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Office of the  
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Dear Ms Conboy

***RE: Electricity Distribution Ring-fencing Guideline – Response to Draft Guideline***

Ausgrid welcomes the opportunity to provide comments on the Australian Energy Regulator's (AER) draft national ring-fencing guideline for electricity distribution (or "Guideline").

Ausgrid recognises that the electricity market is undergoing significant transformation. This, coupled with the Australian Energy Market Commission (AEMC) rule change to open small customer metering and related services, has created the need for broader and more robust ring-fencing arrangements to promote market confidence and facilitate competition in new and emerging markets.

Ausgrid supports the policy objectives that the AER is seeking to achieve through the Guideline. In our view, the policy intent outlined in the Explanatory Statement and the obligations imposed under the Guideline represent a more proportionate and targeted approach than the AER's Preliminary Positions Paper, and as such address a number of concerns that were raised in our previous submission.

However, while Ausgrid supports the proposed policy intent, as outlined in the Explanatory Statement, we are concerned that the current drafting of the Guideline does not appropriately reflect this and/or is in parts inconsistent with the stated policy intent. In particular, we believe there is the potential for negative outcomes for customers if these are left unaddressed. This includes:

- 1) imposing separation obligations on certain services which are incidental or unrelated to the DNSP's network functions, and where there is no threat to competition; and/or
- 2) preventing the DNSP from using regulated assets to offer unregulated services consistent with the AER Shared Asset Guideline, meaning that customers would lose the benefit of cost reductions enabled by this arrangement.

Ausgrid considers that further refinement of the drafting of the Guideline is required to address these issues and to improve its workability. This is important so that DNSPs have a clearer understanding of their obligations under the Guideline, particularly in regards to the nature of obligations that apply to different services.

The key areas where further drafting and consideration is required include:

- ***The use and definition of key terms is unclear*** – differing terms are used to describe services subject to ring-fencing throughout the Guideline, with some terms being undefined. This creates uncertainty and confusion as to how services will be treated, and appears to conflict with the policy intent outlined in the Explanatory Statement and case studies;
- ***Transitional arrangements are insufficient*** – implementation timeframes for ring-fencing arrangements should be aligned to 12 months to allow sufficient time for implementation given the significant increase in the scope of obligations being imposed and the impact that these obligations will have on DNSP's business structures and operations. In addition, further transitional arrangements are required to address circumstances where the AER changes its approach to classifying a particular service;
- ***Physical separation*** - should be re-expressed as separate location instead of the proposed separate building (a location may be in the same building but with appropriate controlled access) as this avoids the imposing excessive costs, while still achieving the intended policy objective; and
- ***The materiality threshold for legal separation is too low*** – setting the materiality threshold for exempting the need for legal separation at \$500,000 for all non-distribution services is too low, and in effect would capture all incidental services provided by the DNSP. A more meaningful materiality threshold that achieves the AER's policy intent would be to apply the materiality threshold on a per service basis at an increased level.

We note that the need to refine the drafting of the Guideline to address the above issues and improve the Guideline's workability is echoed by other DNSPs and is reflected in the Energy Networks Association's (ENA) submission. Further reasoning to support these points is provided in our attached submission. We have also attached, in Appendix 1, suggested mark-ups to the Guideline which are aimed at providing the AER with a workable basis for resolving the drafting issues discussed in our submission in order for the Guideline to be practically implemented, complied with and enforced.

Given our concerns with the drafting of the Guideline, its binding nature and the significant impact that the obligations will have upon DNSPs, Ausgrid requests that the AER circulate a redrafted version of the Guideline for short consultation (we suggest 2 weeks maximum) prior to the Guideline being finalised on 1 December 2016.

Ausgrid acknowledges the constructive manner in which the AER has conducted its engagement on ring-fencing to date and looks forward to working with the AER to further finalise the Guideline.

If you have any questions or wish to discuss our submission in further detail please contact Joe Pizzinga, Chief Financial Officer, on (02) 9269 2121 or via email [jpizzinga@ausgrid.com.au](mailto:jpizzinga@ausgrid.com.au).

Yours sincerely



**TREVOR ARMSTRONG**

Acting Chief Executive Officer



# **Submission on the AER's Draft Ring-fencing Guideline**

September 2016



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## 1. Overview

Ausgrid welcomes the opportunity to provide comments on the Australian Energy Regulator's (AER) draft of its national ring-fencing guideline for electricity distribution (or "Guideline").

Ausgrid recognises that the electricity market is undergoing a state of transformation with the emergence of new technologies that are changing the nature and range of electricity products available to customers. This, plus the Australian Energy Market Commission (AEMC) rule change to open small customer metering and related services – reinforces the need for robust ring-fencing arrangements for electricity distribution to promote the National Electricity Objective and foster competition in new and emerging electricity services.

Ausgrid supports the policy objectives the AER seeks to achieve through this Guideline.

Overall, we consider that the policy intent outlined in the Explanatory Statement, and the obligations imposed under the Guideline represent a more proportionate and targeted approach than the AER's Preliminary Positions Paper.

While we note that the ring-fencing obligations are aimed at clearly delineating the scope of network functions performed by the distribution network service provider (DNSP) from its competitive or contestable activities to facilitate competition in new services and mitigate the risk of the DNSP using regulated revenue to cross subsidise its unregulated activities or engage in discriminatory behaviour – we do not consider that the current drafting of the Guideline will achieve this objective.

