



Electricity Ring-Fencing Guideline

Preliminary positions

April 2016

© Commonwealth of Australia 2016

This work is copyright. In addition to any use permitted under the Copyright Act 1968, all material contained within this work is provided under a Creative Commons Attributions 3.0 Australia licence, with the exception of:

- the Commonwealth Coat of Arms
- the ACCC and AER logos
- any illustration, diagram, photograph or graphic over which the Australian Competition and Consumer Commission does not hold copyright, but which may be part of or contained within this publication. The details of the relevant licence conditions are available on the Creative Commons website, as is the full legal code for the CC BY 3.0 AU licence.

Requests and inquiries concerning reproduction and rights should be addressed to the Director, Corporate Communications,
Australian Competition and Consumer Commission,
GPO Box 4141,
Canberra ACT 2601
or publishing.unit@acc.gov.au.

Inquiries about this publication should be addressed to:

Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001

Tel: (03) 9290 1444
Fax: (03) 9290 1457

Email: AERInquiry@aer.gov.au
AER Reference: 46484

Request for submissions

Interested parties are invited to make written submissions to the Australian Energy Regulator (AER) regarding this paper by the close of business, **30 May 2016**.

Submissions should be sent electronically to: Ringfencingguideline2016@aer.gov.au

Alternatively, submissions can be mailed to:

Mr Chris Pattas
General Manager, Networks
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

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
- 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 on the AER's website.

Enquiries about this paper, or about lodging submissions, should be directed to the Network Regulation branch of the AER on (02) 9230 9133.

Contents

Request for submissions	3
Contents	4
About the ring-fencing guideline	6
1 Introduction.....	9
1.1. What is ring-fencing?	10
1.2. Elements of the AER ring-fencing guideline	11
2 What is the objective of ring-fencing?.....	14
2.1. Proposed ring-fencing objectives	16
3 Which services should be ring-fenced?	18
3.1. Is it possible to ring-fence an asset?	18
3.2. Services currently subject to ring-fencing	19
3.3. Ring-fencing coverage	19
3.4. Case study—metering	22
3.5. Case study—NSP energy storage devices	22
3.6. Case study—connections	24
4 Ring-fencing obligations.....	26
5 Ring-fencing waivers.....	29
6 Reducing the administrative costs of ring-fencing	31
6.1. Transitional arrangements	32
6.2. Other issues	33
7 Reporting, compliance and enforcement	34
8 Next steps	35
9 Summary of questions	36
Appendix A: Relevant NER and NEL provisions.....	37

Appendix B: Current electricity ring-fencing arrangements by jurisdiction

39

Shortened forms

Shortened Form	Extended Form
AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
capex	capital expenditure
EBSS	efficiency benefit sharing scheme
F&A	Framework and approach
MAR	maximum allowable revenue
NECF	National Energy Customer Framework
NEM	National Electricity Market
NER or the rules	National Electricity Rules
NSP	network service provider
opex	operating expenditure
RAB	regulatory asset base
TNSP	transmission network service provider

About the ring-fencing guideline

The Australian Energy Regulator (AER) is the economic regulator for transmission and distribution electricity and gas businesses in Australia's national electricity market (NEM). We are an independent statutory authority, our powers and functions are set in the National Electricity Law (NEL) and National Electricity Rules (NER).

This preliminary positions paper for an electricity ring-fencing guideline is a step away from State based ring-fencing arrangements toward a national ring-fencing guideline. Since 2008, the AER has relied on ring-fencing arrangements that were established by jurisdictional regulators for each State and Territory. To date ring-fencing has been largely focussed on separating regulated network services (poles and wires) from contestable services (electricity retail and generation). Now we are looking at its applicability more broadly to all contestable services, including metering, connection and decentralised energy resources, such as energy storage services. The need for a broader scope to ring-fencing was signalled in the Australian Energy Markets Commission (AEMC) final rule determination on metering contestability.¹ Our aim is also to bring together State and Territory based regimes under a consistent, national approach.

In 2015, the AEMC introduced changes to the NER as part of its Power of Choice program. The Power of Choice Review recommended substantial reforms to the National Electricity Market (NEM) and has been accompanied by a series of rule changes. The rule changes will lead to, amongst other things, greater competition in the provision of metering services. As a consequence of this and other reforms, the AER is required to develop a national ring-fencing guideline by 1 December 2016. The guideline will underpin the increasingly important role third party service providers will play in the supply of metering and other network services to consumers. For example, distribution businesses previously provided residential customers with metering and connection services exclusively. Within a few years these services will be more contestable in most States and provide consumers with far greater choice. The ring-fencing guideline will support the development of these markets by separating regulated monopoly services from services offered competitively.

Ring-fencing refers to the separation within a network service provider of regulated services from contestable business activities or non-regulated services. Regulated services—like traditional monopoly networks regulated by the AER—are separated from those services that are delivered by the competitive market, like energy retailing. Ring-fencing protects the long term interests of consumers by ensuring efficient costs for regulated services provided by networks. It does this by identifying and separating regulated business activities from services available in a competitive market.

¹ AEMC, *National Electricity Amendment (Expanding competition in metering and related services) Rule 2015*, p. 78

A ring-fencing guideline should facilitate the use of new technologies (like use of batteries of energy storage) and greater participation by all providers including network businesses.

Consistent with the Council of Australian Government's (COAG) Energy Council's communique last year² work between COAG Energy Council officials and market agencies will include a review of ring-fencing arrangements in 2016 to:

- support the development of competitive markets in services which are or should be contestable.
- provide clarity and certainty in the market for new investment.
- provide a level playing field for all parties providing energy services.
- accelerate innovation and efficient investment

The purpose of this paper is to draw out key issues that will need to be considered in drafting a national ring-fencing guideline. In this paper we have drawn on previous work undertaken in 2012 to examine ring-fencing, including submissions we received. At the time the AER was considering whether a national ring-fencing guideline was warranted. The recent rule change makes preparation of the guideline a requirement by the end of 2016. Aside from putting forward preliminary views of how the ring-fencing guideline might work, we have posed numerous questions and seek comment from interested parties.

Table 1 Ring-fencing guideline timeline (indicative)

Step	Date
AER to publish preliminary position	April 2016
Submissions due	30 May 2016
AER to hold workshops with key stakeholders	Through mid-year 2016
AER to issue draft Guideline	July 2016
Submissions on Guideline	Early August
AER to hold work shops	August September 2016*
AER to publish additional papers (if required)	August/September 2016
Last submissions due	mid October 2016
Final Guideline (must be within 80 business days draft guideline*)	On or before 30 November 2016*

* NER requirement

² COAG Energy Council, *Meeting Communique*, 4 December 2015.

The timeline makes provision for additional papers should any particular ring-fencing issues require further input from interested parties. A decision to publish additional issues papers (if any) would be made after submissions have been received on the draft ring-fencing guideline.

Updates

Stakeholders that wish to be advised of upcoming workshops or other ring-fencing related issues should subscribe to the AER website for notifications at www.aer.gov.au/newsletter/subscribe and indicate 'ring-fencing' as a topic of interest to you.

1 Introduction

This paper sets out preliminary views on an approach to ring-fencing issues that could form the basis of an AER electricity distribution ring-fencing guideline. The paper builds on earlier work by the AER in 2011 and 2012 to consider electricity distribution ring-fencing. In addition, the paper draws on recent work by the AEMC in regard to expanding competition in metering and in regard to the implications of energy storage for the energy sector.³

Since 2008, we have had the ability to develop a ring-fencing guideline to replace existing jurisdictional guidelines. That we have not done so to date is because we have been largely able to rely on distribution ring-fencing arrangements established by jurisdictional regulators (and the ACCC guideline for transmission).

The existing jurisdictional ring-fencing guidelines have not been revised since they were first published in the early 2000s by individual state regulators. The existing guidelines were designed to support the structural separation of retail, transmission, distribution and generation and do not adequately account for new and emerging technologies like solar PV, network energy storage or market reforms around metering and other service contestability.

