

A few  
words.

**Mr Chris Pattas**

**General Manager, Networks**

**Australian Energy Regulator**

**By email: [ringfencingguideline2016@aer.gov.au](mailto:ringfencingguideline2016@aer.gov.au)**



**28 September 2016**

Dear Mr Pattas,

**Draft Ring-fencing Guideline: Electricity Distribution, August 2016**

AGL welcomes the opportunity to respond to the Australian Energy Regulator's (**AER**) Draft Electricity Distribution Ring-Fencing Guideline, August 2016 (**Draft Guideline**).

AGL is one of Australia's leading integrated energy companies and the largest ASX listed owner, operator and developer of renewable generation. Our diverse power generation portfolio includes base, peaking and intermediate generation plants, spread across traditional thermal generation as well as renewable sources. AGL is also a significant retailer of energy, providing energy solutions to over 3.7 million customers throughout eastern Australia.

In 2015, AGL established a New Energy division, with a dedicated focus on distributed energy services and solutions. AGL New Energy works with customers of all sizes (residential, business and networks) to understand their energy requirements and design tailored solutions. We offer customers 'beyond the meter' energy solutions, new and emerging technologies including energy storage, electric vehicles, solar PV systems, digital meters through our ring-fenced subsidiary business Active Stream, and home energy management services delivered by digital applications. We are also working with customers to develop a network services capability involving load management solutions.

**Importance of effective ring-fencing**

Effective ring-fencing of regulated distribution monopolies from businesses providing competitive services in contestable markets is of fundamental importance to promoting the long term interests of consumers. This is especially so at a time when greater consumer participation and the proliferation of new distributed technologies are prompting the development of entirely new service offerings which have the potential to deliver value to a range of end-users. This emergence of new technologies and business models requires the Guideline to give effect to the overarching principle that customer-led decision making will lead to the most efficient outcome for individual customers and the sector as a whole.

It is clearly in the consumer interest to see a range of service providers operating in markets and competing in the development of a variety of offerings to meet customers' unique preferences. However, without confidence that a level playing field exists, the necessary investment in new markets may not occur resulting in a market characterised by limited competition and delivering poor customer outcomes in terms of choice, service levels and pricing. Ensuring a level playing field in developing markets – where market shape, potential players, and range of services are still emerging – is arguably of even greater importance than in established markets which are already characterised by strong competition and the scope of services is more settled.

Equally there is inherently more risk associated with investments in emerging markets. It would be inappropriate for consumers to inadvertently bear this risk through cross-subsidisation from regulated revenues should distribution network service providers (**DNSPs**) seek to pursue additional revenue opportunities by entering those markets. Hence, as noted by the AER, ring-fencing seeks to protect the long-term interests of consumers in two important ways. Firstly, by ensuring efficient costs for regulated services provided by monopoly network businesses. And secondly, by promoting competition in contestable markets. Thus the Guideline is key to ensuring that the long term interests of customers is protected as the market undergoes rapid transformation.



In AGL's view it is important to bear in mind throughout this consultation process that structural separation (that is, complete ownership unbundling) is the first best solution for achieving the ring-fencing objectives. Structural separation requires a lighter regulatory framework<sup>1</sup> and, as noted by the OECD, separation: limits the need for certain regulations that are difficult, costly and only partially effective; may stimulate innovation and efficiency in the competitive services; and helps to eliminate cross subsidisation.<sup>2</sup> If there are concerns about the ability of the Guideline to achieve the protection of the customer interest or about the costs involved in pursuing effective ring-fencing, then further market reform should be pursued to ensure structural separation can be imposed.

### **Supported elements of the Draft Guideline**

AGL is supportive of many of the elements of the Draft Guideline. In particular:

- **Form of separation:**

The Draft Guideline will require legal, functional and accounting separation of network services from the provision of other services. In AGL's view, each of these elements is critical to the effectiveness of the ring-fencing obligations, and will also assist in the task of monitoring compliance:

- Legal separation creates clear boundaries between providers of prescribed distribution services and providers of other services, as well as clear governance obligations at Board level;
- Accounting separation injects an important degree of transparency and discipline in the observation of non-discrimination and cost allocation obligations; and
- Functional separation is a very practical means of delivering effective ring-fencing by more clearly delineating operational costs and limiting the potential for breach of ring-fencing obligations (even inadvertent breach), and is absolutely necessary for instilling confidence in market participants that the ring-fencing obligations are being observed in practice.