Specifically, we consider the current drafting of the Guideline to be problematic for the following reasons:

- ***The interpretation of key terms is unclear***– differing terms are used to describe services subject to ring-fencing obligations throughout the Guideline, with some terms used being undefined. This creates a complex multi-tiered approach to ring-fencing that causes uncertainty and confusion as to how services will be treated. Further, as drafted, it appears that the Guideline captures services that should not be subject to ring-fencing and appears to conflict with the policy intent outlined in the Explanatory Statement and the provided case studies.
- ***It may have unintended consequences regarding the treatment of shared assets*** – the current drafting of the Guideline may undermine or conflict with the operation of the shared asset guideline. To avoid potential misinterpretations regarding the scope of and application of ring-fencing obligations it should be made explicit in the Guideline that legal and functional separation obligations do not apply to services that use shared assets.
- ***The materiality threshold for legal separation is too low*** – setting the materiality threshold for exempting the need for legal separation at \$500,000 for all non-distribution services is too low, and in effect would capture all incidental services provided by the DNSP. A more meaningful materiality threshold that achieves the AER's policy intent would be to apply the materiality threshold on a per service basis at an increased level.
- ***Transitional arrangements are insufficient*** – implementation timeframes for ring-fencing arrangements should be aligned to 12 months to allow sufficient time for implementation given the significant increase in the scope of obligations being imposed and the impact that these obligations will have on DNSP's business structures and operations. We also note that compliance with some of the obligations, particularly those outlined in clause 4, are contingent upon the establishment of a related body corporate which DNSPs have 12 months to implement. We consider that further transitional arrangements are also required to address circumstances where the AER changes its approach to classifying a particular service.
- ***Physical separation*** - should be re-expressed as separate location instead of the proposed separate building (a location may be in the same building but with appropriate controlled access) to avoid imposing excessive costs, while still achieving the intended policy objective.

- ***Compliance, monitoring and reporting obligations are too stringent***- some of the obligations expressed in the Guideline duplicate existing National Electricity Law (NEL) provisions or are inconsistent with the powers conferred by the AER under the NEL and the National Electricity Rules (NER).
- ***Information obligations are inconsistent with legislation*** - obligations that replicate existing requirements should be deleted, while other requirements need to be clearly linked to the related ring-fencing obligation to avoid being too broad.
- ***Treatment of research and development is unclear*** – further guidance is sought on how the Guideline will treat research and development undertaken by the DNSP in practice given the distinction between research expenditure and development expenditure under Australian Accounting Standards.

If unaddressed, Ausgrid is concerned that the above issues will make it difficult for DNSPs to implement and comply with the Guideline, as it is unclear what is required to achieve compliance and could result in DNSPs misinterpreting their obligations, or similarly stakeholders misinterpreting the compliance obligations and reporting breaches to the AER in error. This has the potential to not only increase administration costs for DNSPs and the AER from having to investigate and report on potential breaches but may also give rise to the perception that the Guideline is not operating effectively.

In addition, we note that the current drafting of the Guideline may also result in obligations being imposed on services which are not subject to competition, and hence face no threat from anti-competitive behaviour - thereby creating unnecessary costs for customers.

To address this issue, Ausgrid has provided in Appendix 1 of this submission, suggested mark-ups to the Guideline with accompanying explanatory notes to explain why we consider changes to the drafting are required. We have also explained in detail in section 3 of our submission how we envisage the amendments would work.

Our proposed drafting amendments attempt to remove the ambiguity and confusion on the interpretation of the scope and application of separation obligations, so that the Guideline can be practically implemented, complied with and enforced.

The suggested mark-ups in Appendix 1 are intended to provide the AER with a useful starting point for considering how the drafting of the Guideline could be refined to better achieve the AER's policy objectives. In refining the drafting of the Guideline, Ausgrid considers the National Electricity Objective would be best promoted if the Guideline:

- clearly describes and delineates the scope of services which are subject to the ring-fencing obligations;
- is capable of implementation without undue costs or risk of misinterpretation;
- is sufficiently robust to facilitate competition over the long term; and
- is capable of being monitored and enforced.

Our submission expands on these issues in further detail. Specifically:

- Section 2 discusses difficulties in interpreting the scope and application of the Guideline;
- Section 3 presents our proposed solution to clarify the scope and application of the Guideline; and
- Section 4 discusses a number of concerns on other aspects to the Guideline.

## 2. Key concerns with the current drafting of the Guideline

Ausgrid considers that there are three fundamental issues with the Guideline:

- 1) The inconsistency in meaning and the lack of clarity in the various terms used in the Guideline.
- 2) The scope of the ring-fencing obligations lacks sufficient definition, and consequently results in a very broad range of services and activities captured by the ring-fencing obligations, including services where a) there is no risk of cross subsidisation and discrimination or b) the service is not related to the electricity markets and products associated with the consumption and production of electricity.
- 3) The different approaches to defining the services subject to the legal, accounting and functional separation create a complex multi-tiered approach to ring-fencing that is confusing and difficult for DNSPs to practically implement.

The use of a broad range of differing terms for legal, functional and accounting separation – not defining those terms, results in a complex and conflicting set of regulatory obligations that at a practical level creates uncertainty and makes the Guideline difficult to implement.

One of the key problems with the current terms and definitions is that it fails to recognise the overlapping nature of the terms and the underlying services. We have sought to demonstrate this point in Table 1, by presenting our interpretation of how the various obligations differ by type of service. In particular, Table 1 highlights how the use of different terms creates a complicated multi-tiered approach to the separation obligations and arguably undermines, rather than promotes, the objectives the AER is seeking to achieve through the Guideline.

**Table 1: AER proposed ring obligations by type of service**

<i><b>Ring-fencing obligation</b></i>	<b>Type of Service</b>				
	<b>Network Service</b>		<b>Non Network Service</b>		
			<b>Non- energy related</b>	<b>Energy-related</b>	
	<b>Network Services – Direct Control Services</b>	<b>Network Service – negotiated services and non-regulated distribution services</b>	<b>Non-network service and non-energy related service</b>	<b>Non-network service and energy related service and not contestable</b>	<b>Non network service and energy related and is contestable</b>
<b>Legal Separation</b>	<b>No</b>	<b>NO</b>	<b>YES</b>	<b>YES</b>	<b>YES</b>
<b>Accounting Separation</b>		<b>NO</b>	<b>YES</b>	<b>YES</b>	<b>YES</b>
<b>Non-discrimination</b>		<b>NO</b>	<b>YES</b>	<b>YES</b>	<b>YES</b>
<b>Functional Separation - location</b>		<b>YES</b>	<b>NO</b>	<b>YES</b>	<b>YES</b>
<b>Function Separation – staff sharing</b>		<b>NO</b>	<b>NO</b>	<b>NO</b>	<b>YES</b>
<b>Information</b>		<b>YES</b>	<b>YES</b>	<b>YES</b>	<b>YES</b>