Furthermore, as an outcome of the AEMC's Power of Choice review, changes made to the NER in December 2015 affect existing ring-fencing arrangements. In particular, we are now required to develop a ring-fencing guideline by 1 December 2016, which is one year ahead of the commencement of metering contestability. Once developed, the AER ring-fencing guideline would apply across the NEM and will replace existing jurisdictional ring-fencing arrangements.

Ring-fencing arrangements for transmission are not discussed separately in this paper. The AER guideline will pertain to distribution services, in part due to the differences in the way that prescribed transmission services are defined in the rules. However, we anticipate the ring-fencing arrangements for transmission services will likely mirror the arrangements that will be put place for distribution. Variations would be likely only where there is an underlying need for any differences to be maintained.

The relevant provisions of the NER relating to the AER ring-fencing guideline are summarised in table 2. The requirements of the NER are not prescriptive and do not identify the intended harm the guideline might seek to avoid. The relevant sections of the NER and NEL are provided in full in appendix A.

³ AEMC, *National Electricity Amendment (Expanding competition in metering and related services) Rule 2015* and AEMC, *Integration of Energy Storage—regulatory implications, final report*, December 2015

Table 2 NER references to distribution ring-fencing guideline

Clause	Element
6.17.1	All DNSPs must comply with the Guideline.
6.17.2(a)	The AER may develop Guidelines that provide for accounting and functional separation between direct control services and other service provided by a DNSP. The application of the guideline may vary between jurisdictions.
6.17.2(b)	The Guidelines may include provisions for: <ul style="list-style-type: none">• Legal separation• Separate financial accounts for SCS, ACS and other services• Allocation of costs between SCS, ACS and other services• Limitations on information flows• Provisions for ring-fencing waivers
6.17(c)	In developing the Guideline the AER must consider consistency between distribution and transmission.
6.17.2(d)	Guideline must be developed in accordance with the distribution consultation procedures.

1.1 What is ring-fencing?

Ring-fencing is needed when both regulated and contestable services are provided by a single network business. Ring-fencing refers to the separation of regulated services from contestable business activities within a network service provider (NSP). In simple terms, ring-fencing is designed to limit the ability of a regulated service provider to confer an unfair advantage when it or one of its affiliates operates in a contestable market. As noted by the AEMC, the following types of behaviours by NSPs result in harm that ring-fencing aims to avoid:⁴

- cross-subsidising the affiliate’s services in the contestable market with revenue derived from its regulated services
- discrimination in favour of an affiliate operating in a contestable market
- providing the affiliate with access to commercially sensitive information acquired through the provision of regulated services

⁴ AEMC, *National Electricity Amendment (Expanding competition in metering and related services) Rule 2015*, p. 399

- restricting the access other participants in the contestable market have to the infrastructure services provided by the regulated entity, or providing access on less favourable terms than its affiliate.

Ring-fencing was initially used in the NEM to give effect to vertical separation between large segments of the electricity supply industry. For example, it was common for an electricity retailer and an electricity distribution business to have a single owner, although few of these now remain. Separation of the retail business from the distribution business was achieved through ring-fencing, which meant that staff, financial accounts and information flows were separated. However, there are significant differences between the jurisdictions with respect to ring-fencing obligations and reporting and compliance requirements.

In more recent times, small customer connections and residential metering—once considered core to electricity distribution businesses—are now being opened up to competition. As a result, ring-fencing is being applied to these smaller segments of the electricity supply industry. Other business activities that may be subject to ring-fencing include load control and management, network battery storage or meter data provision, to mention just a few.

In developing an AER electricity distribution ring-fencing guideline, we are not starting from scratch. Indeed the existing jurisdictional guidelines, which we have administered since 2008, are a good place to start. Key features of the jurisdictional distribution ring-fencing guidelines, as well as the ACCC transmission guideline are summarised in Appendix B. These guidelines, developed in the early 2000s, considered many of the competition principles and issues we will need to consider in developing our own guideline. Since that time, the NEM has evolved but little has changed with respect to the fundamental purposes of ring-fencing to promote competition. The State regulators also considered how their guidelines should be implemented, such as processes for waiver applications and reporting and compliance requirements. We can learn from their approaches and experiences, as well as similar provisions in the gas rules/law.

The fundamental purpose of ring-fencing is to assist in the development of competitive markets where competition is feasible, and to apply efficient incentive-based regulation to the monopoly network market sectors where competition is not feasible. The objective of these reforms has been to ensure both the long-term efficiency and viability of the restructured industries and that the resulting benefits flow through to customers in the form of lower prices, greater choice and higher standards of service.

Question 1: What aspects of current jurisdictional ring-fencing arrangements have or have not worked well?⁵

1.2 Elements of the AER ring-fencing guideline

⁵ Links to the current jurisdictional ring-fencing guidelines can be found on the AER website.

Ring-fencing obligations will need to be developed with very clear requirements for arm's length transactions and be accompanied by rigorous compliance and enforcement activities. This will enable networks to compete with other service providers on an equal basis.

Submissions to our earlier discussion paper suggested ring-fencing should be strict with robust compliance checks and enforcement.⁶ A wide range of views on ring-fencing were also expressed in submissions to the AMEC's discussion paper on the integration of energy storage.⁷ Our preliminary view is that in order to give confidence to third parties looking to compete with NSPs in contestable markets, the ring-fencing regime must be robust. The guideline, therefore, needs clarity of purpose, predictability, reasoned flexibility and the ability to be monitored and enforced.

There are at least four key elements the ring-fencing guideline will need to include:

- (a) The guideline should have an objective that identifies the harm we are seeking to avoid through ring-fencing. The objective is important because it will guide our decisions under the guideline (defining the objectives of ring-fencing).
- (b) We should set out which services need to be ring-fenced in prima facie terms at least (identifying ring-fenced services).
- (c) For those services to be ring-fenced, the guideline will need to set out the ring-fencing obligations (ring-fencing obligations).
- (d) We need to provide guidance on ring-fencing waivers to the extent these are seen as appropriate—that is, the circumstances in which an NSP may be exempted from meeting one or more or all ring-fencing obligations.⁸ In deciding whether or not to grant a waiver, we will examine the nature of the service, the costs of ring-fencing and the ring-fencing objective (waiver processes).

Aside from the key elements of the guideline there are other matters to be considered that relate to the practical implementation of the guideline. These include:

- (e) Transitional arrangements, if any. For example, how quickly do we expect NSPs to become compliant with the new guideline and how will waivers granted under earlier ring-fencing arrangements ('grandfathering') be treated?
- (f) Processes and administration. What are the reporting and compliance requirements? How does an NSP apply for a ring-fencing waiver and will stakeholders be consulted? How will breaches of the ring-fencing guideline be treated?

⁶ See for example Origin Energy, *AER Position Paper Electricity Distribution Ring-fencing Guidelines*, September 2012

⁷ AEMC, *Integration of Energy Storage—regulatory implications, final report*, December 2015, pp 9-11

⁸ A waiver excuses an NSP from meeting more of more ring-fencing obligations where the cost of ring-fencing exceeds the benefit to consumers. See section 5 of this paper.

Each of these elements is discussed below. For each, we consider the current jurisdictional approaches and put forward a preliminary view on the position the AER could take.

2 What is the objective of ring-fencing?

The objective of ring-fencing is to limit the ability of the regulated entity to confer an unfair advantage to itself or to an affiliate operating in a competitive market. This is achieved by separating the regulated from contestable business activities. The separation can be relatively simple, or more onerous. The choice depends on how important it is to keep the different business activities separated and this will depend on the potential harm that could result if regulated and contestable business activities are not kept apart.

The typical means of separating services through ring-fencing are well established: legal, accounting and functional separation, along with restrictions around information flows and staff sharing. To determine how best to use these means of separation efficiently, effectively and in the long term interests of consumers, we need to have a clear understanding of the objectives of ring-fencing. Indeed we need to be able to answer the questions: what is the potential harm that ring-fencing is intended to address and do the benefits of ring-fencing outweigh the costs of compliance?

