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30 May 2016

Dear Mr Pattas

ActewAGL Distribution Response to AER Electricity Ring-Fencing Guidelines Preliminary positions paper

ActewAGL Distribution appreciates the opportunity to respond to the Electricity Ring-Fencing Guideline Preliminary Positions paper released by the AER in April 2016. The attached submission provides comments on the issues raised in the preliminary positions paper and response to each of the AER's questions.

If you would like to discuss any aspects of our submission please contact Patricia Cameron, Principal Regulatory Advisor, on 02 6248 3812.

Yours sincerely



Michael Costello
Chief Executive Officer

ActewAGL

ELECTRICITY RING- FENCING GUIDELINE

ACTEWAGL RESPONSE TO AER PRELIMINARY POSITIONS

Version number 1.0 | Date: 30 May 2016

ActewAGL

for you

Table of contents

Introduction	3
Key Issues	4
The purpose should be broader and align with the long term interests of consumers	4
The Ring-Fencing Guidelines should establish the framework for DNSPs and affiliates to compete in contestable markets.....	5
Well targeted regulation is more efficient than blanket regulation.....	6
Rely on existing arrangements for cost and revenue allocation between multiple services	7
Specific responses to AER Questions	8
1. What aspects of current jurisdictional ring-fencing arrangements have or have not worked well?.....	8
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?.....	8
3. Do you agree with the service classification approach to ring-fencing which is discussed in section 3.3? Is there a better alternative?	10
4. Does the proposed approach to ring-fencing adequately deal with the prospects for development of the contestable market for distributed energy resources (DER)?.....	11
5. Are there other ring-fencing obligations we should impose on NSPs that provide services into contestable markets?.....	12
6. What costs would be incurred in meeting these obligations?.....	12
7. Should assets sharing be restricted between regulated services and contestable service provision?	13
8. Do the factors set out above reflect the issues we should consider in deciding whether to grant a ring-fencing waiver?	14
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?	15
10. How else could the AER minimise the administrative cost of ring-fencing while maintaining the integrity of its approach?	15
11. Is it reasonable for the AER to consider these transitional arrangements to the new ring-fencing guideline?	16
12. How can we ensure ring-fencing compliance is robust and effective without imposing excessive costs that may ultimately be borne by consumers?	

16

Introduction

ActewAGL Distribution (AAD) welcomes the opportunity to respond to the Australian Energy Regulator's (AER's) Electricity Ring-Fencing Guideline - Preliminary Positions Paper released in April 2016¹ (Position Paper).

AAD, a partnership between Icon Distribution Investments Limited and Jemena Networks (ACT) Pty Ltd, owns and operates the electricity distribution network in the Australian Capital Territory.

Icon Water Limited, which is owned by the Australian Capital Territory Government, owns both Icon Distribution Investments Limited and Icon Retail Investments Limited.

ActewAGL Retail, a partnership between Icon Retail Investments Limited and AGL ACT Retail Investments Pty Ltd, purchases and retails electricity services in the ACT and NSW in the Capital (including Goulburn, Yass, Young, Nowra and Bega), Shoalhaven and Queanbeyan regions.

AAD's current ring-fencing obligations are set out in the Ring Fencing Guidelines for Electricity and Gas Network Service Operators in the ACT² (Existing ACT Guidelines). The Existing ACT Guidelines were published by the Independent Competition and Regulatory Commission (ICRC) in 2002. An overview of these Existing ACT Guidelines is set out in our response to the Australian Energy Regulator discussion paper dated February 2012.

The Existing ACT Guidelines are broadly comparable with existing guidelines in other jurisdictions. The Existing ACT Guidelines, in place since 2002, have promoted a robust ring fenced environment in the ACT that incorporates many of the potential elements listed by the AER in the jurisdictional comparison, as set out in the AER's 2011 discussion paper.³

Below is a list of key points that AAD consider are the issues of most importance. The key issues section is followed by responses below to each of the questions set out in the Position Paper.

¹ AER 2016 Electricity Ring-Fencing Guideline: Preliminary positions, April 2016

² <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/jurisdictional-ring-fencing-guidelines>

³ AER Electricity distribution ring-fencing guidelines review - discussion paper, 12 December 2011, section 4.2 on pages 22 to 26.

Key Issues

The key issues for AAD are listed in this section. The purpose of the ring-fencing guidelines could be re-drafted to align with the long term interest of consumers. The Ring-Fencing Guidelines should establish the framework for DNSPs and affiliates to compete in contestable markets for the benefit of consumers.