Table 1 reflects how the Guideline will be applied in practice, leading to the following outcomes:

- Not all of services captured by the term “energy related” services are 'contestable' and subject to competition. However under the current drafting of the Guideline, non-contestable energy related services (e.g. emergency assistance to other DNSPs, emergency recoverable works) will be subject to various obligations, including legal separation. These outcomes will impose unnecessary costs without promoting the NEO as there is no risk to competitive outcomes for customers.
- The Guideline will result in negotiated services and non-regulated distribution services plus a number of energy related services being subject to locational separation but not restrictions on staff sharing.<sup>1</sup>
- Services which are not related to the energy markets (i.e. non-energy related services) will be subject to legal separation and the non-discrimination obligations as they are not captured by the terms *network services* or *distribution services*.<sup>2</sup>
- The Guideline may cause confusion in how the obligations will apply to the provision of shared support services (e.g., HR, payroll, IT) to related body corporates, if at all.<sup>3</sup> Consequently, it could be interpreted as capturing corporate services provided to related entities that may provide energy-related and non-energy related services.

## 2.1 Interpretation of key terms is unclear

The two key undefined terms that have the greatest impact on the application of the Guideline are 'non-network service' and 'energy related services'.

The rules of statutory interpretation dictate that an undefined term must be given its ordinary meaning, in context. We consider the context for the Guideline is Chapter 6 of the NER and the DNSP's distribution determination, in particular the DNSP's classification decision.

Ausgrid demonstrates below, how the absence of definitions for key terms creates difficulties in interpreting and applying the proposed ring-fencing obligations.

### Network services

The legal separation requirements are based on the terms *network service* and *non-network service*, where *network service* is defined in the NER but *non-network service* is not. Under the NER the term *network service* is defined solely for the purposes of the ring-fencing arrangements under rule 6.17.2(a) of the NER and means '*a transmission service or a distribution service associated with the conveyance, and controlling the conveyance, of electricity through the network.*'

In the absence of a definition for *non-network service*, the term should be given its ordinary meaning. That is, it is any service that is not a network service. However, given the limited use of *network service* in the NER and the fact that the AER uses *network service* and *distribution service* interchangeably in the Guideline, it is unclear whether *network service* is in fact a sub-category of *distribution service* or something broader.

Added to this complex interpretation exercise is the fact that in the context of Chapter 6, *network service* has a specific meaning in each DNSP's distribution determination as a result of the AER's

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<sup>1</sup> Ausgrid questions whether this would promote efficient outcomes for customers. Further, if not addressed, Ausgrid is concerned that this will lead to the need for DNSPs to make a substantial number of waiver requests.

<sup>2</sup> Ausgrid cannot see any reason why this treatment would promote the National Electricity Objective, and further consider that it is questionable whether the AER has the legal remit to extend ring-fencing to non-energy related services.

<sup>3</sup> While clause 4.2.2(6)(ii) provides an exception to clause 4.2.2(a) in that it appears to allow a DNSP to provide corporate services to a related body corporate that provides contestable energy-related services, clause 3.1(a) prohibits a DNSP from providing any services other than network services.



classification decision for that DNSP. These Chapter 6 regulatory instruments arguably support a narrower meaning for network service and therefore a broader meaning for non-network service.

The use of the term 'network service' is fraught with interpretation obstacles that are unnecessary and best avoided. As discussed in section 2.2, the AER is not bound to impose legal separation based on a network-non-network service distinction. Further, as the term has limited utility in Chapter 6 (other than in rule 6.17.2(b)), we consider that the interrelated nature of the Guideline when read in conjunction with the rest of Chapter 6 supports not using the term.

Section 3 of our submission sets out our proposed solution for avoiding the need to use distinguish the application of obligations across multiple services, and avoiding the interpretational issues noted above. We have proposed mark-ups to the Guideline in Appendix 1 to reflect this view.

### ***Energy-related services***

Ausgrid is concerned that this term could be open to misinterpretation as the ordinary meaning of the term 'energy-related' is broad and arguably covers any service that is related to energy. The term 'energy' could arguably be broader than electricity and gas. The interpretation of this term in the Guideline is further complicated by the fact that the AER refers to contestable and non-contestable energy-related services inconsistently across the Guideline.

The purpose of the Guideline is to prevent cross-subsidisation and discrimination between direct control services and other services provided by the DNSP. While it is reasonable and realistic to assume that other electricity related services provided by the DNSP need to be ring-fenced, it is unreasonable to extend such obligations to any energy related service provided by the DNSP that is completely unrelated from its distribution system.

To address this, we recommend that the AER instead uses the term "electricity related services" and ties the definition of this to the definition given under the National Electricity Law (NEL), with the definition extended to cover the storage of electricity (similar to the ring-fencing obligations in the National Gas Law). This recommendation is consistent with the context in which the Guideline operates being the NEL and NER and is reflected in our proposed drafting contained in Appendix 1.

## ***2.2 The underlying cause of interpretation issues***

As explained above, the different service categories on which the various legal, accounting and functional separation obligations are imposed creates confusion regarding the intended scope and application of the Guideline to different services.

While Ausgrid recognises that clause 3 of the Guideline is aimed at addressing the risk of cross-subsidies, and clause 4 is aimed at addressing potential non-discrimination, we do not consider that it is necessary for the Guideline to make different service distinctions across the obligations to achieve its desired policy objective.

Specifically, we note that the AER may have sought to impose different requirements for legal, accounting and functional separation because it considered that this was necessary in order to be consistent with its powers under clause 6.17.2(a) and clause 6.17.2(b). In particular, we understand that the AER considers its legal powers are constrained to only make guidelines that require:

- (a) functional and accounting separation between direct control services and other services; and
- (b) legal separation between network and non-network services.

