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Dear Mr Pattas

RE: Electricity Ring Fencing Guideline – AER Preliminary Positions (Reference 46484)

Ausgrid welcomes the opportunity to provide comments in response to the Australian Energy Regulator's (AER's) Preliminary Positions Paper ("positions paper") on the establishment of a national ring fencing guideline (or "guidelines").

Ausgrid strongly supports the policy objective for developing national ring fencing arrangements. We recognise that jurisdictional ring fencing arrangements have not kept pace with changing market and technology developments. This coupled with the fact that existing arrangements vary in terms of scope and obligations from jurisdiction to jurisdiction, has lessened their suitability and effectiveness at targeting the potential for anti-competitive behaviour.

Consequently, Ausgrid agrees that there is a need for ring fencing arrangements to be recalibrated, as part of the establishment of a national ring fencing regime. We consider that this will be particularly important in light of the Australian Energy Market Commission's (AEMC's) decision to open metering and related services to competition, and the falling price of battery storage technology - where we note there is a growing concern from stakeholders that network service providers (NSPs) operating in these markets may have the ability or incentive to engage in anti-competitive behaviour that distorts competition in these new and emerging markets.

Whilst Ausgrid supports the development of robust ring fencing arrangements we do not consider that "robust" equates to stringent and prescriptive measures. Rather, we consider arrangements are likely to be "robust" and effective if they are appropriately targeted at avoiding market distortion, proportionate to the risk of harm occurring, provide clear guidance, and capable of being monitored and enforced.

Ausgrid disagrees with stakeholder views that without stringent ring fencing requirements distribution network service providers (DNSPs) will have an incentive to engage in anti-competitive behaviour when participating in competitive markets. As noted in our attached submission, there are a number of mechanisms that prevent anti-competitive behaviour such as cross subsidisation, information sharing, and discriminatory practices - most notably the provisions in the National Electricity Rules (NER) regarding cost allocation and related party dealings (Chapter 6), access to and protection of consumer data (Chapter 7), access arrangements (Chapter 5 and 5A) and section 46 of the *Competition and Consumer Act 2010 (Cth)* (Competition Consumer Act) which addresses competition issues associated with the misuse of market

power. Ausgrid takes its compliance with these legislative and regulatory obligations seriously, and has in place comprehensive compliance and training programs to ensure that it does not breach its obligations. Ausgrid's compliance with its regulatory and legislative obligations is regularly monitored and reported.

While the preliminary position to apply a broad stringent "one size fits all" approach to ring fencing appears to be in response to stakeholder concerns, we do not believe that such an approach is appropriate for the following reasons:

- ***it misconstrues the AEMC's policy direction on ring fencing*** - the AER places undue emphasis on the need for strict ring fencing provisions without having regard to the ring fencing factors developed by the AEMC that were intended to provide guidance to the AER on developing appropriate ring fencing obligations;
- ***it is based on misconceived and/or unsubstantiated problems*** – the AER makes note of several problems that necessitate the need for stringent ring fencing measures, however these issues appear to be largely overstated or misconceived when considered in light of other elements of the regulatory framework, as explained in section 1 and Appendix C of our submission;
- ***it imposes obligations which are disproportionate to the risk of harm occurring*** – in reaching its decision to impose onerous ring fencing obligations by default, adequate regard has not been given to existing safeguards that address the potential for anti-competitive conduct, nor aspects of existing ring fencing arrangements which have been effective in promoting competition;
- ***it fails to have appropriate regard to the costs associated with its proposed obligations*** - the AER assumes that its proposed ring fencing obligations will have a net public benefit without undertaking any analysis of their likely costs, or consideration of alternative measures that could be imposed to achieve the same outcome, which are more cost effective;
- ***it is likely to have an adverse impact on customers*** – as it reduces the benefits to customers from DNSPs having economies of scale and limits customers choice; and
- ***it gives rise to a number of practical implementation issues*** – we are concerned that managing the prescriptiveness of the obligations via waivers is likely to become unwieldy and burdensome for both the AER and DNSPs.