Regulated network businesses do not face the same costs or risks as unregulated businesses operating in competitive markets. Regulated businesses may also have exclusive access to information they gather as network operators. Furthermore, a regulated business could restrict access to its monopoly assets, favouring its own affiliated businesses over competitors. What this means is a regulated network business could gain an unfair advantage that limits the potential development of competitive markets, which can provide customers with better services and choices and at lower prices.

Arguably, regulated businesses should be excluded from offering services that can be obtained in contestable markets. This is because regulated entities enjoy advantages that are not available to an unregulated business. Under the NER, the advantages include (but are not limited to) the regulatory compact that guarantees the recovery of efficient investments. However, excluding regulated businesses from contestable markets would entail structural separation of regulated from contestable business activities and this goes beyond the scope of ring-fencing under the NER. The rules do not appear to provide us with the authority to impose structural separation of business activities within an NSP. In the absence of any rule changes to strengthen such requirements, however, some may view it is possible for State Governments to preclude NSPs from certain business activities through restrictions imposed as part of distribution licences.

It may be, though, that structural separation may entail other costs. A regulated business may have certain efficiency advantages in the provision of a contestable service. This may be due to comparative advantage stemming from, for example, its scale and scope of network related activities. If so, ring-fencing can seek to balance the competing objectives of promoting competition whilst at the same time providing

regulated NSPs with a means (through a separate affiliate) to offer services into a competitive market. That is, there may be merit in taking an approach that seeks to balance the costs and benefits of ring-fencing. The approach to ring-fencing proposed in this paper is broadly consistent with striking an appropriate balance between such costs and benefits. In regards to the broader issue of whether structural separation should be applied in relation to new services, this is ultimately a policy issue for governments through the COAG Energy Council and in our view would require changes to the NER.

By contrast, this question of structural separation for existing services had been determined by governments at the outset of the NEM. In the 1990s and early 2000s generation assets were structurally separated from networks, largely obviating the need for ring-fencing. However, a decade ago it was common for a combined electricity retailer and an electricity distribution business to have a single owner. That is, retail and network businesses were sometimes integrated—this business model has largely disappeared but a few examples still remain. In this circumstance, separation of the retail business from distribution business is achieved through ring-fencing, which may have included legal, functional and accounting separation as well as restrictions to sensitive commercial information flows.

That said, there was and remain significant differences in the precise ring-fencing obligations between the jurisdictions. For example, there are variations in the types of services that are ring-fenced, the need for legal separation or requirements for ring-fencing monitoring and compliance.

In developing ring-fencing guidelines in each of the NEM jurisdictions, State regulators identified ring-fencing objectives. The objectives are similar (but not identical) and highlight a key object: to separate contestable and regulated activities provided by an NSP.

In Victoria, the ESC guideline has the following objective:

By limiting the ability of distributors to exercise vertical market power in the competitive areas of the electricity industry under this guideline, the Commission is seeking to achieve its objectives under section 8 of the Essential Services Commission Act 2001 and in particular the objectives regarding efficiency in the electricity industry, misuse of monopoly market power, effective competition and benefits to users and consumers.⁹

Similarly, the Tasmanian Guideline states its objective to be:

By limiting the ability of a distributor to distort competition in the contestable areas of the electricity supply industry, the Regulator is seeking to achieve the Regulator's objectives under the Electricity Supply Industry Act 1995 to promote competition in the electricity supply industry and to protect the interests of consumers of electricity.¹⁰

⁹ ESCV, *Electricity Industry Guideline No. 17: Electricity Ring-fencing Guideline*, October 2004

¹⁰ OTTER, *Guideline for Ring-fencing in the Tasmanian Electricity Supply Industry*,

In South Australia, ESCOSA adopted the following objective:

The objectives of Ring-Fencing are to facilitate a competitive electricity supply market by providing controls that seek to:

- 1. avoid the anti-competitive effects of cross-subsidies or other discriminatory interactions between the contestable and non-contestable activities;*
- 2. ensure that unfair advantage is not secured by using information acquired by a monopoly activity, for the benefit of contestable activity;*
- 3. avoid a perception of an uneven playing field that may deter potential market participants; and*
- 4. provide the Commission with sufficiently detailed and accurate information to undertake price reviews.¹¹*

The last of the ESCOSA objectives reflects the role ring-fencing played in providing State regulators with a means to compel an NSP to prepare regulatory accounts. However, this is less of an issue for the AER as it has powers under the NEL to require information to be collected and provided for its own regulatory purposes.

In Queensland, the Queensland Competition Authority's guideline is very much focussed on structural separation:

...the Authority's objective in preparing Distribution Ring-Fencing Guidelines is to assist in creating an environment where the price, quantity and quality of electricity traded in the retail market, and the price, quantity and quality of distribution services used to deliver the energy, are not biased as a result of the vertical integration of distribution and other businesses – irrespective of the degree of integration.¹²

The AER guideline could draw on at least some of the objectives from the jurisdictional guidelines. However, we also need to revise the objectives to reflect the broader scope of ring-fencing given the more complex nature of current interaction between competitive and regulated aspects of network services potentially on offer by NSPs.

2.1 Proposed ring-fencing objectives

Our view is that the ring-fencing objectives aim to:

1. avoid the anti-competitive effects of cross-subsidies between the contestable and non-contestable activities offered by an NSP that would adversely affect markets for contestable services or the efficient provision of regulated services;

October 2004

¹¹ ESCOSA, *Electricity Industry Guideline No. 9 Operational Ring-fencing Requirements for the SA Electricity Supply Industry*, June 2003.

¹² QCA, *Electricity Distribution Ring-Fencing Guidelines*, September 2000

2. avoid discriminatory interactions between the contestable and non-contestable services offered by an NSP that would adversely affect markets for contestable services or the efficient provision of regulated services;
3. avoid providing a preferred or related party with an unfair advantage in offering contestable service that stem from information acquired in providing a regulated services; and
4. in achieving the first three objectives, promote an even playing field that may encourage market entry.

Ring-fencing compliance is not costless. Achieving these objectives should be subject to a consideration of the costs and benefits of compliance. Therefore, in seeking to satisfy the competition principles embedded in the objectives, we should also have regard to the long term interests of consumers as defined in the National Electricity Objective (NEO). In effect this means there will be times when the application of the ring-fencing guideline will need to be considered against the costs of doing so – a cost benefit assessment. This also forms the basis or rationale for deciding whether to grant waivers from ring-fencing obligations, where the costs of ring-fencing are considered greater than the benefits that are being sought (see further discussion of waivers in section 5 below).

Question 2: Do you consider these objectives discussed in section 2.1 adequately reflect the harm ring-fencing is seeking to avoid and the benefits of an even playing field?

With these objectives and the NEO in mind, we need to consider which services to ring-fence. This is discussed in section 3.

3 Which services should be ring-fenced?

Before we can consider which services should be ring-fenced, we need to explain the role of service classification under the NER. This is because service classification tells us what services are or are not regulated by the AER, which in turn will have an important bearing whether ring-fencing may be required. We first consider the classification of services as part of our Framework and approach (F&A) process. The F&A provides guidance to an NSP on which services will be regulated and the form of regulation (for example, price cap regulation), amongst other things. The F&A process commences about a year before an NSP submits a five year regulatory proposal to us for assessment.

NSPs typically provide many different services and these are typically rolled up into service groupings that share similar characteristics. For example, service groupings include 'metering services', 'connection services' or 'ancillary services'. While service classification is not settled until the AER makes its final determination, the F&A provides a good guide as to those services offered by an NSP that will be subject to regulation.

The NER makes it clear that the only services that can be ring-fenced are those offered by NSPs that are not directly regulated by the AER. That is, only direct control services, which is made up of standard control services (SCS) and alternative control services (ACS), may be ring-fenced from all the other services offered by an NSP.¹³

It should be noted that it is services that are ring-fenced, not assets. The AER's power under the NER to establish a ring-fencing guideline refers to the accounting and functional separation of regulated direct control services (SCS and ACS) from other services. So if we or stakeholders took the view that energy storage devices, solar PV or meters needs to be ring-fenced, we need to express this in terms of battery storage services, embedded generation services or metering services.