We believe that the AER's interpretation of clauses 6.17.2(a) and (b) is too narrow and not consistent with how its powers under that clause should be interpreted. The correct and preferred interpretation of clauses 6.17.2(a) and (b) is:

- that clause 6.17.2(a) gives the AER the power to impose functional and accounting separation between direct control services and one or more other services;

- that clause 6.17.2(a) in empowering the AER to make guidelines for functional separation implicitly incorporates the right to make guidelines for legal separation on the same terms as legal separation is a mechanism regularly used in Australia to implement function separation;
- that clause 6.17.2(b) only provides examples of possible mechanisms that the AER may utilise in developing ring-fencing guidelines rather than mandating the matters which must be covered by the guideline.

Importantly, the above interpretation:

- does not require the AER to impose legal separation based on a distinction between network and non-network services;
- does not empower the AER to require that a direct control service be provided by a related body corporate;
- enables the AER to impose separation between direct control services and some but not all of the "other services" the DNSP provides. That is, the AER can choose to ring-fence a particular category of direct control service from a specific group of "other services" provided by the DNSP but not from all other services; and
- is consistent with the AER's power to classify distribution services under rule 6.2 and ensures the distribution ring-fencing guideline operate in conjunction with the classification decisions for DNSPs.

Ausgrid has suggested alternative drafting to address issues associated with the uncertainty of key terms and in Appendix 1. We have also proposed a more simplified principle based approach towards the application of ring-fencing which is also reflected in our suggested mark-up to the Guideline and discussed in further detail in section 3.

### **2.3 Potential for unintended consequences regarding Shared Assets**

As the AER is aware, the Shared Asset Guideline allows DNSPs to use assets which are used to provide regulated services to also provide unregulated services (Shared Assets). Ausgrid is concerned that the current drafting of the Guideline creates a potentially inflexible approach to legal and accounting separation that may complicate the use of Shared Assets and may inadvertently prevent the use of Shared Assets for the provision.

A key example is the maintenance of a shared asset where maintaining the asset would be a service that arguably could be part of a regulated service or an unregulated service. In this situation:

- the actual service would be serving two different purposes and would need to be legally separate under the Guideline which is not possible;
- on a strict reading of clause 4.3.2 of the Guideline, any information no matter how routine or trivial related to the shared asset acquired by the DNSP (such as maintenance information) that would be relevant or necessary to the provision of the non-regulated service by the related entity, would need to be made available to competitors of the related body corporate on an equal basis. This appears to be extremely onerous and costly, if not impractical;<sup>4</sup> and
- further, if the shared asset were to enable a contestable or competitive energy-related service, clause 4.2.2 of the Guideline would appear to prohibit the maintenance or construction of a shared asset by DNSP staff.

To address the above issues, we consider that any service that is provided using shared assets should be exempt from the legal separation, information disclosure and functional separation requirements, and only subject to the non-discrimination and cost allocation provisions. Adopting this approach would provide greater certainty to DNSPs rather than having to consider at each

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<sup>4</sup> We note that a DNSP cannot apply for a waiver from this clause.

determination whether all services enabled by shared assets are able to be classified as a distribution service, and would also avoid the unintended consequences noted above in a manner that still achieves the AER's desired policy outcomes.

Ausgrid has suggested alternative drafting in Appendix 1 to reflect this view.

## **2.4 Threshold for exemption from legal separation obligation**

The AER has proposed a threshold that allows DNSPs to incur costs of up to \$500,000 in any regulatory year for providing any non-network services. In its Explanatory Statement, the AER notes that this threshold is intended to avoid micromanagement and capture incremental ancillary services.

Given the uncertainty in the interpretation of the term network service described above, it is difficult to evaluate the proposed threshold of \$500,000 for exemption from the legal separation obligation as the exact range of services which are permitted to be provided by the DNSP is unclear. For example, it is not clear whether incremental ancillary services such as training, consultancy services may already be captured within the term network services, as they could be considered to be provided in connection with the distribution system.

Consequently, Ausgrid has identified two key concerns with the AER's proposed threshold:

1. There is no NEO justification for preventing a DNSP from providing services which are either a) not subject to competition or b) not electricity related. There should be an general exemption for such services to be not subject to any materiality threshold; and
2. A threshold of \$500,000 per year for total costs is far too low and is not based on economic reasoning. The rationale for the threshold is to prevent DNSP involvement in non-network services implies effective competition emerging to the detriment of customers for those services. Therefore the threshold should be based on an estimate of the extent of DNSP involvement which will not materially impact on competition and should be linked to the potential size of the competitive market for all non-network services. This should be considered at a national level as any DNSP that enters into competitive non-network services is unlikely to be constrained to operating within its area. Given the potential size of non-network services (i.e. smart metering, solar PV and battery storage), a proposed threshold of \$500,000 for all non-network services that may be, or are currently provided, by a DNSP is far too low.

We consider that this issue could be addressed by:

- providing greater specification on the scope of services subject to ring-fencing by making it explicit in the Guideline that it is possible for DNSPs to provide electricity related services where the electricity related service is not being provided on a competitive basis<sup>5</sup>, or the cost of providing the service is less than \$2 million dollars in any regulatory year; and
- explicitly stating that services provided by shared assets or corporate services not directly related to the provision of direct control services, negotiated distribution services or competitive services are not subject to legal separation and are therefore able to be provided by the DNSP subject to accounting and non-discrimination obligations.

We have proposed suggested drafting that gives effect to this suggestion in Appendix 1 and discuss how we envisage this working in more detail in section 3.

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<sup>5</sup> In determining whether an electricity related service is being provided on a competitive basis consideration must be given to the following factors: 1) whether the AER has decided not to classify the distribution service under rule 6.2; 2) whether the DNSP is competing with one or more service providers in the provision of the electricity related service or whether there is the potential for other service providers to provide the electricity related service; and whether the electricity related service would naturally be perceived as a service that should be provided on a competitive basis.

