AGL Energy Limited
ABN: 74 115 061 375

Level 22, 101 Miller St
North Sydney NSW 2060

Locked Bag 1837
St Leonards NSW 2065

T: 02 9921 2999
F: 02 9921 2552
agl.com.au

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AGL

Mr Chris Pattas

General Manager, Networks

Australian Energy Regulator

By email: ringfencingguideline2016@aer.gov.au

30 May 2016

Dear Mr Pattas,

Re Electricity ring-fencing guidelines – Preliminary positions, April 2016

AGL welcomes the opportunity to respond to the Australian Energy Regulator's (**AER**) Electricity ring-fencing guidelines – Preliminary positions, April 2016 (**Position Paper**). We commend the AER on a Position Paper which sets out comprehensively the issues associated with regulated businesses operating in contestable markets, and the importance of robust ring-fencing guidelines that protect the long term interests of customers.

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.

Customer led energy market transformation

Evolving customer preferences are leading a transformation of the National Electricity Market (**NEM**). The availability of distributed renewable energy sources and other technologies is enabling customers to exert greater control over their energy usage and demand improved services and a wider range of products from energy service providers. Although energy remains an essential service, customers now have far greater choice as to how that service is delivered. A decade ago, the choice for customers was simply 'who' sold them energy. Now the choice is who and 'how' – how they will be supported by online services and flexible payment options, how they will combine grid supplied and distributed energy sources, how they expect to be able to monitor and control usage, and increasingly how they will share energy and share in value streams available beyond the home (e.g network and wholesale values). Importantly, the regulatory framework (including ring-fencing) should reflect the shift from a singularly centralised system to a diverse network where customers are best placed to choose the products and services that best meet their unique needs.

AGL New Energy was established in response to this market transformation. 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 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.

Regulatory settings to support a customer-driven market

In AGL's view, the regulatory framework should reflect the importance of customer choice. The success of a customer-led market depends on a number of factors including:

- contestable markets founded on competition and competitive neutrality – of which ring-fencing forms a key component;
- appropriate customer protections and meaningful customer engagement;
- cost reflective pricing which allows customers to make informed choices and capture the value of their choices, and which facilitates the uptake of demand side participation where cost effective for the whole system;
- appropriate technology standards and technology neutrality; and
- efficient network planning and investment, including procurement of non-network solutions (such as demand management and distributed generation) from competitive markets.[1]

AGL is of the firm opinion that, where effective competition is present, customers' interests are best served by competitive markets rather than regulation. Competition allows customers to choose the products and services they want at a price that reflects the value they derive. A competitive market framework does not pick winners – whether they be particular technologies or particular service providers. This is why competitive neutrality and technology neutrality are foundational principles.

Most importantly customers need to be in the heart of discussions about the future decentralised and participatory energy market. Policy and regulation should facilitate decentralised markets that enable customer participation and value sharing. Customers being actively in a market and expressing their preferences leads to the most efficient delivery of energy solutions. Actively involving customers in the delivery of innovative non-network solutions will drive a more future proof network adaptable to the changing environment, and reduce the cost of network investment protecting the long term interests of customers.

Blurring of traditional market roles

As the Position Paper explains, 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. Benefits are expected to flow through to customers in the form of lower prices, greater choice and higher standards of service.

When jurisdictional ring-fencing guidelines were first developed over a decade ago, the NEM comprised a linear value chain with clearly defined market participants (generators, network service providers, retailers and customers). However the diverse range of products and service now enabled by new technologies is blurring the traditional boundaries between network monopolies and retail energy businesses operating in competitive markets.

The increasing availability and cost effectiveness of 'beyond the meter' technologies is also impacting network throughput and demand, and altering the roles and commercial prospects of the various parts of the traditional electricity supply chain. In response, networks have begun to explore how their involvement in the deployment of these technologies can protect (and potentially enhance) network revenue and manage network costs. Due to the highly variable stringency and coverage of existing jurisdictional ring-fencing guidelines, regulated network businesses have been able to establish associated energy services businesses and pursue residential solar and battery trials (amongst others) without clearly or effectively separating out the contestable activities from their regulated business activities.

[1] For further information on reform principles for the broader regulatory framework, see (as an example) Nelson, T. (2016), 'Redesigning a 20th century regulatory framework to deliver 21st century energy technology', published in the *Journal of Bioeconomics,* available at: http://link.springer.com/article/10.1007/s10818-016-9216-9?wt_mc=internal.event.1.SEM.ArticleAuthorOnlineFirst

Pressing need for revised ring-fencing guidelines

In AGL's view revised, nationally consistent distribution ring-fencing guidelines are required as a matter of some urgency. The emergence of new technologies and business models requires the guidelines 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. Revision of the guidelines is necessary to ensure that the long-term interests of customers is protected as the market undergoes rapid transformation. Guidelines focussed solely on the separation of distribution and transmission activities from generation and electricity retail activities are now grossly inadequate.