3.1 Is it possible to ring-fence an asset?

The short answer is that given the current rules we consider it is unlikely that assets can be ring-fenced. We anticipate some stakeholders may hold the view that certain assets types, such as energy storage devices or load control devices, should always be ring-fenced and not provided by NSPs directly. That is, these devices should be ring-fenced irrespective of whether they are used to provide a contestable service in a market or whether they are used purely as an input to the provision of regulated services, due to the potential to crowd out alternative service providers in either case.

As the NER is currently written, the AER cannot prohibit an NSP from acquiring and using any given type of asset. We consider we are only able to require a particular

¹³ NER, cl. 6.17.2(a).

ring-fencing treatment of an asset where it is used to provide services to customers. However, we appreciate some stakeholders may consider more restrictive arrangements should be placed on use or ownership of certain types of assets. In particular, some may view that NSPs should be restricted from acquiring assets that are key to the development of emerging markets, such as energy storage and other types of distributed energy resources.

3.2 Services currently subject to ring-fencing

The current jurisdictional approaches to determining which services are to be subject to ring-fencing are, for the most part, narrowly defined or specifically identified. In Victoria, only retail activities are ring-fenced. In Qld and the ACT, the list is slightly expanded to include production, sale and purchase of energy, as does the ACCC in its transmission ring-fencing guideline. Other jurisdictions use a broader definition of ‘contestable services’. See table 3.

Table 3 Jurisdictional ring-fencing coverage

ICRC (ACT)	Producing, selling or purchase of electricity
QCA (Qld)	Producing, selling or purchase of electricity
ESCOSA (SA)	Contestable business activities
OTTER (Tas)	Contestable business activities or where customer contributions are paid for connection
ESC (Vic)	Business activities provided under a retail licence
IPART (NSW)	Regulated (prescribed) services are ring-fenced from contestable services
ACCC (transmission)	Generation, distribution and retail of electricity

3.3 Ring-fencing coverage

If ring-fencing aims to separate regulated services from unregulated services offered by an NSP, why not ring-fence all contestable services an NSP offers? If the costs were not prohibitive, this might be a suitable approach. Given there will be costs of compliance, perhaps ring-fencing should still be applied by default, but subject to a consideration of the costs where these are material.

An alternative and opposite approach would be to assume no harm is caused by an NSP offering services in a contestable market, unless a net benefit from the application of ring-fencing can be demonstrated. This approach places the onus on consumers or

other stakeholders, such as potential competitors, to identify the situation where a service offered by an NSP could result in harm to consumers or the development of competitive markets.

Our preference is to adopt the first approach, which assumes ring-fencing is beneficial to consumers. We consider this approach is clearly beneficial to the development of contestable markets. Availability of information would also disadvantage consumers and other stakeholders with respect to the alternative approach. We also believe that in those instances where the costs of ring-fencing compliance exceed the benefits, there will be opportunities for NSPs to submit evidence to us (to which they will have first-hand access) to put forward a case for a relaxation of ring-fencing obligations through waivers, as discussed in section 5.

With respect to the services that will be subject to our ring-fencing guideline, there are also a few alternative options. These options include:

1. defining a precise list of services that would be subject to the guideline, essentially taking a similar approach to the jurisdictions. This is the approach taken in most current jurisdictional guidelines
2. providing a general definition of services to be ring-fenced
3. periodically reviewing the services offered by each NSP and determine which services will be subject to ring-fencing at that time (that is, as part of the F&A service classification process).

The advantage of option 1 (service list) is that a specific list of services would make clear precisely which services are ring-fenced, reducing uncertainty. Further, this mirrors that of most existing jurisdictional approaches that identified specific services like 'generation, purchase or selling of energy'. Additional services, like metering or load control services that we might consider should be ring-fenced could be added to the 'list'. The main disadvantage of this approach is that it creates a new and separate regulatory decision making process each time a new service is provided.

The second option (broad definition) would be to define those services to be subject to ring-fencing as 'contestable and potentially contestable services'. This is similar to the way some jurisdictional regulators have defined ring-fenced services, such as IPART and ESCOSA. This would leave it open to the AER to nominate services that must comply with the ring-fencing obligations. As with option 1, this approach would create a new decision making process each time a new service was to be provided. This would create some uncertainty, which the ring-fencing guideline is supposed to remove, according to the AEMC.¹⁴

Option 3 (classification) ties ring-fencing obligations more closely to service classification. That is, the decision about which services will be subject to ring-fencing

¹⁴ AEMC, *National Electricity Amendment (Expanding competition in metering and related services) Rule 2015*, p. 399

is made at the same time the AER considers which services will be subject to regulation in the forthcoming regulatory control period. Once the classification of a service has been defined in terms of whether it should be regulated or otherwise (standard control, alternative control, negotiated or unclassified) so would a decision be made, prima facie, as to ring-fencing obligations.

In a sense, the NER already links ring-fencing to classification given a literal reading of clause 6.17.2. This approach allows the F&A process to be used as a vehicle for revisiting ring-fencing prior to the lodgement of a regulatory proposal. Any changes to classification and therefore ring-fencing obligations would be considered prior to an NSP submitting its regulatory proposal. This means that no additional regulatory decision making process would be required. This approach also ties in with the need to make allowances for jurisdictional considerations as part of ring-fencing. The main disadvantage of this approach is that it potentially captures more services than may be really necessary and therefore may introduce higher costs of compliance.

Given these three options, our preliminary view is to support option 3. The main reason is that there are strong similarities between the purpose of service classification and the purpose of ring-fencing. In determining the classification of services the AER is required to have regard to the form of regulation factors set out in the NEL.¹⁵ These factors are concerned with: barriers to third parties providing a service; the existence of substitute services; and interdependencies between the different services provided by a network business. In simple terms, the factors ask whether there is scope for the (competitive) provision of the service by third parties, or are the services inherently tied to the monopoly services provided by network businesses. The parts of the NER and NEL relevant to classification are provided in appendix A.

In summary, the advantages of the option 3 are as follows:

- links the classification decision to initial consideration of which services will be ring-fenced (does not create a second administrative process)
- provides an approach that tailors ring-fencing to the requirements of each jurisdiction, as is the case for classification
- provides for a 5 year review of ring-fencing of an NSPs services with the F&A and immediately prior to the regulatory proposal being submitted
- effectively means all existing unregulated services, including retail and generation/wholesale services remain outside the NSPs remit. This would facilitate a continuation of restrictions placed on NSPs by jurisdictional authorities.

As noted above, however, this approach to ring-fencing will capture some services that may not warrant ring-fencing because the costs of ring-fencing exceed the benefits to consumers. However, this could be addressed through mechanisms such as ring-

¹⁵ NEL, s. 2F.

fencing waivers that would exempt an NSP from ring-fencing obligations in regard to specific services.

Therefore, we propose that all services offered by an NSP that are not direct control services would be ring-fenced unless a ring-fencing waiver is in place.

Question 3: Do you agree with the service classification approach to ring-fencing which is discussed in section 3.3? Is there a better alternative?

3.4 Case study—metering

What does this preliminary approach mean for residential metering services?

In the 2015 AER Determinations for the NSW and Qld electricity distributors, we unbundled residential metering charges from standard electricity charges. We did this to enable electricity consumers to choose to retain their existing metering service from the distributor or choose an alternative metering service provider. We classified metering services being provided by regulated entities (accumulation and interval type meters) as ACS in preparation for metering becoming contestable.¹⁶ By unbundling metering services and setting cost reflective charges for metering services that remove cross subsidies, we assist the development of a contestable market for metering services. In jurisdictions where metering services are classified as ACS, no ring-fencing obligations would apply as these are still being provided by NSPs on an exclusive basis. This is consistent with the AMEC's observation that metering would not be subject to ring-fencing while these services remained alternative control services.¹⁷

New metering related services (type 4 "smart meters" or equivalent), including the Metering Coordinator, have not been classified in any AER Determinations to date and remain unregulated. Significantly, such services will be opened up fully to competition from December 2017. As these services have not been classified, if offered by an NSP they would be subject to ring-fencing.