## 2.5 *Transitional arrangements are insufficient*

Ausgrid considers that the proposed transitional arrangements are insufficient for the following reasons:

1. **Functional Separation should be permitted at least 12 months to implement.** The transitional period for functional separation should be extended to at least 12 months to allow sufficient time for implementation. Complying with the Guideline's obligations will require extensive physical, staff and system changes. Six months will not allow adequate time to implement such changes, given that the scope of services subject to ring-fencing has expanded significantly and will require DNSPs:
  - to identify all current and prospective services that it offers and how these services are likely to be impacted in order to develop and consider different business models and operating structures for giving effect to the Guideline's obligations in a manner which minimises compliance costs and achieves the company's corporate goals;
  - to obtain expert advice from a range of parties (i.e. legal, consultants, financial, etc) to assist it in choosing a business model and operating structure that best suits its circumstances;
  - to obtain Board approval to implement the business model and structural changes to give effect to the Guideline; and
  - to consult with employees and unions on the nature of its proposed organisational changes to give effect to ring-fencing.<sup>6</sup> Specifically, we note that there may be a need for DNSPs to apply from complying with this obligation until any industrial dispute is resolved.
2. **Aspects of the non-discrimination provisions cannot be complied with on commencement of the Guideline.** Aspects of the non-discrimination obligations, for example, the independent branding, cannot be practically achieved on commencement of the Guideline as they are tied to the establishment of a related body corporate. Consequently, our interpretation is that these obligations (while not explicitly stated in the transitional arrangements contained in the Guideline) will only apply when a related body corporate is established.

To address these issues, Ausgrid suggests that the AER align the commencement of all obligations under the Guideline to 1 December 2016, with DNSPs to seek specific waivers for obligations which it identifies cannot be fully complied with within a 12 month timeframe. We consider that this is a more realistic and practical approach given that the majority of separation obligations are tied to the establishment of a related body corporate, which the DNSP is permitted 12 months to implement.

While we note that the AER has indicated a preference to not extend transitional arrangements and instead take no compliance action for a 12 month period, we are very uncomfortable with this approach as it requires us to assume compliance risk and may result in associated reputation damage. Further, we are concerned that unless DNSPs are provided with appropriate timeframes to be able to comply with the Guideline stakeholders may form the view that the Guideline is not working effectively.

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<sup>6</sup> Ausgrid is required under its Enterprise Bargaining Agreement (EBA) to consult with employees and staff on organisational changes. This process can take considerable time, and may make it difficult for Ausgrid to fully comply with the staff separation requirements within 12 months, particularly if the unions dispute any of the proposed changes and involve the Fair Work Commission. Ausgrid notes that given its industrial relation constraints it may need to seek a waiver that extends the timeframe for complying with this obligation until any such dispute with the unions on this issue is resolved by the Fair Work Commission.



### ***Transitional arrangements need to be extended to accommodate all potential situations***

The waiver process is likely to play an important role in the application of the Guideline but there is insufficient detail in the proposed Guideline regarding key aspects of the process. In addition, the current Guideline fails to provide sufficient explanation on how the AER will manage a number of different scenarios, including:

- a) when a DNSP submits a waiver application in the immediate period following the commencement of the Guideline;
- b) where the AER departs from its classification of a service either from the Framework and Approach or from previous regulatory determinations;
- c) where a new service is introduced during a regulatory period which has not been subject to the existing service classification;
- d) where the distribution determination of the relevant DNSP results in a change to the classification of distribution services provided and that change materially affects the DNSP's obligations under this Guideline; and
- e) where the AER revokes a waiver or waiver is not granted.

The AER also needs to specify the transitional and waiver arrangements to accommodate the scenario where the AER departs from its proposed classification of a service in the Framework and Approach Paper at the time of its final revenue determination. The DNSP would not have sufficient time to change its organisation to adapt to such changes and needs to be given the opportunity to seek a waiver. In addition, in the event of a waiver being rejected, an appropriate transitional period for implementing the relevant ring-fencing obligations will need to be included.

Ausgrid has included suggested amendments in our marked up of the Guideline to address these points.<sup>7</sup> However, we would also appreciate the opportunity to discuss with the AER the transition of Ausgrid current waivers from the NSW arrangements to the national ring-fencing regime.

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<sup>7</sup> Refer to Appendix 1.

### 3. Proposed Solution to clarify application of the Guideline

To address the issues identified in section 2, Ausgrid recommends that the AER considers adopting a principle based approach in the Guideline, which:

- a) clearly defines the competitive services permitted to be provided by a DNSP to include unregulated distribution services (i.e. services which the AER has currently chosen not to classify and new services which were unknown at the time of the AER's service classification), and 'electricity related services'<sup>8</sup> where the service:
  - i) are not provided on a competitive basis, or where limited or no competition exists<sup>9</sup>; or
  - ii) is considered to be incidental to the provision of distribution services (i.e. the total costs of providing the service does not exceed \$2 million per annum);<sup>10</sup>
- b) permits accounting and cost allocation obligations to be applied to competitive services that are permitted to be provided by the DNSP in order to mitigate the risk, or perception of, cross subsidisation;
- c) imposes all ring-fencing obligations (legal, functional and accounting separation, information, non-discrimination) to electricity related services that fall outside the definition of a) above;<sup>11</sup>
- d) explicitly recognises that services that are provided using shared assets or corporate services are exempt from legal and functional separation requirements; and
- e) clearly reflects that the scope of ring-fencing obligations do not extend to services which are not electricity related services.

In addition, Ausgrid considers that the Guideline should clarify that any unregulated service that requires the use of a regulated asset (i.e. services captured by the application of the AER's Shared Asset Guideline) are exempt from legal, and functional separation requirements for the reasons articulated in section 2.3.

Ausgrid considers that adopting this approach would provide greater clarity on which services can and cannot be performed by DNSPs and will provide greater clarity on the scope of the ring-fencing obligations thereby reducing the risk of misinterpretation. Furthermore, as the contestability arrangements differ across jurisdictions, a principle based approach would provide greater flexibility for the Guideline to be applied effectively across the NEM in manner that accommodates jurisdictional differences. We also consider that this approach allows the Guideline to be targeted to those services where competition can deliver better outcomes for customers. As noted in section 2.2 of our submission the rule 6.17.2 does not constrain the AER from adopting this approach.