“If the networks are going to buy into some of the enhancements that are taking place at the retail end that’s got to be a better outcome for the consumer.” Energy and Resources Minister, Josh Frydenberg⁴

“Who competes where... it is the wrong argument. The right argument is how we do things to benefit the ultimate consumer.... What we’re going to do is, we’re going to work together to find the best way to deliver, to work collectively to deliver innovation.” AGL Chief Executive Officer, Andy Vesey⁵

AAD’s suggestions aim to clarify the purpose of the ring fencing guidelines, including the requirement for assessment of the economic net benefits prior to application of the ring fencing obligations, highlight the important contribution to competition that DNSPs can make by operating in contestable markets and provide an explanation of how asset sharing can operate in parallel with ring fencing obligations.

The purpose should be broader and align with the long term interests of consumers

The purpose of the ring fencing guidelines should align with the ultimate objective set out in section 7 of the National Electricity Law (NEL), namely, to promote the long term interests of consumers of electricity. The guidelines are a means to this end, not an end in themselves. Rather than using the term ‘objective’, the ring fencing guidelines could use the term ‘purpose’ instead to avoid confusion with the NEL objective.

The Position Paper proposes four ring-fencing objectives that are better described as identifying the harm that the ring-fencing guidelines are seeking to avoid. However, identifying the potential harm is only a part of the issue at hand. The guidelines should also balance any benefit they create with the costs that they impose such that, overall, they promote the long term interests of consumers.

The Position Paper recognises that ring-fencing is not costless. Guidelines which hinder the ability of distribution network service providers (DNSPs) or businesses affiliated with DNSPs (Affiliates) to compete in contestable markets, for example by preventing them from taking advantage of efficiencies of scale and scope, may not be in the long term interests of consumers. This could be for a number of reasons including, for example, because they cause prices for contestable services to be

⁴ 21 May 2016 “Plan to do a Tesla to electricity grid”, Australian Financial Review p.8

⁵ 23 May 2016 “Death of the Death Spiral”, Australian Financial Review p.9

higher than necessary. The recent Harper Review observed, in the context of making markets work in the long term interests of consumers, that regulation should be as light touch as possible in recognition of the need to balance its costs against its benefits.⁶ Discussion of these compliance costs are set out below (in question 6 and 9).

Although the Position Paper does contemplate consideration of the costs of ring-fencing, it proposes that this occur only at the 'waiver' stage. This approach is inefficient for a number of reasons including that it tends toward an initial over-reach of the guidelines, which must then be corrected through waiver applications.

In addition, AAD suggests that long term certainty and stability should be an express purpose of the ring fencing guidelines. Section 7 of the NEL focuses on the long term and refers to the promotion of efficient investment. Long term certainty and stability are important factors in promoting efficient investment.

In consequence, AAD suggests that the four 'objectives' currently proposed in the Position Paper be replaced with one or two overarching statements of purpose capturing these two issues.

This issue is addressed in more detail in response to Question 2 below.

The Ring-Fencing Guidelines should establish the framework for DNSPs and affiliates to compete in contestable markets

The participation of DNSPs and Affiliates will be important to promoting competition in emerging markets. In consequence, the ring-fencing guidelines should be flexible enough to allow DNSPs or Affiliates to compete in emerging and contestable markets, and to take advantage of efficiencies of scale and scope in order to provide high quality services to consumers at the lowest possible cost.

There are a number of reasons why DNSPs should be encouraged to expand their operations into emerging contestable markets.

First, retailers are likely to have significant existing market power in emerging markets. For example, in metering, the retailer will have power to choose the metering co-ordinator. In solar panels and storage, the retailer has an existing relationship with the consumer and the ability to bundle lower retail prices with storage. On a NEM wide basis, the three largest retailers supplied over 70% of small electricity customers as at June 2015.⁷ Their size gives rise to significant economies of scale. The degree of vertical integration they have achieved through ownership of generation arguably presents a barrier to entry for other competitors. In consequence, the promotion of competition in emerging markets would be well served by encouraging the participation of DNSPs and Affiliates, who also have significant expertise in the electricity industry.

Second, under appropriate ring-fencing guidelines, DNSPs, and their Affiliates can take advantage of economies of scale and scope in order to provide services at lower cost than would otherwise be the case. For example, the costs of corporate

⁶ Competition Policy Review, Final Report, March 2015, page 24.