In summary, ring-fencing would be imposed on services offered by NSPs into the contestable market for metering services. However, regulated metering services (ACS) offered on an exclusive (or regulated) basis would not be subject to ring-fencing.

3.5 Case study—NSP energy storage devices

¹⁶ We regulate both standard control services and alternative control services but there are important differences between these two groups of services, including how the value of assets used to provide these services are treated. Asset values for standard control services are reflected in an NSP's regulatory asset base (RAB). Asset values for alternative control services are kept separate from an NSP's RAB.

¹⁷ AEMC, *National Electricity Amendment (Expanding competition in metering and related services) Rule 2015*, p. 410.

Distributed Energy Resources (DER) create some interesting issues for classification and ring-fencing given they can generate multiple value streams, which stem from the different uses of these assets. The uses include, for example, managing load congestion on networks or trading in electricity wholesale markets by storing and selling electricity as market prices vary. While NSPs can use these assets to help manage their own networks, DER can be used by third party service providers to offer services to customers (which may include offering services to NSPs).

Investment in DER by NSPs has the potential to crowd out investment by competitive third party service providers. As a result there is potential for harm to the development of the market for DER related services. The ring-fencing objectives aim to avoid this harm.

In the circumstance where an NSP uses DER to offer a service into a competitive market, such as the wholesale market for electricity, the service would not be classified as a direct control service and therefore would be ring-fenced under the approach proposed in this paper.

Alternatively, if a DER device was used exclusively as an input to providing standard control network services, for example, to smooth demand peaks thereby mitigating network augmentation, then no ring-fencing would apply in relation to the function provided by this device. This is because the device is being used exclusively as an input to the provision of a regulated standard control network service. However, should an NSP use one of these non-ring-fenced assets to offer a service into a contestable market, the NSP would be in breach of its ring-fencing obligations, since such a service should be ring-fenced and only be provided through a ring-fenced entity. To offer these services, the NSP would need to offer the service via a ring-fenced affiliate or could avoid ring-fencing entirely if the service is offered via a structurally (ownership) separated entity.

An NSP has options in the way that it could employ DER, and with each option there are different ring-fencing implications. Consider an NSP choosing how it should invest in a DER device to manage a shared network issue. The NSP would have three options (at least) in which it could secure the use of the device. The NSP could choose to:

1. Acquire a DER device to provide direct control services only. If the asset is only used as an input to provide a standard control network service, an NSP might argue that no ring-fencing is required because the DER device forms part of a standard control service. Consistent with all assets used to provide standard control services, the asset would be added to the RAB. However, if the asset was used to provide a service that is offered in a contestable market, the NSP would be in breach of its ring-fencing obligations.
2. Through a separate ring-fenced legal entity that it owns, purchase the DER device. The ring-fenced entity utilises the asset to offer services into a contestable market or to its parent NSP. In this circumstance, the contestable service on offer would not be classified (or regulated) by us and the asset

would not be added to the RAB. The regulated NSP could buy the service for network purposes (as needed), using part of its opex allowance.

3. Purchase the services provided with the DER device through a third party. In this case, the costs of using the services of the third party would also be met using the NSP's opex allowance. [Note that if the third party was structurally (ownership) separated from the NSP, ring-fencing obligations would not apply. However, the two business owners could still be related in some way. In these circumstances, we would need to consider the arm's length arrangements between the entities and cost efficiency of the services offered to the NSP by the related party.]

Ideally, an NSP would consider all three options (at least) and select the most cost effective and efficient. The ring-fencing guideline and the incentive mechanisms built into the regulatory framework should work together to ensure that NSPs choose the most efficient option.

We may prefer a certain approach for an NSP to adopt (such as option 2 or perhaps option 3). However, we cannot impose one approach over another. The clear disadvantage of option 1 is that the NSP would not be able to fully utilise the asset—the asset could not be used to engage in contestable activities. Option 1 is therefore unlikely to maximise the efficient use of DER. Nevertheless, option 1 is a choice that NSPs may still elect. We consider that where an NSP selects option 1, it needs to show this is the most efficient option and the effect of using assets in this way should be monitored to examine the effect on the development of competitive markets.

Question 4: Does the proposed approach to ring-fencing adequately deal with the prospects for development of the contestable market for DER?

3.6 Case study—connections

Another example of ring-fencing is connections in NSW.

Connection services are contestable in NSW and, as a result, are not classified as direct control services. Therefore, if any one of the NSW NSPs offers connection services, the services would be ring-fenced. For Essential Energy (servicing regional NSW) the service may only be potentially contestable due to a lack of third party service providers in rural NSW.

As a hypothetical example, Essential Energy might seek a ring-fencing waiver for the provision of connection services given an absence of alternative service providers in regional NSW. We may look favourably at such a waiver if there were no existing alternative service providers. However, there may be prospects for third party providers to enter this contestable market and granting a waiver could discourage entry into the market. Further, the costs to Essential Energy of setting up a ring-fenced entity to provide these services may not be prohibitive.

In forming our decision on granting a waiver, we would consider stakeholder views as well as the prospects for alternative service providers to emerge. We may also ask Essential Energy to demonstrate to us whether the costs of providing the service through a ring-fencing entity were prohibitive. A waiver could also be offered on a restricted basis, such as through a sunset clause attached to the ring-fencing waiver.

4 Ring-fencing obligations

The selection of ring-fencing obligations depends on how much separation is to be achieved. It is probably reasonable to assume the more onerous ring-fencing obligations are also more costly in term of compliance (and regulatory oversight). Full ownership separation (also known as structural separation) for instance, is probably the most effective form (although strictly, it is not ring-fencing). However, loss of economies of scale and scope and increased transaction costs could impose prohibitive costs. As noted in section 2 above, we may not have the power to impose structural separation.

The NER refer to a range of potential obligations: legal separation, accounting separation, cost allocation and restrictions on information flows.¹⁸ We also have discretion to consider other approaches to achieve the separation we consider is necessary. These approaches may be applied in part or in combination to achieve the desired level of separation.

Legal separation requires that the services are provided by different legal entities (the ring-fencing entity may be a subsidiary or an affiliate of the regulated entity).

Accounting separation refers to a requirement to maintain separate accounts for each service so that transactions between the regulated entity and unregulated entity are made transparent.

Functional or operational separation imposes a requirement that the services are provided by different divisions (within the same business). This may or may not be accompanied by full accounting separation but may require some form of cost allocation requirements, such as separate cost centres.

In this paper we have not attempted to quantify the costs of setting up a ring-fenced affiliate or the costs of complying with the proposed ring-fencing obligations. We welcome submissions that provide evidence on these costs.

An example of the ring-fencing obligations we could adopt are provided below. These are adapted from the QCA ring-fencing guideline. We may also add to this list of ring-fencing obligations. However, as ring-fencing by its nature will impose costs on network businesses we need to be mindful that ring-fencing not create inefficiencies, unnecessary compliance costs or unintended consequences.

Proposed ring-fencing obligations

The following obligations are designed to assist in achieving the ring-fencing objectives. A DNSP providing direct control services must:

¹⁸ NER cl. 6.17.2(b).