If a regulated monopoly (or affiliate) can operate in a contestable market using regulated funding, with lower financing costs and data gained through its position as a regulated monopoly, then it will have clear advantages over alternative service providers. Other advantages will arise if its association with the network monopoly allows it to realise value not available to competing providers or to benefit from the network's role as gate-keeper of grid connections.

This combination of factors has the potential to seriously distort competitive outcomes and ultimately deter entry from alternative providers who simply cannot compete on these terms. This will effectively reserve these new and emerging markets (including the beyond-the-meter market) to the exclusive domain of regulated monopolies which, in the long run, will mean less product and service innovation, and less efficiency and price competition, to the detriment of customers.

To mitigate this risk and promote the emergence of a vibrant, competitive energy services market, the revised ring-fencing guidelines must be recrafted to properly account for an evolving energy industry where it is not only generation and retail markets that would be distorted were monopoly network involvement permitted but also a raft of other markets for products and services with an interrelationship with the network, including digital metering and the behind-the-meter market for distributed energy resources (including solar PV, battery storage systems, demand management, load control and home energy management).

Essential components of effective ring-fencing

To ensure the requisite level of confidence exists for new entrants to invest in these markets and for competition to flourish, the guidelines must be more robust in the form and degree of separation required and in the oversight of compliance with the guidelines.

AGL considers that effective ring-fencing entails:

- Legal separation, including an independent Board with no common Directors;
- Not permitting the ring-fenced entity to be a subsidiary of the regulated network business (even if it otherwise forms part of the same corporate group);
- Accounting separation;
- Restrictions on the flow of information;
- Physical, staffing and functional separation;
- Non-discrimination obligations, possibly assured by precluding the ring-fenced entity from offering services in the related network business' franchise service area; and
- No shared assets and minimisation of shared costs (with more prescription regarding the basis for allocating shared costs).

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 is more appealing due to the fact it requires a lighter regulatory framework.[2] The OECD has noted that 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

[2] Doyle, C. (2008), 'Structural separation and investment in the National Broadband Network environment', *A Report for Singtel Optus.*

cross subsidisation.[3] If there are concerns about the ability of ring-fencing guidelines to achieve the protection of the customer interest or about the costs involved in pursuing an effective ring-fenced model, then further market reform may need to be pursued to ensure structural separation can be imposed.

Recognition of need for competition in DER

The evolution impacting the NEM, and putting strain on existing regulatory and market frameworks, is not unique. Policy makers in other jurisdictions are also concluding that the regulatory and market framework needs to protect the neutrality of the grid and promote competition in the delivery of distributed energy resources (**DER**s) and services. For example, in New York, the 'Reforming the Energy Vision' (**REV**) initiative is underpinned by a recognition that competitive markets will deliver DERs and associated network services most efficiently and creatively, and further that the development of competitive markets for DER will be severely impeded if participation by regulated utilities is permitted:

> ' *… because of their incumbent advantages, even the potential for [regulated] utility ownership risks discouraging potential investment from competitive providers. Markets will thrive best where there is both the perception and the reality of a level playing field, and that is best accomplished by restricting the ability of [regulated] utilities to participate*.'[4]

Costs and the customer interest

In AGL's view, the AER should be wary of arguments that suggest that a robust ring-fencing and compliance regime would be too costly to comply with. In fact, as noted by the OECD above, one of the primary arguments for structural separation is the avoidance of complicated regulatory requirements that stifle innovation. But even if ring-fencing is preferred over structural separation, the long term costs of a distorted market, with limited providers, limited customer offerings and a general lack of competitive tension will be far greater than immediate costs of effective ring-fencing and ensuring competing businesses face the same competitive discipline as other providers.

Structural separation would avoid the administrative costs associated with introducing and enforcing ring-fencing arrangements and may improve economic efficiency if it categorically avoids a situation whereby a regulated business would have operated in a competitive market purely as a result of inappropriate ring-fencing arrangements. This option would be most assured of protecting the long term interests of the customer in the energy market transformation.

Considering the pace of change in the energy market, AGL considers that network businesses and their associated commercial ventures should transition to the new framework as expeditiously as possible. We recommend a two phased approach where:

- any new projects or initiatives (including spending under the demand management incentive scheme and innovation allowance (**DMIS/DMIA**) should be required to comply with the guidelines from the date they are effective – that is, no later than 1 December 2016;
- existing projects or initiatives should have 6-12 months to comply, with a progress report or assessment midway through to ensure sufficient advancement to a compliant model.

The longer it takes to implement and the longer regulated business are allowed to operate outside the scope of the new Ring Fencing Guidelines, the greater competitive advantage these business gain over other market participants of metering and behind the meter energy services. Specifically, network businesses and affiliated energy services businesses will continue to develop customer and commercial insights, and cultivate access to hardware and critical suppliers, leveraging their unique monopoly position as a regulated business. There is a risk that these commercial enterprises develop to such an extent that re-establishing a competitively neutral market environment becomes a very difficult task indeed.