The above issues have culminated in ring fencing obligations which are neither fit for purpose nor appropriate. We are concerned that the proposed ring fencing obligations are unlikely to be effective in achieving the guidelines objectives, and are instead likely to distort (rather than protect) efficient outcomes and result in outcomes contrary to the National Electricity Objective (NEO). Specifically, we are concerned that the proposed obligations (as currently drafted) give risk to the following unintended consequences:

- distort efficient investment decisions – by constraining the ability of DNSPs to pursue least cost solutions to improve its productivity and utilisation of its assets;
- artificially constrain the level of competition in the market and stifles innovation– by discouraging DNSPs from participating in the market;
- distort efficient outcomes – by picking "winners" in the market as opposed to letting market forces determine who wins and fails; and
- result in higher prices to consumers – by removing natural economies of scale from some market participants and not others, coupled with the ability to appropriately share costs will prevent DNSPs from being able to provide regulated customers electricity services and potentially unregulated services at a lower price.

Our submission discusses the above issues with the AER's approach in more detail. In addition, our submission notes the importance of the guideline containing appropriate transitional provisions, given the shift to a national approach and the increase in the guidelines scope that will capture services that were previously not subject to ring fencing.

Ausgrid hopes that the feedback provided in our submission assists the AER in refining its approach so that it is more proportionate and avoids the unintended consequences we have identified. We look forward to working collaboratively with the AER in its endeavours to develop robust ring fencing arrangements that support competition and promote the NEO.

Yours sincerely



TREVOR ARMSTRONG
Acting Chief Executive Officer

Submission on Electricity Ring Fencing Guideline – AER Preliminary Positions

May 2016



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Executive Summary

Ausgrid is pleased to provide this submission on the Australian Energy Regulator's (AER's) Preliminary Positions Paper ("positions paper") on developing a national ring fencing guideline ("guideline") for distribution network service providers (DNSPs).

The advent of new smart technologies, the opening up of metering and related services to competition, and the falling price of distributed energy resource(s) (DER) assets and solar photovoltaic (PV) technology are creating new products and services for consumers.

The regulatory framework needs to be fit for purpose for the new energy transformation. Ausgrid believes that any regulation needs to be agile, for example to give greater flexibility to accommodate local energy solutions, demand-side and flexible response services, and storage. In taking the guideline forward, the AER must consider the overall future shape of the energy sector, to foster innovative business models and new products while maintaining effective consumer protection. As noted by the Australian Government Guide to Regulation:

*"regulation is never adopted as the default solution, but rather introduced as a means of last resort...Policy makers must seek practical solutions, balancing risk with the need for regulatory frameworks that support a stronger, more productive and diverse economy where innovation, investment and jobs are created."*¹

In developing the guideline, Ausgrid considers it imperative for the AER to take into account other existing mechanisms currently operating within the wider competition regulation framework as we have done in preparing this response to the AER's preliminary position. In light of this, Ausgrid considers ring fencing to be a supplementary, rather than the primary, measure for protecting customers against the effects of anti-competitive behaviour. The key features of these frameworks are outlined in Appendix 3.

In addition to providing responses to the questions in the positions paper, our submission seeks to provide detailed feedback on the AER's preliminary views on ring fencing. In particular, it seeks to:

- highlight potential problems with the AER's approach so that the AER is able to avoid unintended consequences, for example we are concerned that the AER seems place too much reliance on the waiver process to adapt the guidelines to the particular circumstances. This is impractical and will increase regulatory costs.
- provide a gap analysis of existing mechanisms that protects against potential for DNSPs to engage in anti-competitive behaviour so that the AER is able to determine the appropriate level of ring fencing obligations that should apply under the national guideline;
- provide feedback on the likely costs associated with implementing the AER's proposed obligations and highlight alternative obligations that achieve the same outcome but are less costly and intrusive, for example establish accounting separation and requirements on cross-subsidy and information sharing as the ring fencing obligations. This would be proportionate to the issues as legal, staff, and location separation are not justified, and too costly; and
- outline practical issues which require further clarification in order to improve the workability of the guidelines.

For these reasons Ausgrid would like the AER to:

- Consider existing regulations aimed at protecting consumers and only introduce additional obligations where there is a proven gap and it would deliver benefits to customers.²
- Consider whether the risk of market harm in the service is realistic given the nature of the service, instead of making assumptions on network behaviour.
- Have greater regard to the National Electricity Objective (NEO) in assessing the cost and benefits of its proposed obligations.

¹ <https://www.cuttingredtape.gov.au>

² Refer to Appendix 3.

