



# **Ring-fencing interaction with distributor-led stand-alone power systems**

## **Explanatory Note**

December 2019

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# 1 Introduction

This Explanatory Note provides guidance on the interaction of the AEMC's proposed framework for Distributor-Led Stand-Alone Power Systems (SAPS) with our *Electricity Distribution Ring-fencing Guideline*. The AEMC has outlined a service delivery model for distributor-led SAPS under the *Updating the regulatory frameworks for distributor-led stand-alone power systems* review. Under the AEMC's framework, a SAPS providing a cost efficient alternative to traditional network investment has two distinct components, each providing a separate service:

- a stand-alone distribution system, which is provided by an electricity distributor, and
- a generating system(s) connected to the stand-alone distribution system, which will provide the generation of electricity and also an input into the distribution service.<sup>1</sup>

We expect that in most cases SAPS generating systems would be obtained from competitive markets. Separating the SAPS generation service from the SAPS distribution service has benefits for customers. These benefits include encouraging competition that can lead to efficient price discovery and product innovation in regard to generation services.

In some circumstances, contestable service providers may be unable or unwilling to provide a SAPS generation service, perhaps due to remoteness or other factors. Therefore It may be necessary for a distribution network services provider (DNSP) to provide both SAPS generation and distribution services. In order to do this, a DNSP would require a ring-fencing waiver.

Ring-fencing requires a DNSP to separate delivery of regulated distribution services provided on a monopoly basis from the provision of unregulated services (such as electricity generation).<sup>2</sup> In doing so, ring-fencing protects the efficiency of regulated distribution services, and the competitiveness of markets for contestable electricity services.<sup>3</sup> The AER can grant a ring-fencing waiver to allow the DNSP to provide unregulated services without need to ring-fence the legal and functional delivery of these services. We grant waivers where the costs of ring-fencing compliance exceed benefits to customers, taking the long-term interests of consumers under the National Electricity Objective into consideration.

This Explanatory Note aims to improve clarity regarding when a ring-fencing waiver to allow a DNSP to provide SAPS generation services would be needed, and how we might assess SAPS-related ring-fencing waiver applications from DNSPs.

This Explanatory Note should be read in conjunction with the AEMC's review and draft proposed rules on distributor-led stand-alone power systems.<sup>4</sup> The advice in this

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<sup>1</sup> AEMC, *Final report - Review of the regulatory framework for stand-alone power systems - Priority 1*, 30 May 2019, p. x.

<sup>2</sup> AER, *Ring-fencing Guideline Electricity Distribution - Version 2*, October 2017.

<sup>3</sup> For an explanation of the Ring-fencing Guideline, see AER, *Annual compliance report on Electricity Distribution Ring-fencing Guideline 2017-18*, pp. 18-23

<sup>4</sup> See: <https://www.aemc.gov.au/market-reviews-advice/updates-regulatory-frameworks-distributor-led-stand-alone-power->

Explanatory Note is provided as a guide only. The final rules that will determine how DNSPs can provide SAPS are yet to be made.<sup>5</sup> Our assessment of any ring-fencing waiver applications will depend on the particular circumstances applying to individual SAPS.

We welcome comments from stakeholders on this Explanatory Note. Stakeholders can provide comments through submissions to the AEMC's draft report for distributor-led SAPS directly. This will avoid need for stakeholders to provide separate submissions to the AEMC and the AER. The AER will review submissions to the AEMC with a focus on issues raised in relation to ring-fencing. The AEMC and the AER will engage on this issue in the development of the final package of proposed draft rules to be provided in May 2020. We may update this Explanatory Note once the final rules for distributor-led SAPS are made.

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systems

<sup>5</sup> The AEMC will prepare and submit a final package of rules to the COAG Energy Council for consideration in mid-2020.