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[3] OECD Competition Committee (2006), *Report on Experiences with Structural Separation*, OECD Report.

[4] NYPSC, Case 14-M-0101 – Proceeding on Motion of the Commission in Regard to Reforming the Vision – Order Adopting Regulatory Policy Framework and Implementation Plan (February 26, 2015), pp 67-68

Our responses to the specific questions posed are set out below. 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,

Stephanie Bashir

Head of Policy & Regulation New Energy

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

Jurisdictional guidelines which apply so as to require the provision of 'contestable services' to be ring-fenced from the provision of regulated services seem to have advantages over guidelines which require ring-fencing of much more narrowly and specifically defined services, such as electricity production and sale. As we are currently witnessing, the issue with the latter is that they can very quickly be overtaken by market developments and industry evolution.

Historical concerns around vertical power, privileged data access and inefficient subsidisation of contestable activities using regulated revenue (amongst others) apply equally to the contestable metering markets and emerging beyond-the-meter services markets. Yet under guidelines currently applying in a number of jurisdictions in the NEM, a regulated monopoly network service provider can pursue opportunities in these markets without establishing effective ring-fencing.

There are multiple examples of this already occurring. SA PowerNetworks recently announced it would be installing 100 batteries at customer premises at heavily discounted prices leveraging regulated funding and its data base of customer information compiled through the delivery of regulated services. SAPN has seemingly been able to do this without breaching jurisdictional ring-fencing guidelines despite the 'guaranteed savings' on electricity bills also being offered through the trial. The SAPN trial is not unique. Monopoly distribution businesses in every NEM jurisdiction are conducting behind-the-meter trials involving a range of technologies, including solar PV, batteries and remote load control (hot water, pool pumps, air conditioners). These all leverage regulated funding and customer data sets.

In addition to trials, many monopoly network businesses are pursuing commercial opportunities in contestable markets. For example, CitiPower/Powercor has established a business division ('Energy Solutions') focused on solar and battery sales in the residential and commercial market. AGL has been advised that AusNet Services has launched a commercial 'solar alert' product that leverages AMI data obtained through its regulated operations to alert customers as to the 'health' of their solar system and that five distribution businesses are now approved resellers of Tesla batteries.

These circumstances have a severely detrimental impact on prospects for the development of a vibrant competitive market for these kinds of services. Customers, with unique needs for their individual circumstances, are not best served by monopolistic businesses that are not experienced at providing tailored products and services. Furthermore, third party providers simply cannot compete on these terms and if allowed to continue it will foreclose competition in these markets altogether. They will become the exclusive domain of regulated monopolies which, in the long run, will mean less product and service innovation, and less efficiency and price competition, to the detriment of customers. These initial offerings also set the wrong expectations for customers who may not immediately realise that the heavy discounts offered by network businesses are only possible due to the material subsidisation by the broad customer base via regulated funding.

These examples show how crucial it is to have a forward-looking regulatory framework that will accommodate, rather than be overtaken by, technological and market evolution. Accordingly, AGL favours a broader characterisation of the activities that should be ring-fenced from a monopoly business providing regulated services. This will ensure a more adaptable regulatory framework that will better withstand further market evolution and accommodate new markets not necessarily contemplated at the time of drafting. The framework would need to ensure that there is a clear way of knowing or periodically determining what services are classified as contestable and subject to the guidelines.

The stringency of ring-fencing guidelines also has a direct impact on investor confidence in the market, and in turn on the emergence of effective competition to the long-term benefit of customers. Alternative providers will clearly be better assured by a regime which requires full legal, accounting and operational separation, for example, than one with only limited restrictions on staff location and information sharing.

We note that the relative leniency of some existing jurisdictional guidelines has not appeared to impede the contestable markets which they sought to protect (retail, generation) because they were developed following large-scale corporatisation and privatisation programs of existing and well established businesses. This effectively *structurally separated* the competitive and regulated elements of the supply chain, putting less pressure on the ring-fencing guidelines in their task of protecting the competitive

environment. Without structural separation, and in the context of new and emerging markets, clearly far more stringent ring-fencing guidelines are required.

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?

As the Position Paper explains, 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. Effective ring-fencing protects the long term interests of customers in terms of lower prices, greater choice and higher standards of service.

Competition will not flourish unless there is a level playing field for providers seeking to operate in contestable markets. If a regulated monopoly can operate in a contestable market using regulated funding, with lower financing costs and data gained through its position as a regulated monopoly, then it will have clear advantages over alternative service providers. Other advantages will arise if its association with the network monopoly allows it to realise value not available to competing providers or to benefit from the network's role as gate-keeper of grid connections.

This combination of factors has the potential to seriously distort competitive outcomes and ultimately deter entry from alternative providers who simply cannot compete on these terms. This will effectively reserve relevant markets (including the fast emerging behind-the-meter market) to the exclusive domain of regulated monopolies which, in the long run, will mean less product and service innovation, and less efficiency and price competition, to the detriment of customers. Monopolistic service providers are likely to focus on offering customers 'uniform' products and services that do not reflect their specific unique circumstances. Ineffective ring-fencing also has clear consequences for the efficiency of regulated revenue recovered from the broad customer base where this is used to subsidise commercial activities in contestable markets.

