

Ring-Fencing Guideline (electricity distribution)

We have published our Ring-Fencing Guideline (the “Guideline”) for electricity distribution. Distribution network service providers (DNSPs) are required to comply with the guideline as soon as reasonably practicable, but no later than 1 January 2018.

Overview

The Australian Energy Regulator (AER) determines the revenues that DNSPs may earn from providing regulated electricity services or ‘direct control services’. Direct control services relate to the electricity distribution network operated by a DNSP. A DNSP is the monopoly provider of direct control services and is therefore subject to economic regulation by us.

Aside from direct control services, DNSPs may also provide other unregulated services that are offered on a competitive basis—we refer to these as ‘contestable’ services. This Guideline imposes obligations on DNSPs to separate monopoly from contestable business activities. The obligations set out in the Guideline include functional, accounting and legal separation. The obligations applicable to a DNSP largely depend on the types of services offered by a DNSP or one of its affiliates (see figure 1).

DNSPs are required to report to us on compliance with the Guideline each year.

What is ring-fencing?

Ring-fencing refers to the separation of monopoly services and contestable services where a regulated business also offers services into a competitive market. The obligations DNSPs must abide by are described in the Guideline. The obligations target two potential harms that can occur if a DNSP decides to offer services into a contestable market.

First, the Guideline addresses the risk of DNSPs cross-subsidising contestable services with revenue earned from their provision of regulated distribution (and transmission) services.

Second, the Guideline addresses the risk of DNSPs discriminating in contestable markets in favour of its own business units providing contestable distribution services or through one of its affiliated entities providing contestable electricity services. A DNSP has a significant amount of information about its electricity network and this information could provide it with an unfair advantage in a competitive market. Ring-fencing is designed to enable a DNSP or its affiliates to participate in a contestable market on a fair basis.

Framework

The National Electricity Rules (NER) provide a framework for implementing a national approach to electricity ring-fencing. The Guideline is legally binding, meaning DNSPs must comply with the Guideline.

The NER sets out mechanisms through which we can establish a ‘ring-fence’ around a DNSP from its other business activities. The mechanisms referred to in the NER include legal, accounting and functional separation to limit information flows.

Key components of the Guideline

The ring-fencing guideline is made up of several components. These include provisions to mitigate risk of cross-subsidies and discrimination, waivers, reporting and compliance, and transitional issues. We discuss each of these below.

Consultation

In developing the Guideline we undertook extensive consultation with DNSPs, retailers, consumer advocates and other stakeholders. This included publishing a preliminary positions paper, a Draft Guideline, an information paper and an exposure draft of the Guideline. We received around 80 written submissions overall. We also held workshops and public forums where all parties could express their views in-person. In addition, we held a large number of one-on-one discussions with various stakeholders, including DNSPs, third party providers of competitive services and consumer representatives.

Measures targeted at cross-subsidisation

A DNSP receives regulated revenues for providing direct control services. There is a risk that a DNSP could use regulated revenues to cross-subsidise other services provided in contestable markets. The Guideline includes a coordinated suite of measures to address this risk. Those measures cover legal separation, separate accounting and cost allocation.

Legal separation

The Guideline requires that a DNSP be a legal entity that only provides distribution services. This business separation will mitigate risk of cross subsidies. In particular, independent audit of a DNSP’s accounts will provide a greater level of scrutiny as a result of legal separation. Some limited

exceptions to legal separation may be acceptable, for example, where a DNSP applies to the AER to undertake another regulated activity, like gas distribution.

Separate accounting

The Guideline's separate accounting obligations require a DNSP to establish and maintain internal accounting procedures which allow it to demonstrate the nature and extent of transactions between it and its affiliated entities.

Cost allocation

In simple terms, DNSPs are permitted to earn revenue from customers to recover the costs they incur. Hence, an accurate record of costs is critical. The Guideline's cost allocation obligations strengthen existing cost allocation arrangements by explicitly preventing a DNSP allocating or attributing to distribution services costs that properly relate to other services. The allocation and attribution of costs to distribution services must be consistent with the cost allocation principles in NER cl. 6.15.2.