⁷ AER State of the Energy Market 2015, page 124.

services staff can be allocated between the DNSP and the Affiliate, resulting in lower overall costs for consumers of electricity. The allocation of such costs is required to be undertaken in a manner that complies with the cost allocation methodology approved by the AER.⁸

Well targeted regulation is more efficient than blanket regulation

The approach proposed in the Position Paper is for regulation of all contestable services initially that might later be corrected through the use of a waiver process. That approach is inefficient and not in the long term interests of consumers of electricity. It would require DNSPs to make a series of costly applications for waiver in respect of obligations that the guidelines should not have imposed in the first place. As administrator of the current jurisdictional distribution ring fencing guidelines, the AER is well placed to evaluate their success and to establish that there are net benefits for altering the current policy settings, prior to publishing the final guidelines. As such, the final guidelines should accurately reflect the AER's view as to the optimal policy position at the time that the guidelines are published.

The obligations proposed at page 27 of the Position Paper require refinement to enable a more practical implementation and avoid the need for waivers for DNSPs to engage in conduct that does not represent any risk to competition in contestable markets. For instance:

- in some markets, such as, for example, metering for public lighting, a DNSP (as opposed to an Affiliate) should be permitted to deliver contestable services because the existing cost allocation methodology applicable under the NER⁹ would be sufficient to manage any risks to competition in those markets.
- much of the information obtained by DNSPs is either not relevant to contestable markets or is available to market participants. In consequence, the sharing of such information would not risk distortion to competition.

To the extent that new markets emerge over time, or the position of individual DNSPs changes, the AER has the power to apply the guidelines to new markets or to grant waivers where appropriate.

AAD supports the inclusion of a waiver process, but suggests that it should only be used to deal with true exceptions, such as:

- changing circumstances over time which result in the need to update the applicability of the guidelines to particular services; or
- issues specific to one, or a small number of, DNSPs.

This is addressed in more detail under Question 8 below.

⁸ NER, clause 6.15.1.

⁹ NER, clause 6.15.1.

Rely on existing arrangements for cost and revenue allocation between multiple services

The ring fencing guidelines should enable DNSPs to adapt to changing market conditions and engage in technological innovation that drive operational efficiencies for the benefit of consumers. The Position Paper suggests (on page 23) that if an asset used to provide standard control services was also used to provide a service in a contestable market, the DNSP would be in breach of its ring-fencing obligations.

AAD suggests that the ring-fencing guidelines should not prevent assets being used to provide multiple services.

The National Electricity Rules (NER) expressly provide for assets to be used to provide multiple services, and for the costs of those assets, and revenues derived from the services, to be shared between contestable and non-contestable services.¹⁰ This sharing allows DNSPs to provide network services in the most efficient manner and at the lowest possible cost for a number of reasons. For example, first, the costs of the relevant asset can be shared between network customers and other customers. This helps minimise the cost of network services. Second, DNSPs are the best placed participants to determine where such assets should be installed. In particular, if a grid scale storage unit is to be installed within a network in such a way as to delay or avoid the need for network augmentation, the DNSP is the best placed participant to determine where, when and how to install that unit because it has the best knowledge of the operation of its network and the loads and constraints likely to exist in the future.

This is addressed in more detail under Question 4 in relation to distributed energy resources and Question 7.

¹⁰ See the cost allocation principles at NER clause 6.15.2 and the shared asset principles at NER clause 6.4.4(c).

Specific responses to AER Questions

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

Appropriate level of detail

The Existing ACT Guidelines provide an appropriate level of detail as to the obligations that they impose. For example:

- in relation to the staff that cannot be shared between the DNSP and an Affiliate, clause 3.1(n) specifies that the relevant staff are operations staff involved in enquiries, connection, disconnection and reconnection, etc; and
- in relation to the physical separation, clause 3.1(q) provides that businesses on separate floors of the same building with separate access are sufficiently physically separated.

This level of detail assists DNSPs to understand and comply with the guidelines.

Small business exemption

The existing transmission ring-fencing guidelines provide an exemption in respect of services that attract annual revenue of less than 5% of the network service provider's total annual revenue. This exemption is a sensible and proportionate approach to the difficulty that would otherwise arise from the DNSPs undertaking small jobs that are contestable but can be efficiently undertaken by a DNSP (for example public lighting maintenance).