- **Cost allocation:**

Cost allocation and attribution is a fundamental tool for minimising cross-subsidisation between regulated and non-regulated service provision, and promoting the efficient provision of both. It seeks to mitigate the risk that regulated revenue is used to fund forays into contestable markets, conferring the ring-fenced affiliate a competitive advantage that is effectively funded by the broad customer base (through general tariffs) without their agreement.

The effectiveness of the obligation to allocate costs between regulated and other services is inherently linked to the terms of the supporting Cost Allocation Guideline. DNSPs are currently afforded significant flexibility as to the detailed approaches they are able to propose. Accordingly it will be important for the AER to take this opportunity to review the Cost Allocation Guideline with a view to greater prescription regarding the basis for allocating shared costs.

- **Non-discrimination obligations:**

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<sup>1</sup> Doyle, C. (2008), 'Structural separation and investment in the National Broadband Network environment', *A Report for Singtel Optus*.

<sup>2</sup> OECD Competition Committee (2006), *Report on Experiences with Structural Separation*, OECD Report.

AGL strongly supports the introduction of an overarching non-discrimination obligation. Discrimination has the potential to take many forms, and may be relatively discrete, making it impossible to draw up an exhaustive list of discriminatory behaviour. For example, discrimination could be as subtle as imposing product or performance standards for network connection, or as a condition of tendering for the provision of non-network services, simply because the regulated entity knows those requirements suit the product and service suite of its own ring-fenced affiliate.



- **Information access and disclosure:**

Network businesses have, by virtue of their specific regulated role and responsibilities, privileged access to a great deal of information about customer connections in their service area, as well as on network performance issues. If access to this data was provided to a network business's ring-fenced affiliate, and not to others on an equal basis, that affiliated business would have a distinct competitive advantage in crafting and targeting service offerings to customers in that service area, including offering non-network solutions to the network business itself.

- **Waivers:**

The more extensive the opportunity for waivers from the ring-fencing obligations, the weaker the protections they seek to offer will become over time. Waivers also introduce a degree of uncertainty for market participants seeking to keep track of which waivers apply to which network business and in what circumstance. New entrants and other entities seeking to invest in contestable markets require clarity over, and confidence in, a consistent and robust ring-fencing regime applying across all NEM jurisdictions.

Accordingly, AGL strongly supports the decision to entirely disallow waivers from certain obligations. In fact, and as discussed further below, we consider that waivers should not be permitted for any of the ring-fencing obligations given the extensive list of exceptions to the functional separation obligations that are proposed to be written into the Guideline.

We also agree that reassessing all existing waivers before the commencement of the new Guideline is necessary to avoid highly contradictory outcomes. To automatically grandfather these could result in a suite of activities being effectively exempt from the Guideline despite such activities not being of a type that is even eligible for exemption under the terms of the new Guideline.

- **Transitional arrangements:**

Considering the pace of change in the energy market, AGL considers that network businesses and their associated commercial ventures should be required to transition to the new framework as expeditiously as possible. AGL supports the AER's proposed commencement and transition periods – namely:

- immediate commencement of obligations relating to accounting separation, non-discrimination, information access and disclosure, and cost allocation;
- up to six months to comply with obligations for functional separation; and
- up to a year to comply with legal separation obligations.

The longer period to establish legal separation may be justified on the grounds of complexity, but the shorter period for the other elements of ring-fencing recognises that this is a very fast transforming landscape. The right competitive architecture needs to be in place as soon as possible to ensure that the market entry of new products and services can keep pace with the availability of new technologies and evolving customer expectations.

The longer regulated business are allowed to operate outside of the new Guideline, the greater the potential chilling effect on this emerging market and the more difficult the task of re-establishing a competitively neutral market environment.

It must be recognised that these elements – legal, accounting, and functional separation, cost allocation and non-discrimination obligations, and limitations on information access and disclosure – are not a perfect substitute for the clear separation of regulated and non-regulated business activities (and thereby avoidance of associated cross-subsidisation and discrimination issues) that would result from a complete structural separation. However, they are absolutely necessary if structural separation is not to be pursued.

## Strengthening the Draft Guideline

Despite the above positive elements of the Draft Guideline, we consider that clarification and strengthening is required in a number of areas in order to promote more effective ring-fencing.



- **Ambiguities in ring-fencing obligations**

There are various defined terms used throughout the Draft Guideline – such as network service, distribution service and direct control service – and other terms that are not defined (but sometimes presented in bold typeset confusing the reader) – such as non-network service, non-distribution service and energy-related. Different ring-fencing obligations then attach to each of these services resulting in a degree of ambiguity as to their application and effect.