We consider obligations which are appropriately targeted, proportionate to the risk of anti-competitive behaviour occurring, and capable of being monitored and enforced will facilitate efficient outcomes in these markets by promoting market confidence and supporting the development of competition.

Summary of key positions

1. Ausgrid does not support the underlying premise for the AER's position - specifically we do not agree that robust guidelines must be onerous in order to be effective, nor do we agree that the AER has correctly identified the potential harm that the guideline should be aimed at addressing **(refer to analysis in section 1)**.
2. As the harm that the guideline is aimed at addressing is misconceived and overstated, this has led to the AER applying stringent ring fencing obligations by default. We consider the proposed obligations to be overly onerous and disproportionate to the risk of harm occurring. In particular, we are concerned that:
 - i. obligations (a) to (c) when viewed holistically impose a form of quasi - structural separation, these obligations are likely to impose significant costs upon DNSPs to comply and are likely to have adverse impacts on customers by reducing the benefits provided to customers from economies of scale and limiting customer choice, as well as distorting efficient investment and market outcomes; and
 - ii. obligations (f) to (h) are too broad and unclear, and appear to create considerable uncertainty with respect to their interaction with the well-established privacy principles in operation under the *Privacy Act 1988 (Cth)*.**(refer to analysis in section 2 and response to Question 1)**
3. As the proposed obligations are disproportionate they create scope issues, which we consider are likely to be too unwieldy and burdensome to manage through waivers. We consider a recalibrated approach is required to develop obligations which were better targeted and proportionate to the risk of harm occurring **(see section 4 and 5)**.
4. Ausgrid considers that a more calibrated approach to ring fencing is required. We urge the AER when determining the appropriate level of ring fencing obligations under the guideline to:
 - a) undertake a gap analysis to assess the adequacy of existing mechanisms (both within the regulatory framework and external to the regulatory framework) in protecting against the potential for anti-competitive behaviour to occur; **(see Appendix 3)**
 - b) undertake a cost benefit analysis of obligations, having regard to other alternative measures (including elements of existing ring fencing arrangements which have been working effectively) to determine whether its proposed obligations are proportionate and targeted; **(see section 2 and responses to Questions 3 and 5)**
 - c) determine the underlying driver for stakeholder concerns to ensure that the obligations are targeted and that ring fencing is the most effective mechanism for addressing the concern **(see section 3 and 4)**; and
 - d) tailor the level of obligations imposed under the guideline using broad categories of services (i.e. related businesses, separate services and excluded services) and adopt a layered approach to address scope issues with applying ring fencing to all services which are not classified as direct control services **(see response to Question 3)**.
5. Ausgrid considers that views to restrict asset ownership and sharing is inconsistent with the NEO and undermines other aspects of the regulatory framework **(see section 3)**.
6. Further clarification and guidance is required on a number of aspects of the proposed guideline in order for DNSPs to assess their implications. The guidelines must contain appropriate transitional arrangements to enable compliance **(see section 5)**.

1. Addressing the AER's underlying premises

Ausgrid agrees with the AER and policy makers that robust ring fencing arrangements are required to support the development of competition in new and emerging markets. However, Ausgrid does not consider that ring fencing guidelines necessarily need to be onerous and restrictive for them to be effective, as these concepts are not necessarily synonymous with one another.

Rather, we consider that the guideline is likely to be robust if ring fencing obligations are:

- well targeted at addressing the potential for DNSPs to cause harm to the market;
- proportionate to the risk of harm occurring and deliver a net benefit to the public having regard to the cost the obligations impose; and
- capable of being monitored and enforced.

We note that our view on developing robust ring fencing arrangements contrasts sharply with the approach adopted by the AER in its positions paper. It is our understanding that the AER's preliminary view is that ring fencing requirements must be stringent if they are to be effective and provide confidence to the market.

This position appears to be based on the AER's interpretation of the policy direction provided by the AEMC on ring fencing, and the need to respond to stakeholder concerns regarding the potential harm DNSPs may cause if permitted to participate in new and emerging markets.

However, we note that in reaching its view, the AER appears to focus solely on the potential for market harm without considering: 1) the effects of existing regulatory frameworks on DNSPs; 2) the potential benefits from DNSPs participation in competitive markets; or 3) the potential costs to customers from adopting this approach.