AGL supports the AER's characterisation of the objectives of ring-fencing. However we consider they could be further developed in two ways:

1. Clearly customers are the ultimate beneficiaries of an effective ring-fencing regime and the level playing field that it creates. They are better assured that the services delivered to them via the regulated and contestable markets alike are efficient and that the right conditions will exist to encourage and enable competitive providers to innovate their product and service offerings improving choice, service and price outcomes in the customer interest. We suggest that the objectives more explicitly establish the customer as the focal point and primary beneficiary of effective ring-fencing.
2. The objectives could better draw out the importance of ring-fencing guidelines not only for ensuring a level playing field in existing markets but also in supporting the development of new and emerging competitive markets – i.e. to promote dynamic efficiency – and accelerating innovation and efficient investment. This objective was articulated in the COAG Energy Council's latest communique.[5]

We note that the implementation model will have a great influence on whether the objectives are actually achieved. It is critical that the implementation model does not compromise on these objectives. If the ring-fencing guidelines alone cannot achieve these objectives, then further market reform may need to be pursued to ensure structural separation can be imposed as the first best solution for achieving the ring-fencing objectives.

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?

As the AER notes, the revised ring-fencing guidelines will be required to have a broader scope than existing jurisdictional guidelines due to the more complex nature of current

[5] COAG Energy Council, Meeting Communique, 4 December 2015: http://www.scer.gov.au/sites/prod.energycouncil/files/publications/documents/Energy%20Council%20Communique%20-%204%20Dec%202015%20-%20FINAL_0.pdf

interactions between competitive and regulated aspects of services potentially on offer by network businesses. In AGL's view, the core question should be whether a competitive market for the provision of the relevant service would be expected to materialise but for the participation in that market of a monopoly network business or ineffectively ring-fenced affiliate.

AGL supports the AER's proposed approach involving a presumption that a contestable service should be ring-fenced, with waivers under limited conditions where supported by a clear cost-benefit and, in particular, giving due weight to the public interest in a broadly applicable and robust ring-fencing framework. We note in this regard that the guidelines will need to provide direction as to how the clear qualitative benefits of healthy competitive markets, which are inherently difficult to quantify, are to be compared against more immediate and easily quantifiable implementation costs.

We are firmly against the alternative of assuming no harm is caused by monopoly network businesses offering services in a contestable market, unless the net benefit from the application of ring-fencing can be demonstrated. In the context of a rapidly evolving industry with new technology innovations continually opening up new markets for previously unconceived of services, this approach would operate as a significant drag on new market development. It would also be difficult for third parties seeking to have a service ring-fenced to overcome the substantial information asymmetry that naturally arises.

In terms of the three options identified in the Position Paper for determining what services should be contestable and therefore subject to the ring-fencing guidelines, AGL advocates a fourth option that builds on the second and third options as follows:

- the guideline would include a general description of the services to be ring-fenced (e.g. contestable or potentially contestable services); then
- the F&A process would be used to articulate a more specific list of contestable services;
- although the majority of standard control services would fall within the network business' remit and not be subject to ring-fencing, there would be some services (such as load control) that should be classified as contestable services based on a set of clear and transparent decision criteria. Legacy programs would require specific treatment – as discussed in more detail below;
- alternative control services would generally be ring-fenced and open to competition. However, recognising that contestability will not be suitable for all alternative control services, the AER would determine which alternative control services would continue to fall within the network business remit based on a set of clear and transparent decision criteria.

This would offer clarity about what services must be ring-fenced, and builds on an existing regulatory process that also considers the scope for the competitive provision of a service. However, given the rapidity of the energy market evolution, it is important that there be opportunity to reopen a classification decision to account for new and emerging service markets before the conclusion of a 5 year regulatory period.

Load control programs (hot water, pool-pumps, AC) are a good example of how services can (and should) transition between regulated and contestable service classification over time to reflect changes in the technological and competitive landscape. 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.

Legacy programs may be permitted to continue provided new customers are not recruited into those programs. Clearly new load control programs should not be developed by regulated network businesses but should be procured from contestable markets. Important issues will need to be addressed including firstly, what the impact will be on the customer's eligibility for existing load control tariffs and, secondly, how existing assets used to provide a load control service should be treated following a customer transition.