- (a) not carry on a ring-fenced service unless it is within a separate legal entity to the DNSP,
- (b) not locate a ring-fenced service at the same physical location as the DNSP
- (c) not share staff between the ring-fenced entity and the DNSP
- (d) establish and maintain separate accounts that clearly identify the extent and nature of transactions between the NSP and ring-fenced entity(s)
- (e) ensure there is no cross subsidy between the ring-fenced entity and the DNSP
- (f) protect information provided by a customer or prospective customer and ensure its use is only for the purpose for which that information was provided
- (g) ensure that information provided to a ring-fenced entity is also available to third parties on an equal basis
- (h) ensure information obtained by the DNSP is not disclosed to any party without the informed approval of the customer or prospective customer to whom it pertains

Exemptions to these obligations could be offered in certain circumstances. For example, if:

- (a) the DNSP shares an employee, consultant, independent contractor or agent with an Associate that takes part in a related business; or
- (b) confidential or commercially-sensitive information obtained by the DNSP is disclosed to its employees, consultants, independent contractors or agents or to any employee, consultant, independent contractor or agent of an Associate;

is consistent with protocols prepared by the DNSP and approved by the AER.

Question 5: Are there other ring-fencing obligations we should impose on NSPs that provide services into contestable markets?

Question 6: What costs would be incurred in meeting these obligations?

It may be possible to develop protocols and procedures as an alternative means of satisfying the ring-fencing obligations. For example, an NSP may be able to satisfy us that the ring-fencing objective can be met through procedures and protocols that may be less costly than meeting one or more of the ring-fencing obligations. For example, restrictions on staff movement may be managed through staff training and operating management procedures than through a strict ban. This demonstrates a more flexible approach to achieving the ring-fencing objectives, if the costs of complying with the obligations exceed the benefits to consumers.

The benefits, costs and implications of functional separation need to be considered. The obligations as written suggest assets could be shared across regulated and contestable services in accordance with a cost allocation method. The AER's Shared Asset Guideline, which applies when unregulated revenues are earned from use of regulated assets, could also be restricted. Functional separation could restrict this type of sharing. It might be desirable to contemplate more restrictive ring-fencing obligations that would prevent asset sharing. This might appeal to stakeholders that are concerned about the enforceability and effectiveness of ring-fencing obligations. Clearer functional separation may also enable more effective compliance checking. The effectiveness of electricity ring-fencing to date and in other industry sectors is an aspect of the guideline development that needs to be further investigated. The findings may suggest whether more restrictive approaches to asset sharing may be warranted.

Question 7: Should asset sharing be restricted between regulated services and contestable service provision?

5 Ring-fencing waivers

Waivers provide flexibility to the AER around the ring-fencing obligations. Waivers may be granted for one or more or all of the obligations described in the previous section. In considering whether to grant a waiver, we would consider whether the benefits of ring-fencing, which are articulated in the objectives, exceed the costs (measured against the NEO). In certain circumstances it may be more beneficial to the long term interests of consumers to grant a waiver.

Typically, a service that is not contestable (nor potentially contestable), or where there are no adverse effects on a contestable market, could be granted a ring-fencing waiver for particular periods (with sunset provisions). Obviously, direct control services would automatically be excluded from having to meet any ring-fencing obligations.

The decision criteria for granting a waiver would need to have regard to the ring-fencing guideline objectives and the NEO. This approach would give us discretion over waiver decisions. This level of discretion is not unusual. In its guideline, the QCA states that:

“The QCA may, by notice to a DNSP, waive any of a DNSP’s obligations under section 1 provided that the QCA is satisfied that the DNSP can demonstrate that the administrative cost to the DNSP and its Associates of complying with the obligation outweighs the benefit, or any likely benefit, to the public.”¹⁹

When a service subject to ring-fencing is provided by a regulated network business, a ring-fencing waiver may be granted for one of more ring-fencing obligations. In coming to our decision on whether to grant a waiver, we would consider the following factors:

- the potential harm to be avoided by ring-fencing
- whether the cost of complying with ring-fencing obligations exceeds the benefits defined by the ring-fencing objectives
- safety issues (established by a proper authority) that result in service provision being restricted to an NSP
- jurisdictional restrictions (such as a licence condition or other barrier to entry by third parties) that mean a service is not subject to competition
- whether a service has been classified for a reason other than the potential for development of competition (such as a user specific network service).

This is not intended to be an exhaustive list at this stage.

¹⁹ QCA, *Electricity Distribution Ring-Fencing Guideline*, p 24.

In its Integration of Storage paper, the AEMC made a number of recommendations for us to consider when developing the ring-fencing guideline.²⁰ The recommendations could provide useful factors to consider when assessing a waiver application. In particular, we could consider:

- The ability of an NSP to obtain access to the contestable services efficiently through alternative means, such as contracting the provision of services from third parties.
- The extent to which an activity might generally be expected to be used to provide regulated network services compared with its use to provide contestable services.
- The degree to which it is expected that a network business would have the ability to impact competition in the contestable market through leveraging an advantage from its regulated activities.
- The extent and nature of the advantage that is expected to result from the network business also having a regulated business, and whether this is an artificial advantage arising from its regulated status.
- The nature of the other competitors in the contestable sector. Where other competitors are also regulated network businesses, it may be possible to adopt less extensive ring-fencing requirements, as all competitors would have similar advantages.
- The extent and nature of other benefits that the network business may have in operating in the contestable market, separate from those arising from its regulated status.

Question 8: Do the factors set out above reflect the issues we should consider in deciding whether to grant a ring-fencing waiver?

²⁰ AEMC, *Integration of Storage: Regulatory Implications*, 2015, pp17-18.

6 Reducing the administrative costs of ring-fencing

We acknowledge that ring-fencing obligations will impose costs on the providers of ring-fenced services. There may be concern from stakeholders, particularly from NSPs, about the potential cost of complying with the ring-fencing approach as proposed. In particular, that the approach would introduce new administrative requirements associated with ring-fencing compliance and consequently costs that are ultimately borne by consumers.

An NSP would be able to reduce the costs it incurs for ring-fencing compliance by not engaging in activities that are subject to ring-fencing obligations. That is, by leaving the provision of the service to other parties. We anticipate compliance costs would not be significant unless an NSP was engaged in the provision of services that are subject to ring-fencing. Where an NSP incurs costs due to its involvement in ring-fenced activities, in our view it is the customers of those ring-fenced (contestable) services that should bear the incremental costs of ring-fencing compliance.

Question 9: In which circumstances should the customers of ring-fenced services and not customers of the DNSP's services in general pay the additional costs of complying with ring-fencing obligations?

Regardless of who should meet the costs of ring-fencing compliance, it is important to consider how to minimise the overall cost of compliance. We propose to incorporate a number of features into the ring-fencing guideline that might help reduce and possibly avoid additional compliance requirements. In brief, these features could include:

- fast track waiver applications (for less contentious applications)
- a bulk waiver approval process as part of the ring-fencing guideline, and
- transitional arrangements to provide network businesses with a period to comply with the guideline.

First, we propose a flexible approach to waivers that includes a fast track process for approval of waivers. Fast track waiver applications would be acceptable where use of a service was not material and/or the prospects for competition were minimal. In these cases, a waiver may be granted by the AER based on an exchange of letters that would be published. For example, ownership of roof top solar PV to reduce an NSP's operating cost would be accepted (waiver approved) for a capacity below a given level. The waiver would be conditional on the capacity constraint not being exceeded.

Second, we would undertake a bulk waiver application and decision process as part of the guideline development process. NSPs would identify each non-standard control service they consider should be exempt from ring-fencing. The AER would determine whether or not to provide waivers for all NSPs simultaneously. This process would run parallel with guideline development. Alternatively, it could proceed immediately after

the guideline is finalised. We expect many waiver requests would be common to a number of NSPs if not all.

Third, we expect that a number of test cases for ring-fencing waivers would set precedents for how certain services would be treated under the guideline. Over time we expect the administrative costs of complying with the ring-fencing obligations will diminish.

Services NSPs propose to offer on a commercial basis into competitive markets would face a more extensive consultation process. For example, a more complex/contentious waiver application could include a draft decision (or consultation paper) and a call for submissions prior to a final decision being made.

Question 10: How else could the AER minimise the administrative cost of ring-fencing while maintaining the integrity of its approach?

6.1 Transitional arrangements

We recognise that NSPs will not be able to comply with the guideline from the first day it is published. At this stage we consider it reasonable to allow a period for NSPs to comply with the guideline—a year perhaps.