There is reasonable clarity when it comes to the first set of obligations (legal, accounting and non-discrimination) – i.e. that:

- A DNSP, as a legal entity, may only provide network services (distribution services, transmission services);
- A DNSP must transparently account for any transactions with a related body corporate;
- A DNSP must properly allocate costs among distribution services, as well as between distribution services provided by it and non-distribution services provided by a related body corporate; and
- A DNSP must not discriminate in favour of a related body corporate.

However the application of the obligations relating to functional separation becomes confused by the different terms and expressions used, many of which are undefined. For example:

- Physical separation obligations are proposed to only apply to direct control services so that DNSP staff providing these services must not be located at the same premises as DNSP staff providing negotiated or unregulated distribution services or at premises where the DNSP's related body corporate operates.
- However, there are exceptions for staff not providing energy-related services, nor directly involved in the provision of direct control services. A common understanding of the terms *energy related* and *directly involved* is necessary to understand how these exceptions will impact the effectiveness of the Guideline and to avoid future disputes about their application.

Similar issues arise in relation to the expression of the staff sharing restrictions and exceptions.

We note that these problematic scope and definitional issues would be avoided under a complete structural separation, thereby reducing compliance monitoring costs and concerns and providing customers and other market participants with greater confidence to engage.

- **Exceptions to functional separation obligations**

In AGL's view, the proposed exceptions to the staff sharing obligations are too broad. We acknowledge that sharing certain corporate services staff, such as payroll and human resources, is likely to be a reasonable exception to the general prohibition on staff sharing. However, we firmly disagree that there should be an exception for senior executives. While senior executives are unlikely to want to access information on individual customers, they will most certainly be provided reports which aggregate relevant data in order to enable them to make the strategic decisions required by their role (whether these be key operational, product, pricing, financing or resourcing decisions). The effectiveness of ring-fencing is highly susceptible to compromise in these circumstances. The restriction on staff sharing should extend to all senior executives, including executive directors.

As discussed in the section above, we also consider that the terms in which some of the other proposed exceptions are couched are too vague to be able to assess their application and impact. What is an *energy related* service? And what does it mean to be *involved* or *directly involved* in the provision of a service? There is broad scope for interpretation of these expressions. The exception to staff sharing should instead be described in more limited and precise terms and, in AGL's view,

should be restricted to certain specified corporate support services, for example payroll and human resources.



- **Exception to legal separation**

AGL does not support the proposed exception to the legal separation obligations. Although the proposed \$500,000 threshold appears to be relatively low, it still has the potential to adversely affect competition in emerging markets considering that volumes and revenues in such emergent markets are naturally very low.

If this exception is retained then the intention behind the exception should be set out in the Guideline itself – i.e. the exception should only apply to the provision of contestable services ‘that are incidental to, but necessary to support the provision of, the DNSP’s network services’. This caveat will ensure that, as intended, DNSPs can only rely on the exception to do the minimum necessary to support its own network services.

The exception should also, as proposed, be set at a fixed dollar value rather than as a percentage of revenue which would create inconsistencies across DNSPs. The operation of the exception and the applicable materiality threshold should both be subject to review by the AER as the policy and market environment evolves.

- **Waivers**

Given the extensive list of exceptions to the obligations for functional separation that are proposed to be written into the Guideline, AGL queries the need for a further more general waiver process. As discussed earlier, every waiver acts to weaken the effectiveness of, and undermine market confidence in, the ring-fencing regime. As such, ring-fencing waivers should only be granted in exceptional circumstances, where the costs of complying with the ring-fencing obligations demonstrably outweigh the benefits.

To the extent waiver applications are to be permitted, then procedural transparency is of utmost importance. As currently written, there is no guidance as to when the AER will invite public submissions on a waiver application and no obligation on the AER to publish an application or the reasons for any waiver decision. This will undermine confidence in the waiver process and the Guideline more generally. It removes the opportunity for stakeholders to raise any concerns they have either with a decision to grant or not grant a waiver, or with a decision to invite public submissions on the application. Whether or not a public consultation is undertaken, the AER should *always* publish a waiver application (at the time it is received) and the reasons for its decision (at the time it is made).

The matters to which the AER should have regard when considering a waiver application should, where relevant, be expanded to include evidence that the DNSP has attempted to procure the relevant service from the contestable market and the revealed costs of doing so.

AGL supports the proposals in the Draft Guideline for all waivers to be of limited duration and subject to review as the market evolves.

- **Reporting, compliance and enforcement**

A robust reporting, compliance and enforcement framework is critical to ensuring that the ring-fencing obligations are strictly observed in the long-term interests of customers. As well as ensuring the efficiency of prices paid by customers for regulated services, a stringent and effectively enforced ring-fencing regime has a direct impact on investor confidence in contestable markets and the emergence of effective competition.