Further, in seeking to respond to stakeholder concerns, the AER may have overlooked the fact that some stakeholders may have an incentive to overinflate or misrepresent the potential for DNSPs to have a detrimental impact on competitive markets. For instance, retailers, third party energy providers and companies seeking to become metering coordinators (MCs) have a vested interest in lobbying the AER to restrict DNSPs' participation in new and emerging markets, as it protects their market share and commercial interests.

Ausgrid is concerned that the above issues have culminated in the AER adopting a preliminary view that is not justified and is based on a number of misconceptions. The following sections are aimed at demonstrating this point and providing evidence that shows that the proposed ring fencing obligations are disproportionate, and likely to have unintended consequences.

1.1 Key assumptions

Ausgrid notes that there are a number of key assumptions underpinning the AER's view for the need for stringent ring fencing requirements. Specifically, we note the AER considers that such an approach is required in order to:

- 1) give effect to the AEMC's policy direction on ring fencing;
- 2) provide confidence to the market;
- 3) restrict DNSPs' participation in new and emerging markets as their participation in these markets is likely to crowd out investment; and
- 4) address unfair advantages that DNSP might seek to leverage from having guaranteed cost recovery and economies of scale.

This section provides analysis of these assumptions 1) and 2) and seeks to prove that these assumptions are misconstrued. Assumptions 3) and 4) are discussed in section 1.2 as part of our analysis on the potential for harm.

1.1.1 AEMC policy direction

It is our understanding that the AER's view that strict ring fencing provisions are required is in part based on its desire to give effect to the AEMC's policy direction on ring fencing. Whilst Ausgrid is broadly supportive of this aim, we are concerned that the AER may have misconstrued the AEMC's policy direction on ring fencing, and in addition place undue reliance on views that have not been properly tested.

We note that the AER's view on ring fencing appears to be based on a very narrow interpretation of the policy direction provided by the AEMC in its advice to the Council of Australian Governments (COAG) Energy Council on the integration of battery storage (battery storage advice) and its decision on the expanding competition in metering rule change.

Ausgrid is concerned that in reaching its view on ring fencing, the AER appears to focus solely on comments made by the AEMC regarding the need for strict ring fencing provisions to provide market confidence without having appropriate regard to the broader policy direction provided by the AEMC.³

While we note that the AEMC makes reference in its advice for the need for strict provisions, this view is qualified by its broader policy direction that the AER consider a series of factors when determining the appropriate level of ring fencing required.⁴ Consequently, the AEMC's view that strict provisions are required, should be considered as a general view (rather than a firm direction) that required further assessment against the factors contained in Recommendation 2.

Specifically, Ausgrid draws the AER's attention to part (e) of Recommendation 2, which directs the AER to consider whether other elements of the regulatory framework adequately address concerns about the interaction between regulated and non-regulated activities, and to also consider whether existing elements provide sufficient protection from concerns, in which case there may be less need for more onerous ring fencing restrictions.⁵

In reaching its position that extensive obligations should apply, the AER has not undertaken the analysis recommended by the AEMC. Rather, it has decided to apply onerous obligations by default and apply Recommendation 2 as part of its assessment on whether or not to grant waivers. We consider that this approach misconstrues the AEMC's policy direction provided in its advice on battery storage.

The AER should have regard to the factors outlined in Recommendation 2 from the outset, as this policy direction was provided for the express purpose of guiding the AER in determining the appropriate level of ring fencing that should apply. The overarching policy intent for Recommendation 2 was to provide the AER with guidance on developing obligations that are fit for purpose and consistent with the NEO. This policy direction was not provided for the purpose of seeking to assist the AER in deciding waivers.

Comments made by the AEMC regarding the need for strict ring fencing must be considered in light of their proper context. Further, broad statements by the AEMC do not obviate the need for the AER to have regard to the costs associated with the measures it has proposed, and whether they are appropriate having regard to existing safeguards that protect against the potential for anti-competitive conduct.

Ausgrid considers that it is vital that the AER undertakes this analysis in order to ensure that the national ring fencing guideline is fit for purpose and consistent with the NEO.

³ AEMC, *Integration of Storage: Regulatory Implications, Final report*, 3 December 2015, Sydney.

⁴ Ibid, refer to recommendation 2, pp 17-18.

⁵ Ibid, p 18.