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

In order for the contestable market for DERs to develop to the maximum extent, all beyond-the-meter services (in fact, all services enabled by DERs) should be ring-fenced, even where used to provide a network service. The Australian Energy Market Commission (**AEMC**) reached the same conclusion in its Integration of Energy Storage, Final Report, where its leading recommendation was that:

- all services provided by network business beyond the meter should be treated as contestable and not provided by a network business except through an effectively ring-fenced business; and
- where storage beyond the meter would be useful for providing network support, these services must be contracted from a third party or ring-fenced business.[6]

Under a framework which seeks to maximise customer choice and economic benefit, the network business would be incentivised to contract efficient network services delivered through third party owned / operated (or effectively ring-fenced) DERs, including beyond-the-meter installations. This would promote the most efficient investment in DERs, where the owner is able to capture the personal value of the device (e.g. for managing in-home comfort and energy spend), as well as contract the device out to offer services in the competitive wholesale markets or network services to network businesses.

The technology is already there to achieve these kinds of outcomes. For example, AGL has a strategic partnership with Sunverge whose intelligent distributed energy storage system captures solar power and delivers it where and when needed most. It is a dynamic and fully programmable platform able to deliver bespoke outcomes satisfying the needs of end-use customers and utilities alike. Some of the platform's capabilities were recently demonstrated in an AGL-led demand response trial hosted by United Energy in Victoria.[7] That trial produced encouraging results, not only in the demand reductions achieved but in the customer feedback on the trial which received a 100% satisfaction rating.

As the Position Paper notes, a network business installing beyond-the-meter storage exclusively for network support services seems very unlikely to maximise the efficient use of the DER. It is also difficult in practical terms to conceive how this would occur without impacting the host customer's own energy use behaviour and spend – and thereby straying into the territory of contestable service provision and crowding out competitive third party service providers. Also, as this model does not place the customer front and centre it seems unlikely to win support and succeed in the long term.

In absolutely precluding a network business from offering services beyond-the-meter (other than via an effectively ring-fenced entity), it would be important to avoid disincentivising the network business from nevertheless contractually procuring network services from beyond-the-meter installations where that would be the most efficient means to meet the network's service obligations. That is, to maximise the efficient use of the DER that network value should be made available to competitive providers of the relevant network service.

Thus alongside regulatory reform to ensure that all beyond-the-meter activities are contestable, it will be critical to ensure that the right incentives exist to encourage monopoly network service providers to give due consideration to non-network options in network planning. Where a non-network option would be the most efficient means of meeting the network's service obligations, the network business should then be required to procure the solution from competitive markets.

This would open up the market by identifying a much wider range of projects for non-network solution providers (including those looking at beyond-the-meter demand management) to target. Once the network value of non-network solutions is unlocked, it is a benefit that will be shared between customers, networks and competitive non-network solution providers alike. These types of projects have the scope to reduce the cost of network investment and operation and enable a more future proof network adaptable to the changing environment.

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[6] Australian Energy Market Commission, Integration of Energy Storage – Regulatory Implications, Final Report, December 2015, http://www.aemc.gov.au/Major-Pages/Technology-impacts/Documents/AEMC-Integration-of-energy-storage,-final-report.aspx

[7] https://www.agl.com.au/about-agl/media-centre/article-list/2016/march/agl-trials-impacts-of-emerging-technologies-on-the-grid-and-energy-bills

As recommended by the AEMC in its Integration of Energy Storage, Final Report, achieving these outcomes requires review of existing incentive mechanisms (such as the NER's efficiency benefits sharing scheme and the capital benefit sharing scheme), as well as the Annual Planning Report process and the Regulatory Investment Test for Distribution / Transmission framework.[8] When the DMIS/DMIA guidelines are revised later this year, it will be essential that the AER design these so as to further promote the development of competition and customer choice in beyond-the-meter services.

With the right regulatory settings, the industry of the future will be characterised by customers, DERs, energy service providers and networks all working collaboratively – and sometimes in so-called 'co-opetition' – in a dynamic, participatory and efficient system and market environment. As much has been recognised in other jurisdictions – such as New York where, even in the context of an integrated distribution-retail model, it has been determined that competitive markets will deliver DERs and associated network services most efficiently and creatively, and further that the development of competitive markets for DER will be severely impeded if participation by regulated utilities is permitted:

> '*… because of their incumbent advantages, even the potential for [regulated] utility ownership risks discouraging potential investment from competitive providers. Markets will thrive best where there is both the perception and the reality of a level playing field, and that is best accomplished by restricting the ability of utilities to participate.*'[9]

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

In AGL's view, the key features of a ring-fencing approach that would be consistent with the ring-fencing objectives, the National Electricity Objective (NEO) and national competition policy, and therefore that should be encapsulated in the ring-fencing guidelines are:

Legal separation	Legal separation creates clear boundaries between providers of prescribed distribution services and providers of other services. It creates clear governance arrangements whereby Directors are bound to act in the best interests of the company as a separate entity (not necessarily the company that owns that company), with these decisions having to be made for 'a proper purpose'. The corporate constitution should expressly state that Directors must act in the best interests of the company and not its holding company. Legal separation removes or at least largely mitigates the value of 'gaming' the cost allocation process. It also makes the role of the regulator in policing the separation less onerous. This is a key advantage of legal separation (as noted by the OECD and other academics).
Independent Board	To ensure the independence of the legally separate entity, AGL considers that the ring-fencing guidelines should prohibit any common Directors of the ring-fenced entity and the network business.
No parent/subsidiary relationship	The network business should not be permitted to establish the ring-fenced entity as a subsidiary (even if it otherwise forms part of the same corporate group). This better ensures Directors will act in the best interests of the ring-fenced entity and not a regulated parent business.