Ausgrid has provided marked up amendments to the Guideline that reflect the above in Appendix 1. Our suggested amendments are aimed at improving the workability of the Guideline by moving away from a complex multi-tiered approach to a more simplified principle based approach. Our suggested mark-ups are intended to provide the AER with a useful starting point for how it can refine the

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<sup>8</sup> 'Electricity related service' has the same definition as 'electricity service' in the National Electricity Law and captures services relating to the storage of electricity.

<sup>9</sup> In determining whether an electricity related service is being provided on a competitive basis Ausgrid has proposed that a principle based approach is adopted which requires consideration of: 1) whether the AER has decided not to classify the distribution service under rule 6.2; 2) whether the DNSP is competing with one or more service providers in the provision of the electricity related service; and whether the electricity related service would naturally be perceived as a service that should be provided on a competitive basis.

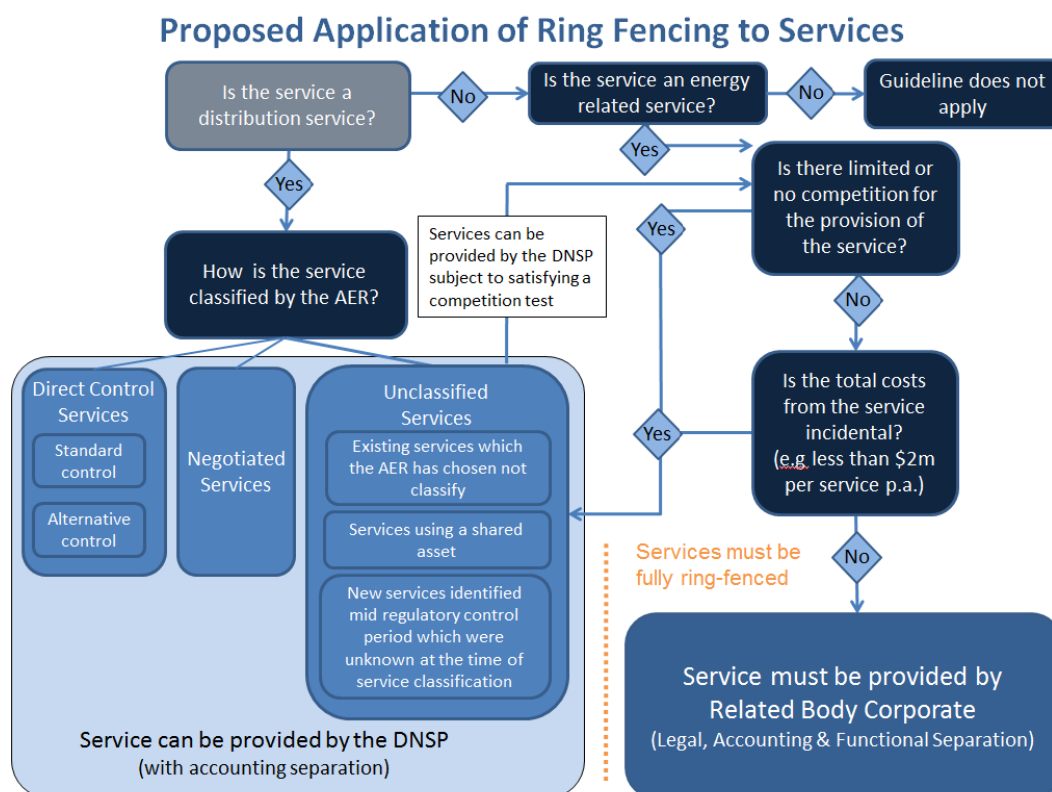
<sup>10</sup> Incidental services refers to services which are performed because they are related to the provision of direct control services, or provided at customers request rather the DNSP actively seeking to pursue commercial opportunities. An example of this type of service is the review and testing of manufacture's products that can be installed on Ausgrid network by Accredited Service Providers (ASPs). Ausgrid would not perform this service if it were not for the fact that assets are gifted back and required to be maintained by Ausgrid.

<sup>11</sup> Services which do not meet the requirements of a) and are not a direct control service, negotiated distribution service or regulated transmission service must be provided by the a related body corporate and subject to all ring-fencing obligations subject to the approval of waivers by the AER.

Guideline so that DNSPs have a better understanding of their compliance obligations, and the obligations are capable of being practically implemented.

Figure 1 below, sets out Ausgrid's proposed framework for applying ring-fencing obligations to different services.

**Figure 1: Ausgrid's proposed framework for applying ring-fencing obligations<sup>12</sup>**



The above diagram sets out in a simplified manner how Ausgrid considers that Guideline should be applied in practice to DNSPs. The starting point for determining whether a service was captured by the Guideline's requirements would be whether or not the service is a distribution service, and should be linked to the AER's classification of services.

However, as currently drafted there are a number of unregulated services which are captured by the definition of distribution services<sup>13</sup> which may not be appropriate for the DNSP to provide due to the potential for competition. Consequently, there is a need for the AER to undertake a further assessment of which services should be allowed to be provided by the DNSP without legal and functional separation, and which services should be provided by a related body corporate and fully ring fenced from the DNSP.

We consider that this is necessary in order to achieve the AER's policy intent of clearly delineating regulated services from contestable and/or contestable services in a manner which does not inadvertently capture services where there is limited or no capacity for these services to be provided by the market, or where the service is incidental to the provision of distribution services.

For example, under Ausgrid's current distribution determination the AER has decided not to classify emergency recoverable works. Under the current drafting of the Guideline, Ausgrid would not be able to utilise its staff to provide this service and would instead need to provide this service through a

<sup>12</sup> Whilst not represented in the diagram, regulated transmission services are also able to be provided by the DNSP without needing to comply with any ring-fencing separation requirements.