We may decide that existing jurisdictional waivers should remain in effect but a sunset clause (a year or more perhaps) be imposed. Additional time may be granted where current ring-fencing provisions are very different.

We consider there are several reasons why NSPs should be given time to comply with the new ring-fencing guideline. These reasons include:

- In a practical sense, NSPs will not be able to have ring-fencing compliance arrangements in place until sometime after the guideline has been finalised.
- When the new guideline comes into effect, the new arrangements will be more difficult for some NSPs to meet compared to others—due largely to the differences between current and new ring-fencing obligations.
- NSPs with existing waivers will need time to seek new waivers. We could either grandfather existing waivers or provide a period of time before new waivers must be obtained.
- We can expect many of the services currently offered without waivers will need to be relocated under a separate legal entity. This is because the AER guideline will likely impose a more stringent ring-fencing regime than applies in most jurisdictions. Alternatively, the NSPs could seek a waiver.

Question 11: Is it reasonable for the AER to consider these transitional arrangements to the new ring-fencing guideline?

6.2 Other issues

Research and development

From time to time NSPs undertake trials and invest in research and development (R&D) that has a commercial focus but may seek a waiver to avoid the cost of ring-fencing. Should a waiver be granted or should these activities be ring-fenced? The answer may depend on the NSP being able to substantiate that the R&D directly relates to the operation of the shared network. Arguably, only in such circumstances would a waiver be granted for these trials or other R&D activities.

Information sharing

An NSP has access to information due to its positions as a monopoly service provider. Subject to privacy concerns, there may be opportunities for NSPs to make information available to the market that would facilitate the development of competitive markets. For example, a requirement for NSPs or affiliates to share information concerning mid-scale solar investments that could offer network support benefits.

Triggers and openers

If classification is used to determine which services are subject to ring-fencing, a review would take place automatically occur every 5 years at the time the F&A is reviewed and new service classifications are established. However, how would we accommodate changes to circumstances within the regulatory control period? For example, say a jurisdiction opens connection services to contestability. We may need to consider if a trigger or re-opener provision can deal with this.

7 Reporting, compliance and enforcement

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.

In general, the onus will be on NSPs to satisfy us they have complied with the ring-fencing guideline.

We propose each NSP will be required to report annually:

1. for each ring-fenced service, summarise its compliance with respect to each ring-fencing obligation
2. on compliance breaches and remedies
3. undertake an audit of its compliance using an independent third party
4. submit summary financial accounts for each ring-fenced entity, indicating the size and nature of transactions with the NSP.

To aid transparency, we propose these annual reporting requirements should be published on NSP and AER websites.

In response to our 2012 paper on ring-fencing, we received submissions suggesting that penalties be applied for breaches of the ring-fencing guideline.²¹ Where there are breaches of the guideline, the AER could seek court enforceable compliance with the guideline. Whether pecuniary penalties should be available for non-compliance is an issue about which interested parties may wish to comment.

Question 12: How can we ensure ring-fencing compliance is robust and effective without imposing excessive costs that may ultimately be borne by consumers?

²¹ See submissions from AGL and SA Power Networks at <https://www.aer.gov.au/node/12493>

8 Next steps

The next key milestone is the preparation of a draft ring-fencing guideline. We will commence preparing this guideline once we have received and considered your submissions, due to us by the close of business on 30 May 2016. We intend to meet with interested parties during this phase of the guideline development process.

We look forward to receiving and value your submissions. Issues raised in submissions will be considered and responded to in preparing our draft guideline. Table 4 summarises future dates for the Ring-fencing guideline development process.

Table 4 Ring-fencing guideline timeline

Step	Date
AER to publish preliminary position	April 2016
Submissions due	30 May 2016
AER to hold workshops with key stakeholders	Through mid-year 2016
AER to issue draft Guideline	July 2016
Submissions on Guideline	Early August
AER to hold work shops	August September 2016*
AER to publish additional papers (if required)	August/September 2016
Last submissions due	mid October 2016
Final Guideline (must be within 80 business days draft guideline*)	On or before 30 November 2016*

* NER requirement

9 Summary of questions

Question 1: What aspects of current jurisdictional ring-fencing arrangements have or have not worked well?

Question 2: Do you consider these objectives discussed in section 2.1 adequately reflect the harm ring-fencing is seeking to avoid and the benefits of an even playing field?

Question 3: Do you agree with the service classification approach to ring-fencing which is discussed in section 3.3? Is there a better alternative?

Question 4: Does the proposed approach to ring-fencing adequately deal with the prospects for development of the contestable market for DER?

Question 5: Are there other ring-fencing obligations we should impose on NSPs that provide services into contestable markets?

Question 6: What costs would be incurred in meeting these obligations?

Question 7: Should assets sharing be restricted between regulated services and contestable service provision?

Question 8: Do the factors set out above reflect the issues we should consider in deciding whether to grant a ring-fencing waiver?

Question 9: In which circumstances should the customers of ring-fenced services and not customers of the DNSP's services in general pay the additional costs of complying with ring-fencing obligations?

Question 10: How else could the AER minimise the administrative cost of ring-fencing while maintaining the integrity of its approach?

Question 11: Is it reasonable for the AER to consider these transitional arrangements to the new ring-fencing guideline?

Question 12: How can we ensure ring-fencing compliance is robust and effective without imposing excessive costs that may ultimately be borne by consumers?

Appendix A: Relevant NER

6.17 Distribution Ring-Fencing Guidelines

6.17.1 Compliance with Distribution Ring-Fencing Guidelines

All Distribution Network Service Providers must comply with the Distribution Ring-Fencing Guidelines prepared in accordance with clause 6.17.2.

6.17.2 Development of Distribution Ring-Fencing Guidelines

(a) Guidelines must be developed by the AER for the accounting and functional separation of the provision of direct control services by Distribution Network Service Providers from the provision of other services by Distribution Network Service Providers (the Distribution Ring-Fencing Guidelines). The guidelines may vary in application as between different participating jurisdictions.

Note:

Clause 11.14.5 will have a bearing on the application of these guidelines in certain cases.

(b) The Distribution Ring-Fencing Guidelines may include, but are not limited to:

(1) provisions defining the need for and extent of:

(i) legal separation of the entity through which a Distribution Network Service Provider provides network services from any other entity through which it conducts business; and

(ii) the establishment and maintenance of consolidated and separate accounts for standard control services, alternative control services and other services provided by the Distribution Network Service Provider; and

(iii) allocation of costs between standard control services, alternative control services and other services provided by the Distribution Network Service Provider; and

(iv) limitations on the flow of information between the Distribution Network Service Provider and any other person; and

(v) limitations on the flow of information where there is the potential for a competitive disadvantage between those parts of the Distribution Network Service Provider's business which provide direct control services and parts of the provider's business which provide any other services; and

(2) provisions allowing the AER to add to or to waive a Distribution Network Service Provider's obligations under the Distribution Ring-Fencing Guidelines.

(a) In developing or amending the Distribution Ring-Fencing Guidelines the AER must consider, without limitation, the need, so far as practicable, for consistency between the Distribution Ring-Fencing Guidelines and the Transmission Ring-Fencing Guidelines.

(b) In developing or amending the Distribution Ring-Fencing Guidelines, the AER must consult with participating jurisdictions, Registered Participants, AEMO and other interested parties, and such consultation must be otherwise in accordance with the distribution consultation procedures.

11.86.8 Distribution Ring-fencing Guidelines

(a) AER must by 1 December 2016 publish Distribution Ring-Fencing Guidelines.