[8] Australian Energy Market Commission, Integration of Energy Storage – Regulatory Implications, Final Report, December 2015, http://www.aemc.gov.au/Major-Pages/Technology-impacts/Documents/AEMC-Integration-of-energy-storage,-final-report.aspx

[9] NYPSC, Case 14-M-0101 – Proceeding on Motion of the Commission in Regard to Reforming the Vision – Order Adopting Regulatory Policy Framework and Implementation Plan (February 26, 2015), pp 67-68

Accounting separation	The guidelines should make clear that the ring-fenced entity must maintain consolidated and separate accounts. These must clearly identify the extent and nature of transactions between the network business and ring-fenced entity.
Restrictions on the flow of information	The potential for inappropriate sharing of information should be limited to maximum extent possible. This would involve a prohibition on the sharing of information between the regulated network business and the ring-fenced entity other than to fulfil obligations under applicable energy market rules. This position would be strongly complemented by legal separation.
Physical, staffing and functional separation	Physical, staffing and functional separation should be required. This would include: - no shared staff; - physically separate office locations; and - separate IT systems. Legal separation complements this.
Non-discrimination, assured by operating exclusion from franchise service area	The guidelines should include clear non-discrimination obligations, including network access. These are extremely important as emerging markets are likely to see the competitive market inextricably linked to the regulated market. In particular, the standards, terms and conditions imposed by the regulated business on all parties operating in the emerging market (e.g., batteries beyond the meter; solar PV) will inextricably influence the types of services and technologies able to be introduced into that competitive market. In these circumstances, the regulated network business has an inherent incentive to impose terms and conditions that favour the services and technologies it is seeking to sell in the contestable market via its affiliated business, as opposed to the services and technologies that the market might prefer and that could be provided by its competitors. A means of achieving the non-discrimination objective would be to exclude a ring-fenced entity from operating in the franchise service area of the affiliated network business. This removes any incentive for the network business to discriminate in favour of the ring-fenced affiliate. This is a mechanism that would promote a high degree of confidence in the contestable market and is low-cost from a compliance monitoring perspective.
No shared assets	There should be no shared assets between the regulated network business and ring-fenced entity.
Minimisation of shared costs and avoiding cross subsidies	Protection of competitive neutrality requires that all costs attributable to the operation of the contestable business be allocated to it. The inappropriate allocation of costs between regulated and other services may allow regulated business to subsidise the provision of non-regulated services. AGL recommends that the effectiveness of the current Cost Allocation Principles outlined in the Rules be reviewed, and provide more prescription in the guidelines regarding the basis for allocating shared costs, with this being linked to some measure of level of effort

	wherever possible. Competitive neutrality is best served by seeking to ensure that as much as possible of the likely cost that would be incurred by a business involved in unregulated services be recovered from the revenues of that business (as compared to the revenue recovered from its associated regulated business).

AGL counters the contention that the more robust the ring-fencing guidelines are, the more costly they are to implement, monitor and enforce. For example, at the most stringent end of the spectrum, once the upfront costs of establishing a structurally separate entity have been borne, ongoing compliance with the guidelines is far easier to establish and police. It is also an approach to be recommended on the basis that it will have the greatest success in promoting a level playing field and instilling confidence in potential market entrants, and ultimately assuring the efficient delivery of regulated and contestable services to the long term benefit of customers.

In AGL's view it is important to bear in mind throughout this consultation process that structural separation is the first best solution for achieving the ring-fencing objectives. If there are concerns about the ability of ring-fencing guidelines to achieve the protection of the customer interest or about the costs involved in pursuing a ring-fenced model, then further market reform may need to be pursued to ensure structural separation can be imposed.

The Position Paper notes that the AER may approve exemptions from particular ring-fencing obligations in certain circumstances. These appear to defeat the intent of the ring-fencing guidelines and are not supported by AGL. All exemptions should be addressed via the formal waiver process, and not an ancillary protocol approved by the AER following a bi-lateral discussion with the relevant network business. Every procedural exemption will act to gradually weaken the ring-fencing guidelines and create a body of precedent that creates uncertainty as to when the ring-fencing guidelines will be enforced in their entirety.

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

AGL does not agree that developing protocols and procedures is an effective alternative means of satisfying the ring-fencing objectives. A ring-fenced 'division' will not offer customers and the market the same assurance regarding the efficiency of contestable and regulated service functions, and the competitive neutrality of the market place, as more robust ring-fencing requirements. To ensure the requisite level of confidence exists for new entrants to invest in contestable markets and thereby deliver positive outcomes to customers in terms of choice, price and service, the guidelines must be robust in the form and degree of separation required and in the oversight of compliance with the guidelines.