Measures targeted at discrimination

The Guideline includes complementary sets of general and specific obligations on a DNSP not to favour a DNSP's *related electricity service providers*. In the absence of these obligations we consider there is a risk of a DNSP's related electricity service provider gaining an advantage over competitors in contestable markets for energy-related services by reason of their relationship with the DNSP.

General non-discrimination obligations

The general non-discrimination provisions require a DNSP to:

- deal with its related electricity service provider on an arm's length basis
- deal with its related electricity service provider and their competitors, or customers of those competitors, on substantially the same terms and conditions and provide substantially the same quality, reliability and timeliness of service.
- avoid providing information to its related electricity service provider that the DNSP has obtained through its dealings with a competitor of that provider that may advantage the provider

Specific obligations: Offices, staff, branding and promotions

The Guideline includes specific functional obligations in several areas.

- Office sharing — DNSPs should be physically separate from related electricity service providers, that is they should have different offices
- Staff sharing — DNSPs should not share staff with related electricity service providers
- Branding — DNSPs should use independent and separate branding for its direct control services
- Promotions — DNSPs should avoid advertising or promoting the services provided by its related electricity service providers.

Some exemptions apply to these specific obligations. DNSPs

can also apply for waivers from these obligations.

Specific obligations: Information access and disclosure

The Guideline imposes specific obligations on a DNSP as to how it is to deal with electricity information acquired or generated by it in connection with its provision of direct control services unless it is publicly available.

The Guideline requires a DNSP to keep this information confidential and only use it for the purpose for which it was provided. It also prevents the DNSP from disclosing this information unless it has the customer's consent or is required to do so by law or to enable it to provide distribution services.

Where a DNSP shares electricity information with a related electricity service provider, that it acquires or generates in connection with providing regulated distribution services, it must provide access to that information on an equal basis with third parties who are competing with the related electricity service provider.

Waiver provisions

A waiver is a permission we may grant to a DNSP exempting it from having to satisfy one or more of the obligations in the Guideline's provisions. The Guideline allows DNSPs to apply for waivers in relation to the functional separation of accommodation or employees, co-branding obligations and in respect of legal separation.

However, not all of the Guideline's provisions are subject to waivers. Core ring-fencing obligations for cost allocation, separate accounts, non-discrimination and information protection cannot be waived.

There are two specific circumstances in which we are likely to grant a waiver from legal separation obligations. First, in relation to other services provided by a DNSP that are also regulated services, whether regulated by us or by another economic regulator. Second, in relation to services that a DNSP is required by law to provide. Of course, a DNSP will still be required to satisfy us that a waiver should be granted because doing so is in the long term interests of consumers. We may also consider other circumstances and will assess waiver applications on their merits.

Where a waiver from legal separation obligations is granted it would be appropriate to also grant waivers from office and staff separation obligations and, potentially, obligations restricting co-branding. More generally, we will assess applications for waivers from the Guideline's non-discrimination obligations on their merits.

Reporting compliance and enforcement

The Guideline requires a DNSP to establish and maintain internal procedures to ensure compliance with its ring-fencing obligations. This includes keeping a range of records as follows:

- to demonstrate compliance with cost allocation obligations and the requirement to maintain separate accounts
- office and staff registers
- information sharing protocol and information disclosure register.

The Guideline requires a DNSP's compliance with ring-fencing

obligations to be independently verified annually and a report submitted to us within four months of the end of a financial year. Also, a DNSP must self-report to us a material breach of its ring-fencing obligations within 5 business days of the breach occurring. We may seek enforcement of ring-fencing obligations by a court in the event of any breach of those obligations by a DNSP.

Any interested party may submit a complaint to us about a possible breach of ring-fencing obligations. We will investigate complaints in accordance with our compliance and enforcement policy.

For more information:

More information on our final decision can be found on our website: www.aer.gov.au.

Figure 1 Distribution services linkage to ring-fencing