AAD proposes that an equivalent exemption should be included in the distribution ring fencing guidelines.

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?

The object of the ring-fencing guidelines should align with the ultimate objective set out in section 7 of the NEL, namely, to promote the long term interests of consumers of electricity.

The Position Paper proposes four ring-fencing objectives that identify the harm that the ring-fencing guidelines are seeking to avoid.

The objectives currently proposed in the Position Paper are narrow and preclude any balancing exercise between the benefits and the costs of ring fencing. AAD suggests that the four objectives in the Position Paper should be replaced in the guidelines with an overarching purpose at a higher level. For example, the recent Harper Review observed, in the context of making markets work in the long term interests of consumers, that regulation should be as light touch as possible in recognition of the need to balance its costs against its benefits:

'Market regulation should be as 'light touch' as possible, recognising that the costs of regulatory burdens and constraints must be offset against the expected benefits to consumers.'¹¹

The potential benefits from balancing the costs and the benefits are acknowledged in the Position Paper.¹² Specifically, for contestable markets in the electricity industry, the potential costs of imposing too onerous a ring-fencing regime include:

- loss of the efficiency benefits arising from the participation of Affiliates. DNSPs, and their Affiliates, have significant expertise and experience in the electricity industry.¹³ They also have access to economies of scale and scope. In consequence, Affiliates are well placed to provide services in the electricity industry at a high quality and at a low cost. Imposing too onerous a ring fencing regime risks sacrificing these potential benefits.
- loss of benefits from effective competition. The three largest retailers in the NEM all have existing relationships with customers and significant generation assets that are difficult for a new entrant to replicate. These large retailers are likely to gain a significant share of other markets that will emerge (such as for the role of metering co-ordinator). As such, in these contestable markets, it is more likely that an onerous ring fencing regime will exacerbate a lack of competition than that a less onerous regime will create a lack of competition.

The Position Paper proposes a cost / benefit analysis in the waiver section of the guidelines. Including this concept only at the waiver stage is inefficient and inappropriate for reasons including:

- It is likely to result in skewed initial position which requires correction through a subsequent waiver process. This is an unnecessary inefficiency and potentially inconsistent with the NEO. The AER will have more than sufficient information to determine appropriate policy settings at the time it publishes the guidelines. To the extent that new markets emerge over time, the AER has the power to apply the guidelines to those services where appropriate.
- The 'overall' purpose of the guidelines would be unstated and unclear. Under the approach proposed in the Position Paper, the 'objectives' of the guidelines would not be a relevant touchstone in determining applications for waiver. Instead, those applications would impliedly be determined according to a distinct set of objectives. This confusion as to the true overall purpose of the guidelines would create significant uncertainty in the industry and the true overall purpose would likely not be achieved.

Ultimately, the ring-fencing guidelines will be one of a number of components of regulation designed to promote the national electricity objective set out in clause 7 of the NEL. An overarching purpose would better align with the national electricity

¹¹ Competition Policy Review, Final Report, March 2015, page 24.

¹² Position Paper, page 14.

¹³ For example, the role of metering co-ordinator will soon become a contestable service in December 2017 and distribution businesses have provided metering services since the inception of the NEM.

objective than the objectives proposed in the Position Paper for a number of reasons. For example, the fourth objective proposed in the Position Paper refers to 'promoting an even playing field'. DNSPs and their Affiliates have access to efficiencies of scale and scope which can be used to provide services at higher quality and lower cost than would otherwise be possible. In consequence, imposing ring-fencing guidelines that prevented those businesses taking advantage of those efficiencies would be counter to the interests of consumers of electricity in the short and the long term.

AAD suggests that there should be an express purpose to achieve long term certainty and stability. Stability and certainty are widely accepted as beneficial for a regulatory framework because they reduce the regulatory risk faced by regulated businesses and therefore reduce the returns that those businesses require. However, the Position Paper does not refer to these considerations and instead proposes a relatively uncertain process under which the AER would purposely over-regulate and then allow DNSPs to make a series of waiver applications in an effort to correct that over-regulation.

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

Blanket regulation

The Position Paper incorrectly posits a binary choice between ring fencing regulation applying, by default, in all situations or in none. In reality and 'all or nothing' approach is unnecessary and inefficient.