In AGL's view, the AER should be wary of arguments that suggest that a robust ring-fencing and compliance regime would be too costly to comply with. Such reasoning enhances the arguments for structural separation. If ring-fencing is preferred, it should be noted that the long term costs of a distorted market, with limited providers, limited customer offerings and a general lack of competitive tension will be far greater than immediate costs of effective ring-fencing and ensuring competing businesses face the same competitive discipline as other providers. We have seen this in Victoria, where digital meters were rolled-out by network businesses under mandate and serious questions continue to be raised regarding the costs of that program and the benefits, many of which are yet to be realised. Whereas the market-led rollout is proceeding in other jurisdictions with a clear customer focus and lower costs (in fact, in most cases at no upfront cost to the customer).

We note the inherent difficulties in constructing a cost-benefit analysis of a ring-fencing regime when the costs are immediate and quantifiable but the benefits are longer-term and only qualitatively identifiable. In any event, any costs put forward by network businesses regarding compliance must be made transparent so that they can be properly interrogated.

We note that structural separation would avoid the administrative costs associated with introducing and enforcing ring-fencing arrangements and may improve economic efficiency if it categorically avoids a situation whereby a regulated business would have operated in a competitive market purely as a result of inappropriate ring-fencing arrangements (i.e., the ring-fencing arrangements enable an otherwise inefficient regulated business to provide those contestable services, or an efficient regulated business to provide those contestable services in an economically inefficient way).

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

AGL considers that there should be clear restrictions on asset sharing between regulated services and contestable service provision. Shared assets encounter similar difficulties as shared costs in terms of ensuring the efficiency of services provided by network businesses and their ring-fenced affiliates, and the competitive neutrality of the contestable market.

One important objective of ring-fencing is to force regulated businesses to identify and separate out the assets used in, and costs of, providing regulated services from unregulated services. Accuracy in such asset and cost separation will ensure that (a) the price of regulated services are not inflated (by the costs of unregulated services), and (b) the price of unregulated services are not subsidised by regulated revenue streams thereby conferring an unfair advantage to the ring-fenced entity and potentially forcing out more efficient players and reducing choice and innovation.

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

In AGL's view, ring-fencing waivers should only be granted in exceptional circumstances, where the costs of complying with the ring-fencing guidelines demonstrably outweigh the benefits. All waiver applications should be assessed on a case-by-case basis on their individual merits. Due weight must be given to the market design principles embedded in the ring-fencing regime – that is, the ring-fencing objectives and the public harm that they seek to prevent.

The formal assessment framework must be robust, transparent and easy to follow. The decision criteria against which all waivers will be assessed should be clearly set out and where possible couched in objective terms to minimise discretion. All applications, decisions and supporting reasoning must be made public and open to consultation. The formal hurdles and gateways that the waiver application must pass should include a requirement for the network business to produce evidence that it has attempted to procure the relevant service from the contestable market. All waivers should have a sunset or review date to account for potential changes in the technological or competitive landscape which mean that a waiver no longer serves the long term interests of customers.

The Position Paper identifies a number of relevant factors that the AER would consider when determining whether a ring-fencing waiver is appropriate. It is important that these factors are not allowed to be gamed to circumvent ring-fencing obligations. For example, safety in the provision of electricity services is clearly paramount, but wherever possible other mechanisms should be explored to address concerns (e.g. product, installation and operational standards). A waiver of ring-fencing obligations should only be a temporary or last resort measure.

We consider that some but not all of the factors extracted from the AEMC's Integration of Energy Storage, Final Report, will be relevant in determining whether a ring-fencing waiver is appropriate. For example, it seems erroneous to focus on the degree to which an activity might generally be used to provide regulated network services compared with its use to provide contestable services. Whatever the relative apportionment, there exists a risk without effective ring-fencing that efficiency of *either* the regulated or contestable service functions are impacted.

Nor should the nature of other competitors in the contestable sector be a strong indicator of whether ring-fencing obligations should be waived. That is, simply because the majority of service providers operating in a particular market are affiliated with a ring-fenced entity should not indicate that a relaxing of the ring-fencing obligations is appropriate. Some issues are spatial (i.e. the advantages that a regulated business's affiliate has in dealings with customers in their franchise area, not in other areas). Where this is the case, a less

extensive ring-fencing arrangement may simply allow an affiliate of a regulated business to have some form of monopoly power in the provision of 'contestable' services within the service area of their regulated affiliate.

There should also be a high degree of rigour applied when adjudicating whether appropriate conditions for granting a waiver are truly present. For example, Energex was recently granted an exemption from complying with the current Queensland ring-fencing guidelines despite not initially producing any evidence of the costs of complying and despite the contestable market being ready, willing and able to offer the services in respect of which the waiver was granted.[10]

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?