## 2 Case studies

This section provides two case studies to illustrate when a ring-fencing waiver may be needed to allow a DNSP to provide SAPS generation services. The case studies also describe the factors the AER may consider when granting a ring-fencing waiver to allow a DNSP to provide SAPS generation services. Each case study assumes that the National Electricity Law (NEL) and National Electricity Rules (NER) have been amended to allow a DNSP to provide a SAPS as an alternative to traditional network investment, under the service delivery model in the AEMC's review and draft proposed rules.

We recognise there are a range of different potential situations in which a ring-fencing waiver to allow a DNSP to provide SAPS generation services may be in the interests of customers. These two case studies are illustrative only, and not intended to describe all possible situations.

When a DNSP approaches us with a waiver application to provide SAPS generation services we would consider a range of factors, including:

- The extent to which the DNSP has demonstrated that third-party providers are unable to provide the SAPS generation service. Evidence to support this could include the outcomes of a tender, expressions of interest, or other relevant consultation processes.
- The extent to which the DNSP has sought to address any barriers to provision of SAPS generation services on a contestable basis, including through engagement with SAPS generation service providers.
- The extent to which any affected customers might be impacted by SAPS generation arrangements.
- Any other factors relevant to granting a ring-fencing waiver.<sup>6</sup>

The AER has discretion to consult publicly on ring-fencing waiver applications. In determining our waiver application assessment process and timeline, we would consider the evidence supplied by the DNSP as part of their waiver application, and the extent to which the DNSP has undertaken its own stakeholder engagement.

Ring-fencing waivers provide flexibility under the ring-fencing framework. Since the commencement of the Ring-fencing Guideline, we have granted ring-fencing waivers to DNSPs, including to accommodate the practicalities of reduced competition in remote and regional areas.<sup>7</sup> Our Ring-fencing Guideline also exempts DNSPs from certain ring-fencing obligations in locations where competition is limited or unlikely—defined as a 'regional office'.<sup>8</sup>

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<sup>6</sup> AER, *Ring-fencing Guideline Electricity Distribution - Version 2*, October 2017, cl. 5.3.2.

<sup>7</sup> AER, *Decision - DNSP applications for waivers from the Electricity Distribution Ring-fencing Guideline*, December 2017, pp. 66-87.

<sup>8</sup> A 'regional office' is defined in cl. 1.4 of the Guideline as an office that has less than 25,000 connection points within a 100 kilometre radius of that office

## 2.1 Case study one: Ring-fencing waiver is not needed

A DNSP has identified a spur line on a rural long feeder in its network that is approaching the end of its operating life. The spur line currently serves five customers, all on large isolated properties. In its Distribution Annual Planning Report (DAPR) the DNSP has identified that it is more efficient to serve these customers with five individual power systems than it is to replace the existing feeder spur. This SAPS option is preferable to traditional network investment.

The DNSP publishes a request for quote (RFQ) on its website, calling for proposals from providers of SAPS systems to provide the SAPS generation service for these five customers. The DNSP notifies service providers registered on its Industry Engagement Register that the RFQ has been published.

The cost of the traditional network option is under the Regulatory Investment Test - Distribution (RIT-D) threshold of \$6 million, and a RIT-D is not required. Separately, the DNSP commences a customer engagement process in accordance with its SAPS Customer Engagement Strategy, as outlined in the AEMC's draft proposed rules.<sup>9</sup>

Following an evaluation of the quotes received from suppliers in the tender process, the DNSP selects a successful SAPS generation service provider. This SAPS service provider is contracted to design and construct independent power systems for the five customers. The SAPS service provider is also contracted by the DNSP to provide operations and maintenance services for the five individual power systems.

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### **In this case study, a ring-fencing waiver is not required:**

- The DNSP only provides regulated 'SAPS distribution' services.
  - The DNSP procures contestable 'SAPS generation' services from the market.
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## 2.2 Case study two: A ring-fencing waiver is needed

A DNSP has identified a spur line on a rural long feeder as a potential site for a SAPS. The spur line is located in a remote area of national park and serves one customer. The spur line has a remaining estimated life span of 25 years. However, in its DAPR the DNSP has identified that the cost of replacing the line with an independent power system would be lower than the cost of ongoing vegetation management. This SAPS option is preferable to traditional network investment.