This is particularly the case given:

- the Position Paper acknowledges that the costs associated with applying all the ring-fencing obligations to all contestable services would be prohibitive;¹⁴ and
- the preparation of the guidelines has been scheduled to occur over a 9 month period. By December 2016, the AER will be well placed to prepare a list of services that should be subject to the guidelines. Failing to do so would prolong the uncertainty as to the application of the guidelines which would be detrimental to the efficient provision of the very services that the guidelines are intended to protect.
- for selected services it may be appropriate to apply a narrower set of ring fencing obligations, such as where accounting rules of cost allocation is considered sufficient to manage a low risk of market distortions.

List of services

The Position Paper lists three options for defining the services that the guidelines will apply to. AAD suggests that the services subject to the guideline should be defined in a manner that is clear and provides long term stability and certainty to industry participants. AAD suggests this would be best achieved by the AER

¹⁴ Position Paper, page 19.

maintaining a national list identifying specific services to which the ring fencing guidelines apply, which would be subject to review once every five years.

The stated aim of the Position Paper is a consistent national approach.¹⁵ A nationally consistent definition would best achieve that goal and a list would provide stakeholders with the certainty that the guidelines apply to the services set out on that list, without precluding the guidelines from applying to other services in the future, including emerging services that do not yet exist.

The Position Paper suggests that the framework and approach service classification process should be expanded to include the services that are the subject of the guidelines. There are a number of difficulties with such an approach including:

- it is contrary to the AER's stated aim of a nationally consistent approach. Specifically, the framework and approach service classification process applies to each DNSP separately. As such, adding a service to the list of ring-fenced services for one DNSP in the framework and approach paper would not alter the application of the ring-fencing guidelines for DNSPs in other NEM regions. Further, using the F&A framework creates the possibility of different approaches applying in different regions and at different times, which would create inefficiencies for entities operating on a national basis.
- there is a significant risk that the AER does not currently have the power to undertake such an exercise under the current NER. Specifically, rule 6.8.1(a) confers a power upon the AER to make a framework and approach paper. Rule 6.8.1(b) contains an extensive list of matters that must be set out in the framework and approach paper. Although that list is not stated to be exhaustive, there is a strong argument that the NER do not permit the AER to make decisions in the framework and approach paper as to the application of the ring-fencing guidelines, which are addressed in rule 6.17.

4. Does the proposed approach to ring-fencing adequately deal with the prospects for development of the contestable market for distributed energy resources (DER)?

The Position Paper suggests (on page 23) that if a storage unit used to provide standard control services was also used to provide a service in a contestable market, the DNSP would be in breach of its ring-fencing obligations.

It is possible that DER will grow to become important in providing direct control services to the prescribed standard at the lowest possible cost. Further, to the extent that DER can provide multiple services, this would create opportunities to allocate the cost of such assets between those multiple services with appropriate charges, thus lowering the costs to network users, and consumers of electricity generally. In consequence, the guidelines should not operate to preclude DNSPs from owning storage units, or from using those units in the most efficient manner possible, even if that use is partly for the provision of network services and partly for the provision of contestable services.

¹⁵ Position Paper, page 6.

In relation to this issue, the Position Paper suggests an alternative model in which third parties own DER assets and DNSPs acquire services from those third parties (which payments would, for the purposes of revenue regulation, be opex). AAD does not agree to that structure in the ring-fencing guidelines because it would be inefficient and thus not in the long term interests of consumers of electricity. There are a number of reasons for this including:

- DER will likely form an important part of distribution networks in the future. However, in order to maximise the benefit, DNSPs will need to have autonomy in determining how they should be incorporated into the distribution network, including where, when and at what scale. DNSPs are best placed to make these decisions because they have the best knowledge of the capabilities and requirements of their networks. Precluding DNSPs from owning DER would prevent them from having full autonomy in determining how DER should be incorporated in order to maximise the benefit to the network and thus best promote the long term interests of consumers.
- Additional administrative costs related to contracting with third parties.
- DER assets may be able to be used for multiple purposes. Where this is the case, it would be inefficient if the ring fencing guidelines effectively precluded DNSPs from pursuing additional revenue streams. Instead, the existing NER encourages DNSPs to share the use of assets. The cost allocation guidelines and shared asset guidelines are targeted at ensuring an equitable sharing of costs and revenues arising from assets with shared uses.
- the services that can be provided by DER may evolve over time such that a DER asset which was initially installed exclusively for the purposes of providing network services becomes capable of providing additional services. In such a case, it would be inefficient if the ring fencing guidelines effectively precluded DNSPs from pursuing additional revenue streams as they became available.