AGL wholly agrees with the AER's assessment and justification of where costs should lie in the event that a network business decides to pursue opportunities in contestable markets. Costs associated with establishing a ring-fenced affiliate should be borne by customers taking up the services that the ring-fenced affiliate offers. If a network business determines that that there is a revenue opportunity in a contestable market, its success or failure in that market should not be insured or subsidised by the broad customer base. Through the regulatory compact, the broad customer base has only agreed to pay for the efficient provision of regulated direct control services.

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

In this section, the Position Paper suggests that a network business would be likely to receive a fast-track waiver in relation to ownership of rooftop solar PV to reduce the network business' operating costs. We understand this to be a reference to a network business owning a solar PV system at its own office premises, but would appreciate clarification on this point. Clearly permitting a network business to own solar PV on customer premises would go directly against the objectives of ring-fencing discussed at length in the remainder of the Position Paper.

As stated above, AGL considers that ring-fencing waivers should only be granted in exceptional circumstances, where the costs of complying with the ring-fencing guidelines demonstrably outweigh the benefits. As a general principle we consider that all waiver applications should be assessed on a case-by-case basis on their individual merits.

However we acknowledge that at the commencement of the new ring-fencing regime, there may be a number of services requiring decision. Provided that the criteria are clear, the decisions transparent and there is opportunity to contest or object to a decision, then we consider that a bulk or fast track waiver process may be appropriate only at commencement of the guidelines or in parallel with their development.

To the extent waivers are granted, these should include a sunset clause or review date to account for potential changes in the technological or competitive landscape which mean that a waiver no longer serves the long term interests of customers.

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

Considering the pace of change in the energy market driven by rapid technological development and evolving customer expectations, AGL considers that network businesses and their associated commercial ventures should transition to the new framework as expeditiously as possible. We recommend a two phased approach where:

- any new projects or initiatives (including spending under the DMIA) should be required to comply with the guidelines from the date they are effective – that is, no later than 1 December 2016;

[10] Australian Energy Regulator, Energex ring-fencing waiver 2015 https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/ring-fencing-waivers/energex-ring-fencing-waiver-2015

- existing projects or initiatives should have 6-12 months to comply, with a progress report or assessment midway through to ensure sufficient advancement to a compliant model.

AGL is wary of the AER using existing waivers, granted under a quite different framework, as precedent for the appropriateness of a waiver under the revised guidelines. Any existing ring-fencing waivers that have been granted under jurisdictional arrangements should be reviewed and re-considered in light of the intent and approach decided upon in the new guidelines. Where these are inconsistent, the network business should be required to transition those arrangements within 6-12 months.

A relatively large proportion of network businesses have used existing demand management incentive mechanisms to undertake demand management and distributed generation trials. These 'learning opportunities' have in some cases been used to assist the distribution business to develop a commercially focussed business model for use by a ring-fenced affiliated business. This has particularly been the case with regard to the provision of PV systems with and without batteries to residential properties.

There is a substantial task, the importance of which should not be underestimated, in unwinding the various trials that have been permitted to proceed before the update to the ring-fencing guidelines. Despite trials being pursued ostensibly to better understand the impact of emerging technologies on distribution networks and for investigating potential non-network solutions, in reality valuable commercial IP is created through this process – IP that is essentially being funded by the broad customer base. If that IP is then permitted to reside with a newly created, ring-fenced business that participates in competitive markets, it will have a significant advantage over other competitive service providers.

The guideline will also need to address transitional issues for services moving from regulated to contestable service classification. Load control programs (hot water, pool-pumps, AC) are a good example of the issues that arise. 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.

During the transition, legacy programs may be permitted to continue, provided new customers are not recruited into those programs. Clearly new demand management programs should not be developed by the regulated network businesses but should be procured from contestable markets. Important issues need to be addressed including firstly, what the impact will be on the customer's eligibility for existing load control tariffs and, secondly, how existing assets used to provide a load control service should be treated following a customer transition.

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

AGL supports the reporting and compliance regime proposed in the Positon Paper. To ensure the requisite level of confidence exists for new entrants to invest in contestable markets, the guidelines must involve a robust compliance and oversight regime. In AGL's view, the AER should be wary of arguments that suggest that a robust ring-fencing and compliance regime would be too costly to comply with. Such reasoning enhances the arguments for structural separation. If ring-fencing is preferred, it should be noted that the long term costs of a distorted market, with limited providers, limited customer offerings and a general lack of competitive tension will be far greater than immediate costs of effective ring-fencing and ensuring competing businesses face the same competitive discipline as other providers.

We note that the ability to prove and monitor compliance with the ring-fencing guidelines will actually be easier where full legal, financial and operational separation is required as opposed to less stringent mechanisms, such as protocol and procedure development. It is also an approach to be recommended on the basis that it will have the greatest success in instilling confidence in market competitors of the fairness of the playing field

In addition we support the availability of pecuniary penalties for a failure to comply with the guidelines reflecting the importance of the ring-fencing objectives and the customer interest that the guidelines seek to protect.