Appendix B: Current electricity ring-fencing arrangements by jurisdiction

	IPART (NSW)	ICRC (ACT)	QCA (Queensland)	ESCOSA (SA)	OTTER (Tasmania)	ESC (Victoria)	AER Transmission guidelines
Legal separation	Not addressed.	DNSP must not carry on a related business.	DNSP must not carry on a related business within that legal entity.	DNSP must not hold a retail licence or a generation licence (except when generation is carried out for network support purposes and where no revenue is earned from such generation).	Not addressed.	Not addressed.	TNSP that supplies ring-fenced services must be a legal entity and must not carry on a related business, unless related business does not attract total revenue of less than or equal to 5% of the TNSP's total annual revenue.
Accounting separation	Not addressed.	DNSP must establish and maintain consolidated and separate accounts for the provision of distribution services and its other businesses.	DNSP must establish and maintain consolidated and separate accounts for the provision of prescribed distribution services and excluded services.	Not addressed.	Separate accounting ring-fencing guidelines covering how DNSP should present accounting reports and disaggregation statements where they provide contestable services.	Not addressed.	TNSP must establish and maintain separate set of accounts for provision of ring-fenced services and separate amalgamated accounts for entire business.

	IPART (NSW)	ICRC (ACT)	QCA (Queensland)	ESCOSA (SA)	OTTER (Tasmania)	ESC (Victoria)	AER Transmission guidelines
Allocation of costs	DNSP must ensure costs relating to a distribution service are fully allocated to either prescribed distribution services or excluded distribution services on a causation basis.	DNSP must not cross-subsidise a related business.	DNSP must allocate any costs that are shared between prescribed distribution services, excluded services and other activities in a manner that ensures there is no cross subsidy and according to a methodology approved by the QCA.	Not addressed.	Separate accounting ring-fencing guidelines covering how DNSP should present accounting reports and disaggregation statements where they provide contestable services.	Not addressed.	TNSP that provides ring-fenced service must allocate costs that are shared between any ring-fenced services and any other activity.
Access to information	DNSP must provide information relating to the provision of prescribed distribution services to an independent accredited service provider on terms that are no less favourable than the terms on which that information is made available to that part of the DNSP's business that provides contestable services.	DNSP must ensure that, where commercially valuable information is made available to a related business it is also made available to similarly situated entities.	DNSP must not provide distribution network access to a related business on more favourable terms than those it provides to any other customer or Code participant.	DNSP must ensure that any information obtained in the course of conducting a licensed business which might reasonably be expected to affect materially the commercial interests of a related business or provide a related business an advantage over its competitors is disclosed to the related business and its competitors in a non-discriminatory manner.	DNSP must establish access controls so that users of DNSP's information systems do not have access to information concerning the distribution service if the user is providing a contestable service.	DNSP must ensure that distribution information it provides to any retail business is available to all retail businesses.	TNSP that provides ring-fenced services must ensure that information it provides to any associate that takes part in a related business is available to any other party, and that preferential treatment is not given to an associate that takes part in a related business.

	IPART (NSW)	ICRC (ACT)	QCA (Queensland)	ESCOSA (SA)	OTTER (Tasmania)	ESC (Victoria)	AER Transmission guidelines
Customer information	Not addressed.	DNISP must ensure that information obtained by conducting its business and which might reasonably be expected to affect materially the interests of an existing or prospective customer is not disclosed to any other person without the approval of the existing or prospective customer to whom that information pertains. Exceptional circumstances given in guidelines.	DNISP must ensure that all confidential information provided by a customer or prospective customer is used only for the purpose for which that information was provided and not disclosed without the approval of the customer or prospective customer. Exceptional circumstances given in guidelines.	DNISP must ensure any information obtained in conducting a licensed business is used only for the purpose for which that information was provided or obtained.	Not addressed. However, guidelines provide that when communicating with a customer, DNISP must not communicate in a way that would favour the distribution or related business over another service provider in provision of contestable services, and where appropriate, DNISP must communicate to customer that contestable services may also be obtained from independent service provider.	Not addressed. However, guidelines provide that when DNISP is communicating with a customer, it must make clear that it is a distributor carrying on distribution business, and when retail business communicating with customer, it must make clear that it is a retailer carrying on retail business.	Not addressed.

	IPART (NSW)	ICRC (ACT)	QCA (Queensland)	ESCOSA (SA)	OTTER (Tasmania)	ESC (Victoria)	AER Transmission guidelines
Waivers	Tribunal may grant DNSP waiver from provision of guidelines upon request and after considering factors including costs of compliance, DNSP's ability to achieve economies of scale, the effect of the waiver on competition, and after public consultation (if relevant).	Not addressed.	QCA may waive DNSP's ring-fencing obligations if satisfied that cost of complying outweighs benefit or likely benefit to public. QCA to ask for and consider any submissions it receives.	Commission may grant waiver from ring-fencing obligations if satisfied that the benefit or likely benefit of compliance will be outweighed by administrative cost to Distribution Licensee.	Regulator may grant waiver at request of distributor of any obligation under guidelines after undertaking consultation process and if satisfied that costs of compliance outweigh benefits.	Not addressed.	ACCC may waive TNSP's ring-fencing obligations if satisfied that the benefit to the public is outweighed by the administrative cost to the TNSP of compliance.
Physical and functional separation	DNSP must ensure that the offices from which DNSP staff provide specified services are separate from the offices from which DNSP staff provide contestable services.	DNSP must ensure office space is physically separate from that of related businesses. DNSP must ensure that operational staff involved in providing commercially sensitive services (such as customer connection and meter reading) are not also staff of a related business.	DNSP must ensure that its marketing staff are not also staff of a related business.	DNSP must ensure that any marketing staff involved in the DNSP's licensed business are not also involved in a related business; and any operations staff involved in both the DNSP's licensed business and a related business are shared between the two businesses on a non-discriminatory arm's length commercial basis.	DNSP must ensure that parts of business providing or marketing regulated distribution services operate independently and have separate work areas from parts of business providing contestable services. Also, DNSP must ensure that its employees are not staff of related business providing contestable services.	DNSP must ensure that units marketing or providing distribution services and units within retail business operate independently and have separate work areas with access controls that prevent staff of either unit entering into work area of other unit. Also, DNSP staff must not also be staff of retail business.	TNSP must ensure that its marketing staff are not also servants/consultants of an associate that takes part in a related business, or that its servants/consultants are marketing staff of an associate that takes part in a related business.

	IPART (NSW)	ICRC (ACT)	QCA (Queensland)	ESCOSA (SA)	OTTER (Tasmania)	ESC (Victoria)	AER Transmission guidelines
Non-discrimination	<p>A DNSP must provide a prescribed distribution service to an independent accredited service provider on terms that are no less favourable than the terms on which it provides that prescribed distribution service to that part of the DNSP's business which provides contestable services.</p>	<p>A DNSP must conduct business with Related Business at arm's length and in a competitively neutral manner. In particular, where utilities have network use of systems agreements with a Related Business the arrangements:</p> <ul style="list-style-type: none"> - should be on a contract basis with terms and costs clearly defined - should be transparent - should be on terms no more favourable than would be offered to a third party in the same commercial circumstances; and - must be to the ICRC's satisfaction. 	<p>A DNSP that provides prescribed distribution services in Queensland must not provide access to a related business on more favourable terms than those it provides to any other customer or Code participant.</p>	<p>The Distribution Licensee must ensure that, in providing goods or services for which the Licensed Business is the monopoly supplier to a Related Business or a competitor of the Related Business, those goods and services are provided on a non-discriminatory, commercial basis.</p>	<p>A distributor must not, in conducting its regulated distribution services or act in a manner that unreasonably discriminates either against or in favour of any business providing contestable electrical services or against or in favour of the customers of any business providing contestable electrical services.</p>	<p>In conducting its distribution business, a distributor must not make decisions or act in a manner that unreasonably discriminates in favour of any electricity business or in favour of the customers of any electricity business.</p>	<p>A TNSP that provides ring-fenced services must not make decisions or act in a manner that discriminates in favour of an associate in relation to the terms or conditions on which those services are provided. To avoid doubt, a TNSP providing ring-fenced services must offer those services to its customers on terms and conditions no less favourable than it provides to itself or its associates.</p>

Source: attributed to ESAA in Oakley Greenwood, *Assessment of edge of grid distributed generation alternative*, January 2015.