<sup>13</sup> For example services that require the use of shared assets, existing distribution services that the AER has chosen not to classify, and new services not identified at the time of the AER's service classification decision.

related body corporate or obtain it competitively through the market. The nature of this service makes it difficult to outsource, and may involve restoration work that only DNSP staff are authorised to perform. Requiring this work to be performed by a third party will significantly increase outage and restoration times and has no associated benefit to customers as there is limited or no capacity in the market to provide these services.

Another example of services that may be inappropriately captured under the drafting of the current Guideline is where Ausgrid is requested to provide engineering consulting advice for the construction of major infrastructure affecting highly complicated electricity network environments like the Sydney CBD. These services, while energy related, have no or very limited competition due to the highly specialised nature of the advice. Under the current drafting of the Guideline, Ausgrid would be prevented from providing this type of service unless provided through a separate legal entity. However, the issue with this is that the skills and expertise required for the advice reside with personnel within the DNSP who would ordinarily perform activities relating to the provision of direct control services. Consequently, our understanding is that under the current drafting of the Guideline, Ausgrid would not be unable to provide this type of services to customers unless a waiver was granted, despite the fact that Ausgrid was not actively pursuing work of this nature, and there existed limited or no capacity for the market to provide this type of advice. The time and uncertainty involved in seeking a waiver may make it unfeasible for Ausgrid to continue to provide these kinds of services.

As illustrated in Figure 1, we propose that services which are unclassified distribution services or services which are not distribution services should be further examined to determine whether there is sufficient competition to warrant the need for the service to be provided through a related body corporate. Where it is determined that there is no or limited competition, the service should be able to be provided by the DNSP subject to accounting and non-discrimination obligations under the Guideline. Where there is the potential for the service to be provided on competitive basis, the AER should further consider whether or not the service is incidental or immaterial in nature and therefore warrants allowing the DNSP to continue to provide the service subject to accounting and non-discrimination obligations.

Where there is the potential for competition, Ausgrid consider that a further test should be applied to determine whether the electricity related service should be subject to legal separation and all ring-fencing obligations are material.<sup>14</sup> However, as noted in section 2.4, we consider that the AER's current materiality threshold of \$500,000 in costs of providing non-distribution services is too low and would have the effect of requiring all unregulated services to be provided by the related corporate. To address this issue we propose that materiality is assessed on a per service basis, per annum at an increased level. We consider that an appropriate materiality threshold would be to allow DNSPs to provide energy related services where the cost of providing the service is less than \$2million in costs per annum, assessed on a per service basis.

Ausgrid considers that this approach avoids the unintended consequences identified with the current drafting of the Guideline noted in section 2 of our submission and provides greater certainty to DNSPs regarding the intended scope and application of the Guideline to services. In practice, we consider that this would work by the DNSP notifying the AER of services which are unclassified distribution services or energy related services that should be allowed to be provided by the DNSP without being subject to the full suite of ring-fencing obligations, with the onus on the DNSP to satisfy the AER that services satisfy either the principle based competition test or are not material.

Ausgrid considers that these amendments would significantly improve the effectiveness of the Guideline and simplify its practical application so that the Guideline is targeted to those services where there is a potential for anti-competitive outcomes and do not impose unnecessary costs for customers. Importantly, we consider that our proposed approach will reduce the risk of misinterpretation by stakeholders on the scope of ring-fencing obligations that apply to services.

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<sup>14</sup> Subject to the need for any waivers due to the unique nature or circumstances that make it inappropriate for all ring-fencing obligations to apply.



## 4. Comments on other aspects to the Guideline

In addition to the concerns on the interpretation and application of the Guideline, Ausgrid would like to raise further comments on other aspects of the Guideline and have also included our suggested amendments to address these matters, or have sought to highlight where further areas of the Guideline would benefit from further guidance and/or clarification from the AER.

### 4.1 *Functional separation through separate buildings is unnecessary*

The functional separation obligation for physical separation under clause 4.2.1 (a) should be re-expressed as separate location instead of the proposed separate building. The AER objectives for adequate separation of staff can be achieved through expressing the obligation as separate locations which will avoid any unnecessary costs associated with having related bodies operate in separate buildings.

While we understand that the AER is concerned that allowing the DNSP and staff of the related body corporate to co-exist in the same building may create the perception that this may give rise to the risk of inappropriate information sharing Ausgrid considers that this can be mitigated by appropriate access restrictions and by the operation of the non-discrimination provisions under clause 4.1. We do not consider that there is any unfair competitive advantage gained by permitting a related body corporate to operate from the same buildings as the DNSP entity, as the related body corporate will still be required to pay rent and associated costs on a commercial basis and required to have separate branding. This is similar to any other commercial arrangement where floor space in a building owned or leased by the DNSP is tenanted out to other companies.

Ausgrid is concerned that maintaining the current drafting of this obligation will increase DNSPs costs in complying with its obligations unnecessary, resulting in increased costs for electricity customers without providing any offsetting benefit.

### 4.2 *Compliance, monitoring and enforcement provisions are too stringent*

Ausgrid notes that the Guideline makes reference to the AER's ability to issue Regulatory Information Notices (RINs) in clause 3.2.1. However, we consider that this clause should be removed from the Guideline to the extent that they are duplicative of NEL provisions and further appear outside the scope of the AER's powers under rule 6.17.2 of the NER.

Ausgrid considers that aspects of the proposed compliance and enforcement arrangements in clause 6 of the Guideline are not appropriate given the nature of the ring-fencing obligations.

In our view, the requirement to notify the AER within 5 business days of compliance breaches is inappropriate for the kind of obligations to which the Guideline relates and, could be considered to be outside the scope of the AER's powers under rule 6.17. We consider that a compliance requirement of this nature should be supported by an express power, as is the case with similar regimes (for example, the reporting regime under the National Energy Retail Law). Ausgrid notes that it does not appear that the AER is imposing the reporting requirement under its monitoring and reporting obligations in NER rule 8.7.

Further, neither rule 6.17 nor Chapter 6 of the NER explicitly confer on the AER a specific power to impose compliance reporting on a DNSP in respect of ring-fencing obligations or economic regulation of distribution services generally.

