new or varied agreements relating to the leasing of excess battery capacity and service provider arrangements will need to comply with Version 4 of the guideline as of the date of commencement.
- Annual compliance reporting will be required for the period of commencement date to 31 December 2023. Reports should be submitted by 30 April 2024.

It is clear from our experience with DNSPs that some existing arrangements and processes may need to be updated to enable compliance. This process may take time to implement. As a result, in the first year of compliance with Version 4 of the guideline, a TNSP's annual compliance report can be a shorter report that relies on limited assurance by an auditor.[139] This could allow the AER to target specific areas of compliance for independent assessment.

While limited assurance and reduced compliance is required in the first year of Version 4 of the guideline, it is expected that if TNSPs take immediate action to move towards compliance, 12 months is likely to be sufficient time to transition.

Should TNSPs fail to reach compliance by this date, waivers may be considered on an ad-hoc basis.

While the transitional period proposed is not as extensive as the two years requested by AusNet, we consider the amended guideline balances the need for implementation of effective ring-fencing with the transitional costs that will be incurred by TNSPs.

6.3 Existing arrangements

Some TNSPs are already providing services that would not be permitted under the draft guideline without a waiver, including leasing batteries and providing generation services. This section considers whether such existing services should be required to transition to the new requirements.

6.3.1 Submissions

While TNSPs did not support expanding the guideline's legal separation requirement, they considered that if that requirement is expanded, then it should apply prospectively due to the costs involved in transferring assets and activities, including contracting, tax and licencing issues.[140] That said, when we requested information from TNSPs about the extent of other

[139] Auditing and Assurance Standards Board, *Standard on Assurance Engagements ASAE 3000 Assurance Engagements Other than Audits or Reviews of Historical Financial Information*, June 2014.

[140] Transgrid, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 3; ENA, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 2.

services currently being provided, we were provided with only limited information suggesting that the transition to compliance should not be burdensome.

Other stakeholders suggested that existing services should transition to the new arrangements, similar to the transitional arrangements we adopted under the distribution ring-fencing guideline.[141] For example, AEO claimed that having services treated differently would be complicated and undermine consumer confidence in ring-fencing.[142] AGL considered grandfathering would not be required if a waiver approach is introduced.[143]

6.3.2 Draft position

Generally, we consider that existing services should transition to the new arrangements under Version 4 of the guideline. We agree with some stakeholders' concerns that operating two separate ring-fencing frameworks would be complex, could create confusion, and would make it more difficult for the AER to monitor compliance.

However, as we did for distribution,[144] we consider it appropriate to make an exception from our transitional arrangements for existing agreements in respect of leasing of spare battery capacity. As such, we have proposed to amend the transmission guideline so that the prohibition on third party leasing of batteries only applies with respect to new or variations to existing arrangements. Contractual arrangements already in place will not be impacted, unless and until they are varied to grant rights in contravention of the guideline prohibition. As a result, these arrangements will not need to comply with Version 4 of the guideline.

We understand that ElectraNet and Transgrid both currently own and operate a battery that is leased to a third party and partially Australian Renewable Energy Agency (ARENA) funded.[145] In addition, we understand that AusNet Services owns a battery that was developed with support from ARENA and the Victorian government, with a retailer acting as the market intermediary.

These projects have contributed, or are expected to contribute, to important knowledge development on the potential application of grid-scale batteries. Grid-scale batteries are among those energy systems that will be critical to providing electricity system security and reliability as Australia's energy mix comes to be dominated by variable renewable energy generators. For these reasons, we consider that ElectraNet, Transgrid and AusNet Services should not have to legally separate these battery services or cease their existing contractual agreements.

To our knowledge, the ElectraNet, Transgrid and AusNet Services' batteries are the only examples of batteries providing existing services that would not be captured by the restriction on leasing arrangements under the updated guideline and are services that need to be

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[141] AEO, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022 p 3, Iberdrola, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022 p 4; NECA, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022 p 3; NSW DNSPs, *Ring-fencing Guideline Electricity Transmission: Issues Paper* submission, 22 July 2022, p 3.

[142] AEO, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 3.

[143] AGL, *Ring-fencing Guideline Electricity Transmission Issues Paper* submission, 22 July 2022, p 2.

[144] AER, *Ring-Fencing Guideline Electricity Distribution,* November 2016, p 24.