The cost of the traditional network option is under the RIT-D threshold of \$6 million, and a RIT-D is not required. The DNSP commences a customer engagement process in accordance with its SAPS Customer Engagement Strategy.

### **Stakeholder consultation: Option 1—the DNSP issues a public tender for SAPS generation services**

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<sup>9</sup> See draft proposed rule 5.13.4 in the package of rules published with the AEMC's draft report on *Updating the regulatory frameworks of distributor-led stand-alone power systems*, December 2019.

The DNSP publishes a RFQ on its website, calling for proposals from providers of SAPS systems to provide the SAPS generation service for the customer. The DNSP notifies service providers registered on its Industry Engagement Register that the RFQ has been published. The DNSP receives no quotes from SAPS suppliers. In email correspondence between staff of the DNSP and potential tenderers, several SAPS generation providers indicate that they are willing to construct the SAPS generation system, but that the location of the customer is too remote to offer operations and maintenance services for the SAPS generation system.

The DNSP decides to issue a second RFQ for construction of a SAPS generation system only. Several SAPS service providers offer attractive tender responses. The DNSP decides to procure SAPS generation system from the market.

The DNSP submits a waiver application to the AER to provide ongoing operations and maintenance for the SAPS generation system. The DNSP provides evidence that SAPS service providers are unwilling to offer ongoing operations and maintenance services for the SAPS generation system, in the form of RFQ outcomes and email correspondence with SAPS generation service providers.

We determine that the DNSP has submitted sufficient evidence to demonstrate that the cost of compliance with the Ring-fencing Guideline would exceed the benefits of compliance for customers. In the absence of a waiver, no one would provide ongoing operations and maintenance services for the SAPS generation system. We grant the DNSP a waiver of legal and functional separation obligations under the Ring-fencing Guideline, to allow the DNSP to provide ongoing operations and maintenance services for the SAPS generation system.

#### **Stakeholder consultation: Option 2—the DNSP does not publicly tender for SAPS generation services and the AER conducts its own consultation**

The DNSP considers that SAPS service providers are unlikely to provide SAPS generation services for this customer. The DNSP applies to the AER for a ring-fencing waiver to allow the DNSP to construct the SAPS generation system and provide SAPS generation ongoing operations and maintenance. The DNSP states that a waiver is needed because the customer is located in a very remote national park area, and their experience in past tender processes suggests that no SAPS generation service provider will offer an acceptable tender response.

We determine that the DNSP has not submitted sufficient evidence to demonstrate that the cost of compliance with the Ring-fencing Guideline would exceed the benefits to customers. We put the DNSP's ring-fencing waiver application out to public consultation. Several SAPS service providers submit to the AER that they would be willing to construct the SAPS generation system, but would not be in a position to offer ongoing operations and maintenance for the SAPs generation system, due to the customer's remote location.

We determine that the cost of compliance with the Ring-fencing Guideline in respect of ongoing operations and maintenance would exceed the benefits of compliance for customers. In the absence of a waiver, no one would provide ongoing operations and maintenance services for the SAPS generation system. We grant the DNSP a waiver of legal and functional separation obligations under the Ring-fencing Guideline, to allow the DNSP to provide ongoing operations and maintenance services only for the SAPS generation system.

We recommend that the DNSP undertake further consultation with stakeholders before returning with another waiver application to construct the SAPS generation system. The DNSP subsequently undertakes a RFQ and successfully selects a SAPS service provider to construct the SAPS generation system.