While Ausgrid understands the need for the AER to monitor and enforce compliance with the Guideline, Ausgrid considers an annual reporting obligation is a proportionate mechanism for the obligations contained in this Guideline. As drafted, the obligations contained in this Guideline are difficult to implement, as some breaches may be difficult to uncover and rectify. For this reason, a five business day reporting obligation is also not appropriate.

### **4.3 Information obligations are inconsistent with existing legislation**

Ausgrid supports the need to ensure that DNSPs treat and protect information it has acquired through its regulatory functions accordingly and does not use its position to provide its related body corporates with an unfair advantage. However, we consider the purpose of the information disclosure requirements should be to support the other ring-fencing obligations contained in the Guideline taking into account existing information disclosure obligations contained in other electricity regulatory instruments and at general law. On this basis, we consider obligations that replicate existing requirements should be deleted and other requirements should be clearly linked to the related ring-fencing obligation.

Specifically we recommend that:

- a) clause 4.3.1 is deleted as it replicates DNSPs' existing obligations in relation to confidentiality contained in the National Electricity Law, National Electricity Rules, National Energy Retail Law and National Energy Retail Rules;
- b) clause 4.3.2 be drafted so the obligations are consistent with the other ring-fencing obligations where the information separation should be between direct control services and the services which the Guideline requires to be ring-fenced (i.e. services being provided by the related body corporate); and
- c) clause 4.3.3 is deleted as it is also directed at the treatment of information generally and is considered unnecessary for similar reasons to why clause 4.3.1 should be deleted.

Ausgrid has proposed specific drafting amendments to the information access and disclosure obligations in the Guideline to reflect the recommendations outlined above. We consider the proposed amendments to be better targeted at giving effect to the policy objectives the AER is seeking to achieve than the current drafting.

### **4.4 Treatment of research and development expenditure**

We consider that the AER needs to consider further and provide explanation on the treatment of research and development expenditure relating to network activities. While we understand that the AER's intention is for such expenditure not to be captured if it is incurred in relation to distribution services, we question whether this will work in practice due to the following distinction between research expenditure and development expenditure under Australian Accounting Standards:<sup>15</sup>

- Research expenditure is expenditure on original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding. The commercial feasibility and practical application of that knowledge cannot normally be determined in advance.
- Development expenditure comprises expenditure on the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.

The implications of this are that DNSPs will need to anticipate in advance whether research will produce results that can be applied to only regulated or non-regulated services. This may not be realistic. They will also face significant disincentives or risk of non-compliance, in sharing that information or collaborating with the staff of a related body corporate to undertake research. This would not promote improved service outcomes for customers or competition in competitive markets.

Clause 4.3.2 of the Guideline would oblige a DNSP to make that research available to competitors thereby deterring a DNSP from undertaking research that may in whole or in part have the potential for wider benefit. This is especially significant in an environment of new and emerging technologies.

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<sup>15</sup> Australian Accounting Standards Board – Standard 138, intangible assets, paragraphs 31 to 64.

Similarly where developments can be more effectively and efficiently undertaken jointly for regulated and non-regulated services, customers would be denied the benefits from such arrangements.

Consequently, understanding how research and development expenditure will be treated by the Guideline is not a straight forward task and requires further consideration and guidance from the AER.

#### 4.5 Areas requiring further clarification

The following table sets out the aspects in the Guideline which require further guidance and/or clarification by the AER. Clarification of these issues would provide DNSPs with a clearer understanding of their obligations under the Guideline and lower the risk of misinterpretations.

Clause reference	Issue	Clarification
Not applicable	Under Ausgrid's current determination, type 5 and 6 metering services are classified as alternative control services, and hence meet the definition of a distribution service. While the AEMC metering contestability rule will commence from 1 December 2017, it is Ausgrid's understanding that this classification will remain in place until 1 July 2019.	Ausgrid seeks clarification from the AER that such metering services can continue to be provided by the DNSP in the same legal entity and will not be subject to any separation or non-discrimination obligations for the remainder of this current regulatory period.
Clause 4.1(b)(vi)	There is no guidance in the Guideline as to what is meant by 'independent and separate branding' and the Explanatory Statement provides minimal assistance.	The term "brand" is not as legally clear a concept, Ausgrid requests guidance on what in practical terms may be considered to constitute a "brand" and whether, the separate legal entity could for example, use any or all of the colours, logo or wording fonts and styles of the DNSP.
Clause 4.1(b)(ii)	Ausgrid is concerned that this obligation may be interpreted as requiring DNSP to treat competitors on an equal basis and offer the same commercial terms to all competitors. This may undermine DNSPs ability to negotiate commercial outcomes to the benefit of customers.	Ausgrid seeks clarification that this obligation does not require DNSPs to deal with competitors on substantially the same commercial terms as its related body corporate but is aimed at ensuring that DNSPs provides competitors and their customers access to its infrastructure on a similar basis as its related body corporate.
Clause 4.1	While the Guideline does not require 'arm's length' dealing under clause 4.1, the Explanatory Statement suggests this is required.	Our interpretation of this requirement is that DNSP and its related body corporate are required to act independently and in a way that does not favour the related body over other market participants. Ausgrid seeks further guidance on what behaviours would constitute an arms-length relationship to assist in complying with this obligation.
Clause 4.2.2(a)	Clauses 4.2.1(b)(ii) and 4.2.2(b)(iii) of the Guideline create exceptions to physical separation and separate staffing requirements for staff who are 'not directly involved' in the provision of direct control services or regulated transmission services.	Ausgrid requests that the AER provides further guidance in relation to when staff might be considered to be 'directly involved' in the provision of services and how this requirement relates to contractors and consultants.
Clause 4.3.2	The drafting of the information sharing obligation is very broad.	Ausgrid seeks further guidance on how DNSPs would comply with this obligation in practice. For example, is the requirement subject to any considerations of materiality or relevance or is it an absolute requirement.
Not applicable	It is currently unclear how the Guideline will treat new services which emerge during the regulatory period and do not fit into a current service classification.	Ausgrid seeks guidance on how new services will be treated.