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

AAD does not consider there are any other issues not addressed in the Position Paper that should be addressed by the ring-fencing obligations.

6. What costs would be incurred in meeting these obligations?

The obligations proposed in the Position Paper would result in DNSPs, and Affiliates, incurring a number of costs, including:

- loss of efficiencies of scale and scope that would otherwise exist;
- administrative costs of ensuring compliance;
- business disruption costs; and
- non-financial costs.

For the reasons set out below (in question 9), these costs would ultimately be borne by customers of the DNSP.

Loss of efficiencies of scale and scope could be significant. These costs would arise from a number of obligations including an inability to share certain types of staff. Proposed obligation (c) in the Position Paper is to:

'not share staff between a ring-fenced entity and a DNSP'.

The draft guideline should specify which types of staff cannot be shared. If the Position Paper was interpreted literally - such that no sharing of any type of staff was permitted, this would create very high costs because a DNSP and an Affiliate would need to effectively 'double up' with each employing staff to duplicate a number of functions and positions where this would be otherwise unnecessary. For example, they would need to double up on corporate services staff (including, for example, financial and corporate reporting and insurance), legal staff, reception staff, etc.

To illustrate, a DNSP may employ a lawyer. Under an appropriate ring-fencing regime, that lawyer's salary could be shared between the DNSP and an Affiliate. Ring-fencing guidelines which precluded sharing of any staff would have the effect of preventing that sharing, such that the DNSP would incur the entire salary for lawyer and the Affiliate would need to employ a separate lawyer or require outsourcing at a higher unit cost.

Administrative costs would also be significant. They would include, for example, the cost of reporting including an independent auditor undertaking an annual audit of compliance.

Business disruption costs would occur in the event that the list of services subject to ring-fencing is changed so as to require a DNSP to separate out the provision of the relevant service from its regulated business. Those costs could be significant and form a key reason why long term certainty and stability is an important criteria.

Non-financial costs would be likely to include safety and reliability issues and loss of innovation. DNSPs, and Affiliates, have significant expertise and experience in managing distribution networks, including in connecting new load or generation to a network. The ring-fencing guidelines could have the effect of precluding those businesses from taking advantage of that expertise and experience. This could have safety or reliability implications by reducing the quality of the services provided. Further, the ability of DNSPs to adapt to changing market conditions and technological innovation as well as to respond to policy reforms would be constrained by overly onerous ring-fencing obligations.

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

Asset sharing should not be restricted. To do so would encourage inefficiency. The ability to use assets for multiple purposes gives rise to significant efficiencies of scope which result in cost savings that can be passed onto consumers of electricity in the form of lower electricity prices.

The NER expressly provide for asset sharing, including through the cost allocation principles and the shared asset principles.

The shared asset principles positively provide that asset sharing should be encouraged:

'the *Distribution Network Service Provider* should be encouraged to use assets that provide *standard control services* for the provision of other kinds of services where that use is efficient and does not materially prejudice the provision of those services'¹⁶ [our emphasis]

The AER has published shared asset guidelines which are consistent with the shared asset principles and provide for consumers to benefit from the sharing of assets through lower electricity prices. Those guidelines apply in circumstances where the cost of an asset was allocated to regulated services in accordance with the applicable cost allocation methodology but the asset is subsequently able to be used for additional purposes.

Similarly, the cost allocation principles expressly contemplate that assets may be shared between businesses operating with ring-fencing.¹⁷

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

AAD agrees that waivers should be available in specified circumstances, including where the benefits of ring-fencing do not exceed the cost, or for other reasons as reasonably determined by the AER.

The factors listed on pages 29 and 30 of the Position Paper require amendment to avoid uncertainty that would otherwise arise. For example:

- The first dot point on page 29 (the potential harm to be avoided by ring-fencing') should be removed as it appears to duplicate the immediately following dot point (which refers to the benefits defined by the ring fencing objectives).
- the reference to the 'cost' of ring-fencing should be defined as including both financial and other costs. For example, there could be safety or reliability costs arising from ring-fencing. These should be taken into account.
- The third dot point should be clarified or removed. Safety issues should fall to be considered as a potential cost of ring-fencing. Including safety issues as a separate factor could be interpreted as implying too narrow an interpretation of the 'costs' of ring-fencing.
- The third and fourth dot points should be removed or clarified. It would be a perverse outcome if the ring fencing guidelines precluded a DNSP from providing services which, by virtue of separate regulations, no other business was permitted to provide. Requiring DNSPs to apply for a waiver in respect of such services would impose unnecessary costs on those businesses (which would be passed onto consumers).