[145] ARENA, *Transgrid Wallgrove Battery*, September 2022.

grandfathered. However, **we invite stakeholders to advise us if there are additional services that may require further consideration.**

In addition to the batteries above, a similar situation applies for Transgrid's diesel generators. We understand the generators provide back-up power for the NSW community of Broken Hill in the event of an outage on the single 220 kV transmission line that supplies the town. We understand that the electricity generated is delivered to the wholesale market and thus is a generation service rather than a network service, although the generators only operate in the event of a transmission outage. We consider it is unlikely in consumers' best interests to require Transgrid to legally separate these services given the role they play in providing back-up supply to Broken Hill. Therefore, we encourage Transgrid to apply for a waiver from our final guideline to continue under the existing arrangements for existing services provided as part of the Broken Hill diesel generators.

For clarity, we note that stakeholders should not consider our draft position as a precedent for our treatment of future waiver requests.

7 Other issues

7.1 Additional ring-fencing obligations

As noted in our issues paper, by implementing more comprehensive and robust ring-fencing requirements the ability for us to impose additional ring-fencing obligations will no longer be required.[146] We consider it better regulatory practice to establish a more comprehensive and stable set of guidelines rather than relying on an ad hoc approach to ring-fencing.

Stakeholders did not provide any submissions on this topic and as such, our draft position is that this clause be removed. This will provide TNSPs and the market with confidence about TNSP's role in offering certain services.

7.2 Civil Penalties

The current transmission ring-fencing guideline does not attract a civil penalty. Accordingly, the AER does not have authority to impose pecuniary penalties on TNSPs if they were to breach a ring-fencing obligation.

Breaches of the distribution guideline attract tier 1 civil penalties.[147] We consider that the ability to impose financial sanctions on non-compliant market participants provides the AER with an additional mechanism which may be a more efficient use of resources than court action and is likely to be more effective than external communications (such as naming of behaviour that leads to a breach).

In its submission, Iberdrola suggested the AER should be able to impose penalties for non-compliance.[148]

Given that the review of the transmission ring-fencing guideline will bring the guideline up to date with current conditions in the electricity market, the AER is considering revisiting whether a civil penalty provision for transmission ring-fencing may be appropriate. We note that this will require further work outside of the current review, including a change to the National Electricity Regulations and the NER. We recognise the valuable role civil penalties play as a deterrent, and as an enforcement mechanism to ensure compliance with the monitoring framework we are proposing to adopt. We are inclined to advocate to Energy Ministers for this change to the law and request stakeholder feedback on this. Accordingly, **we are seeking feedback on whether civil penalties are an appropriate next step to the guideline review.**

7.3 Reviewing the guideline

While this guideline review has made some significant changes to Version 3 of the guideline, this is the first step in ensuring that the guideline remains fit for purpose. We acknowledge that there are some information gaps in understanding whether there is harm occurring from certain TNSP behaviour. This guideline review focussed on reducing information asymmetry

[146] AER, *Ring-fencing Guideline Electricity Transmission* Issues paper, May 2022, p 35.

[147] Compare NER, 6.17.1 and 6A.21.1. Breaches of our distribution ring-fencing guidelines were made a civil penalty provision on the grounds that (according to the AEMC and AER) a breach would result in unacceptable market participant behaviour, namely financial gain to the contravener.

and closing some gaps. It is possible that in the future when we have more evidence, stronger measures may be required. This is an iterative process and as with distribution we intend to continue to review and update the guideline when market changes or new information warrant a review.

Appendix A – Table of revised clauses Version 3 to Version 4

Guideline clause name	Clause number in Version 4 (*current*)	Clause number in Version 3	Amendment
Nature and Authority	1	N/A	Inserted
Application of this Guideline	1.1	1 - 3	Amended
Confidentiality	1.2	N/A	Inserted
Interpretation	1.3	4	Amended
Definitions	1.4	4 - 6	Amended
Process for revisions	1.5	17	Amended
Legal Separation	3.1	7.1	Amended
Establish and Maintain accounts	3.2	7.3	Amended
Obligation not to discriminate	4.1	7.2	Amended
Staff separation -- Marketing staff	4.3	7.7	Amended
Information access and disclosure	4.2	7.6	Amended
Service Providers	4.4	N/A	Inserted
Granting of waivers	5.1	11	Amended
TNSP's application for a waiver	5.2	N/A	Inserted
AER's consideration of a waiver application	5.3	N/A	Inserted
Class waivers	5.4	N/A	Inserted
Publication of reasons	5.5	N/A	Inserted
Reviewing a waiver	5.6	N/A	Inserted
Waiver register	5.7	N/A	Inserted

Maintaining compliance	6.1	12	Amended
Reporting	6.2	13 - 15	Amended
Compliance breaches	6.3	16	Amended
Complaints and Investigations	6.4	N/A	Inserted
Transitional arrangements	7	N/A	Inserted