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**In this case study, a ring-fencing waiver is required:**

- The DNSP provides regulated 'SAPS distribution' services.
  - The DNSP also provides a 'SAPS generation' service under a ring-fencing waiver, namely, ongoing operations and maintenance of the SAPS generation system.
  - The DNSP procures a contestable 'SAPS generation' service from the market, namely, initial construction of the SAPS generation system. Once complete, the SAPS service provider transfers the SAPS generation system to the DNSP to conduct operations and maintenance. The SAPS generation assets are not added to the DNSP's regulated asset base.
  - Where the DNSP is able to demonstrate that the market cannot provide a required SAPS generation service, using evidence from consultation with SAPS service providers and/or an RFQ process, we will consider the extent of public consultation required to reach a decision.
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### 3 FAQs

Submissions to the AEMC's *Review of Regulatory Frameworks for Stand-Alone Power Systems– Priority 1*<sup>10</sup> have raised questions regarding the interaction between regulatory arrangements for DNSP-led SAPS and ring-fencing. We address some of these below.

#### **Can a DNSP repair a fault on a SAPS generation system to restore power supply to a customer?**

Repairs and maintenance of a SAPS generation system should be performed by a third-party service provider contracted to provide SAPS generation services. This is because repairing of SAPS generation assets is a service that is available from a number of suppliers other than the DNSP via competitive markets. It is important that fault response services are considered when the DNSP establishes arrangements for SAPS generation services. Where a provider of a SAPS generation service is unable to provide fault response, a DNSP may need to apply for a waiver to provide fault response on an ongoing basis.

#### **Should a DNSP apply for a waiver to provide temporary power supply to a customer in an emergency?**

DNSPs are permitted to provide customers with temporary generation where necessary as part of their normal services to distribution customers. For example, a network customer may lose power when a natural disaster (such as a bushfire or a cyclone) causes damage to network assets that connect to their premises. Following an assessment of required repairs to the network, a DNSP may decide that it is more efficient to provide the customer with a SAPS on an ongoing basis instead of replacing the damaged network assets. In this type of situation, a DNSP could provide the customer with temporary generation as part of their regulated distribution services, without needing to request a waiver, and subsequently procure SAPS generation services as an alternative to network replacement. However, a longer term arrangement would need to be consistent with the framework for SAPS set out in the NER.

#### **Would the AER grant a ring-fencing waiver to cover the lifespan of SAPS generation assets (e.g. 25 years)?**

Under our current practice, the maximum duration of long-term waiver is a full regulatory control period (which is five years). Limiting waivers in this way has two benefits. First, it allows us to review ring-fencing waivers on a regular basis, to determine whether the circumstances of the waiver remain relevant. Second, it allows us to consider whether any changes to the rules or regulatory framework have changed that may affect the need for existing ring-fencing waivers. This is no different to our assessment of the regulatory treatment of services ('service classification') provided by DNSPs each five years, which we

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<sup>10</sup> In August 2018, the AEMC was asked by the COAG Energy Council to undertake a review of the regulatory arrangements for SAPS under the national energy laws and rules. Under the terms of reference, the review was split into two priority areas: priority 1, focussing on the development of a national framework for customers that move from grid-connected supply to SAPS provided by DNSPs, and priority 2, focussing on the development of a national framework to support the supply of electricity from SAPS provided by parties other than DNSPs.

are required to do under the NER as part of our revenue determination process for all DNSPs. Where there are no material changes to the circumstances surrounding service classification, we typically would extend the regulatory treatment to the next five year regulatory control period. We expect to adopt the same approach to granting of SAPS waivers to DNSPs.

**The Ring-fencing Guideline allows the AER to revoke a waiver with 40 days' notice. Does that make granting a SAPS waiver too uncertain for the DNSP?**

In the event that a DNSP does not comply with the conditions of a ring-fencing waiver, the AER has a number of options to enforce waiver conditions. In determining the most appropriate way to respond to a breach of waiver conditions by a DNSP, the AER would consider a number of enforcement factors and enforcement options.<sup>11</sup> Revoking a waiver with 40 days' notice would be a 'last resort' enforcement option. We would consider this option following engagement with the DNSP, and have regard to the costs to the DNSP and the benefits for electricity consumers.

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<sup>11</sup> AER, *Compliance and enforcement policy*, July 2019, pp. 8-9.