¹⁶ NER, clause 6.4.4(c)(1).

¹⁷ NER, clause 6.15.2 (6), which provides that one of the cost allocation principles is that the 'principles, policies and approach used to allocate costs must be consistent with the *Distribution Ring-Fencing Guidelines*'.

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?

Costs associated with ring-fencing will be borne by customers of the distribution network firm that is subject to ring-fencing. For example:

- Any inability to access efficiencies of scale and scope would result in the DNSPs incurring higher costs. Employing an extra staff member results in higher operating expenditure. Purchasing an asset (such as a storage unit) results in capital expenditure. DNSPs are entitled to recover their efficient capital and operating costs. The NER provide for the sharing of such costs in certain circumstances with the effect that the DNSPs overall costs are reduced. If ring-fencing precludes the sharing of such costs, then those costs will be passed on to the customers of the DNSP.
- The obligation to comply with the ring-fencing guidelines would be imposed upon the DNSP. In consequence, the cost of ensuring such compliance (for example, paying for the services of an independent auditor) must be borne by the DNSP. It would be contrary to the NER to impose a regulatory burden upon a DNSP but to disallow that business from recovering the cost of complying with that regulatory obligation.¹⁸

The presence of costs associated with ring-fencing is widely accepted as one of the reasons that ring-fencing regulation should be as 'light touch' as possible.¹⁹

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

Blanket regulation

Under the approach proposed in the Position Paper, significant administrative costs would arise because of an inappropriate initial position as to the services subject to ring-fencing and the consequent necessity for DNSPs to make applications for waiver to correct this position. As is set out above, it is unnecessary and would be inefficient, if, at the conclusion of the lengthy process associated with the drafting of the guidelines it was not possible to identify the services to which the guidelines should initially apply.

The necessity for a waiver process should arise from changing circumstances over time which result in the need to update the applicability of the guidelines to particular services.

Cost of annual independent audit prohibitive

The Position Paper proposes, (on page 34) that DNSPs would engage a third party to undertake an independent audit of their compliance with ring-fencing obligations on an annual basis. The cost of this process would be prohibitive and thus not be in the long term interests of consumers.

¹⁸ NER, clause 6.5.6(a)(2) provides that a building block proposal must include the total forecast operating expenditure which the distribution business considers is required in order to comply with applicable regulatory obligations or requirements associated with the provision of standard control services.

¹⁹ Competition Policy Review, Final Report, March 2015, page 24.

To ensure regular third party oversight without these prohibitive costs the guidelines should require an independent auditor to undertake an annual review in which the auditor would have the flexibility to undertake a targeted review of particular aspects of compliance each year (but would not be required to undertake a full audit of compliance in every area in every year).

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

Transitional arrangements should be clearly specified in the guidelines, and that they should apply not only at the commencement of the new guidelines, but also to the extent there are changes in the guidelines such as changes to any list of ring fenced services.

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

Confidential information

The Position Paper contemplates (page 34) that the AER would publish on its website all material provided to it as part of the proposed annual reporting requirements. AAD observes that this material would be likely to contain large amounts of confidential and commercially sensitive information. AAD suggests that the AER instead publish a short high level summary of its conclusions regarding each DNSPs compliance with the ring fencing guidelines (or otherwise), together with any material that is not confidential or commercially sensitive. In consequence, the guidelines should not require the AER to publish on its website submissions or reports to AER of compliance, performance, review results and financial accounts.

Cost of annual independent audit prohibitive

As is set out above in question 10, rather than requiring a third party to undertake an independent audit of each DNSPs compliance with ring-fencing obligations on an annual basis, the guidelines should require an independent auditor to undertake an annual review in which the auditor would have the flexibility to undertake a targeted review of particular aspects of compliance each year (but would not be required to undertake a full audit of compliance in every area in every year). This would avoid DNSPs incurring the high costs associated with a full third party audit every year.

Blanket regulation

As set out in the Key Points section, better targeting of the ring fencing guidelines and more limited dependence on the waiver process such that the need for waivers is occasional rather than the norm, would reduce the costs of the ring fencing regime for the AER and industry.

Ease of production of reports

Costs can also be contained by ensuring that reporting of compliance with ring fencing is relatively simple and fast to produce.