The components of reporting and compliance that are proposed in the Draft Guideline (development of internal compliance procedures, independently audited annual compliance reporting, and self-reporting of breaches as they occur) are, in AGL’s view, the minimum necessary. We would support further work to develop a more robust compliance regime.

Recognising, also, that the AER does not have unlimited resources to pursue compliance and enforcement action under the National Electricity Law and Rules, we consider that compliance with rule 6.17 and the Guideline be a strategic priority for the AER in the first few years after the new Guideline takes effect. This would include ensuring adequate funding and resourcing of their oversight function.

AGL also considers that the availability of pecuniary penalties is important given the potential harm to consumers and the market in the event of non-compliance with the Guideline. Thus additional measures that could be pursued outside of the Guideline process include recommending to the COAG Energy Council to designate rule 6.17 as a civil penalty provision and including rule 6.17 as a potential candidate for a higher maximum penalty per the final recommendations made under the 2013 *Review of Enforcement Regimes under the National Energy Laws*.<sup>3</sup>



- **Ring-fenced services and treatment of legacy programs**

Under the Draft Guideline, the ring-fencing treatment of different services is linked back to the Framework and Approach process. The Draft Guideline recognises that services may transition between service classifications over time. However the Draft Guideline does not provide a framework for how such transitions should be managed.

A prime example is DNSP legacy load control programmes (hot water, pool-pumps, AC). In light of substantial changes in the technological and competitive landscape, there are clear arguments for reclassifying all load control / demand management services as contestable. New 'smart' control platforms allow load control to be delivered in ways that give the customer greater say in how, when and the degree to which their load is controlled and how they expect to be compensated for the network value delivered. New demand management programs compare favourably with historical ripple control or timer/switch systems which do not actively involve the customer, who has little influence over the degree and timing of control of their own loads.

Transitional arrangements in this case might include:

- confirmation that legacy programs be permitted to continue provided new customers are not recruited into those programs;
- confirming all new load control services should be procured from contestable markets;
- confirmation that all load control customers (whether participating under a legacy or new program) retain eligibility for existing load control tariffs; and
- specifying how existing assets used to provide a load control service are to be treated following a customer transition.

Different transitional arrangements will be required depending on the particular service under consideration. This could be dealt with in a similar way as for the transition of DNSP activities when an existing waiver is varied or revoked. That is, the Draft Guideline could confer on the AER some discretion to determine how the transition should be managed, with a set of guiding principles applying to the exercise of this discretion.

### **Further market reforms**

Although effective ring-fencing is essential for the development of vibrant competitive markets for the provision of innovative services that make use of the growing and continually evolving range of Distributed Energy Resources (**DER**), it is unlikely to be sufficient on its own to see those markets flourish. The key further change required is to ensure that where DER can be used to provide network services or network support (including from a behind-the-meter installation), that these services are procured from a third party or ring-fenced business operating in the competitive market, rather than provided by the DNSP itself. This framework is most likely to maximise both customer choice and economic benefit by promoting the most efficient investment in DER.

### **Ring-fencing and service innovation**

Some DNSPs have expressed concern about the impact of ring-fencing on their ability to innovate in the way network services are delivered to customers. On the contrary, effective ring-fencing will prompt greater testing and involvement of, and partnering with,

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<sup>3</sup> NERA Economic Consulting and Allens-Linklaters, *Review of Enforcement Regimes under the National Energy Laws, A Report Prepared for the Standing Council of Energy and Resources*, November 2013, <http://www.scer.gov.au/sites/prod.energycouncil/files/publications/documents/Review-of-Enforcement-Regimes-under-the-National-Energy-Laws-Final-Report.pdf>



the competitive market in the delivery of network services. With proper signalling to the market of emerging constraints and grid stability issues, and a willingness to constructively engage with third party service providers, the prospects for innovation are maximised. Third party provided solutions are likely to utilise a range of DERs and be provided through an aggregation of both grid-side and behind-the-meter installations. They will often manage constraints in ways which involve customers and allow multiple value streams to be realised thereby making the most efficient use of installed equipment. Important concurrent reforms are underway which seek to ensure that the right information is made publicly available on prospective network constraint and service issues to facilitate these developments.

Should you have any questions in relation to this submission, please contact Eleanor McCracken-Hewson, Policy and Regulatory Manager, New Energy, on 03 8633 7252 or myself on 03 8633 6836.

Yours sincerely,



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