1.1.2 Promoting market confidence

Ausgrid notes that the AER's proposal to impose onerous ring fencing requirements is in part being driven by the need to promote market and stakeholder confidence in the effectiveness of the guidelines.

Whilst stringent requirements might promote market confidence, this must be carefully assessed against the NEO. Further, ring fencing provisions do not necessarily have to be strict in order to provide confidence to the market. Rather, we consider ring fencing will provide market confidence if obligations are appropriately targeted, and capable of being monitored and enforced.

In Ausgrid's view, it is the monitoring and enforcement of ring fencing obligations that will be the most effective means for delivering confidence to the market. Current concerns driving the perception that there is a need for onerous ring fencing requirements largely stem from the lack of stakeholder confidence in how compliance will be monitored and breaches enforced (as opposed to the risk of harm occurring).

As stakeholders are concerned that there will be a lack of strong monitoring and enforcement of the guidelines (in particular a lack of sufficient penalties for breaches), they have formed the view that onerous ring fencing obligations are required to act as a deterrent for the DNSP to engage in anti-competitive behaviour.

Imposing stringent ring fencing obligations is not an effective solution for addressing this problem. Rather, a more targeted response to this issue is to strengthen compliance and enforcement provisions of the guideline. Market confidence is likely to be promoted if compliance with the guideline is regularly and transparently reported through either the DNSP's annual report or via the AER's annual Regulatory Information Notice (RINs). Any breaches in compliances should also be reported publicly on the AER's and DNSPs respective websites. We consider that the reputation damage associated with the publication of breaches acts as a strong deterrent from engaging in anti-competitive behaviour. Ausgrid also considers that imposing fines for breaches may have merit if this helps to deliver market confidence.

In addition, we note that an underlying driver for stakeholders' lack of confidence in ring fencing in preventing DNSPs from engaging in anti-competitive behaviour is due to the fact that jurisdictional ring fencing arrangements have not be updated since they were first established. Consequently, they have not kept pace with technology and market developments, which have reduced their effectiveness over time. We anticipate that these issues will be addressed as part of establishing national ring fencing arrangements.

1.2 Potential for harm to occur

Ausgrid does not agree with the potential harm identified in in the positions paper. Viewing these issues in light of existing elements of the regulatory frameworks shows that these concerns are either overstated and/or unsubstantiated.

As noted earlier, some stakeholders may have a vested interest in overstating the risk of harm from DNSPs participating in competitive markets. This section is aimed at providing the AER with analysis on the potential for DNSPs to cause harm given existing protections in the regulatory framework. Specific issues examined in this section include:

- whether DNSP participation in emerging markets will crowd out non-regulated investment;
- whether economies of scale give DNSPs an unfair competitive advantage;
- whether DNSPs enjoy guaranteed cost recoveries;
- the ability of DNSPs to influence the price of contestable services;
- the ability of DNSPs have to restrict access; and
- the ability of DNSPs to engage in inappropriate information sharing.

We hope that by demonstrating that the harm the AER is seeking to address through ring fencing is overstated, it will reconsider the need for onerous requirements to achieve the guideline's objectives.

The remainder of this section sets out further reasoning to demonstrate that the presence of DNSPs in these markets will not impede the competitive development of those markets.

1.2.1 Risk of crowding out non-regulated investment

The AER's current position is that onerous ring-fencing requirements are needed to protect consumers from DNSPs utilising assets employed for regulated services to offer related contestable services. In its preliminary position paper, the AER argues that investment in distributed energy resources (DER) by DNSPs has the potential to crowd out investment by competitive third party service providers, therefore having a detrimental impact on the market development of DER services.⁶

We consider that the AER's assessment on the risk of DNSPs crowding out third party service providers for DER services is unfounded and not evidence based. For example, the DER market of solar photovoltaic systems has shown that only a small number of NSPs have been in the solar market.⁷ Across Australia, there has been a large growth in customer installed solar systems increasing from 62,000 solar systems in 2009 to over 1.5 million solar systems by early 2016. These customer-driven purchases have been supplied almost entirely from specialist solar companies and electricity retailers.

Energy storage devices at a customer's premise is a new and emerging market but based on the early customer battery product offerings it could be argued that there is already healthy competition for these DER services from established solar companies and electricity retailers. For example, both Origin Energy and AGL are already marketing battery products to customers as well as many solar companies.⁸ Based on these early indicators, we do not believe it is a high risk that DNSPs or transmission network service providers (TNSPs) will crowd out competition in the DER services market and have a detrimental impact on the market development of DER products and services.

The three options given in the DNSP energy storage case study in the positions paper are examples of how a DNSP might consider using DER assets as an alternative to a traditional network investment. These are just three possible options, and as noted by the AER:⁹

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

Ausgrid considers that it is important that DNSPs have the flexibility to consider all possible options rather than being constrained to only obtaining DER services through third parties. This is because purchasing DER services through a third party may not always be viable or represent the least cost solution to a network need for the following reasons:

- The duration which DNSPs can enter into contractual agreements with third party providers could be constrained by the length of the regulatory period. The asset life of DER assets will be longer than the five year regulatory period. However the DNSP's ability to enter into long term procurement contracts which pay for the cost over the asset life, will be constrained by the requirement for such expenditure to be re-assessed at every determination, and hence by the prospective risk of the AER dis-allowing the expenditure.
- This constraint on DNSPs will affect the price and the appetite for third party providers to offer such services to DNSPs.
- There will be additional administrative and transaction costs of having to negotiate contracts with third party providers. The DNSPs will have to ensure that the contracts for DER related

⁶ AER, *Electricity Ring-Fencing Guideline: Preliminary positions*, April 2016, p 24.

⁷ Ausgrid notes that Powercor and SA Power Networks are actively involved in the solar PV market and have a number of PV related project. We are also aware that Transgrid is considering exploring opportunities in this market.

⁸ Ausgrid also notes that AusNet Services is also undertaking a trial in Victoria relating to battery technology.

⁹ Ibid.

services enable it to provide the regulated services consistent with its reliability and service quality obligations. There could be differences in the operational certainty and delivery of the service under the third party provider option compared to the option of DNSP investing in the DER asset itself.

The regulatory framework includes schemes such as the Demand Management Incentive Scheme (DMIS) and Demand Management Innovation Allowance (DMIA) and Chapter 5 of the National Electricity Rules (NER) which sets out the obligations for NSPs to consider non-network options to address network limitations. In addition, any investment by DNSPs in such assets for direct network services will be subject to the expenditure efficiency arrangements under Chapter 6. These provisions require a DNSP to consider the potential for non-traditional alternatives such as the use of network or customer owned DER to form part of the least cost solution for a network need. Any ring-fencing guidelines should ensure that additional barriers to the consideration of non-traditional alternatives are not inadvertently created for DNSPs or conflict with the existing regulatory framework.

It is also important to note that the reasons for a DNSP investing in DER assets, and how the asset is used, will be quite different from the motivation and use of DER assets by customers. They are not the same and therefore DNSP investment in DER assets should be viewed as additional to, and not a substitute for, customer-driven purchases of DER services. Consequently, regulated investment in DER assets for specific network services should not impede customer choice in DER services.

Without strong evidence to support the argument, we question whether there is risk of DNSPs crowding out investment in DER services. Furthermore, seeking to restrict or constrain DNSPs ability to invest in DER assets or explore ways to improve the utilisation of its assets is not consistent with the NEO.

1.2.2 Economies of scale do not necessarily confer an unfair advantage

A DNSP's size and regulated functions do not necessarily provide it with an unfair advantage over competitors, nor impede the development of competition in new or emerging markets.

Specifically, we note that the Competition Consumer Act does not prohibit a corporation from having substantial market power. Rather, section 46 only prohibits a corporation which has such power from taking advantage of that power for a proscribed anti-competitive purpose.

Large firms with natural economies of scale seeking to diversify into new markets are not a circumstance that is limited to the electricity industry. There are a number of examples of large firms diversifying into new services (for example, Apple into financial services via ApplePay, Coles and Woolworths offering insurances products) and their doing so does not mean there will be a detrimental impact on competition in these markets.

Economies of scale do not of themselves confer an unfair advantage as demonstrated by other large businesses such as Coles or Telstra who have entered contestable markets relating to emerging technologies.

In the energy sector itself, we note that many smaller players are able to operate in the energy retail market despite the presence of three major dominant players (Origin, AGL and EnergyAustralia) that arguably have strong economies of scale. Ausgrid is not disputing that ring fencing is required to address the specific risks that arise at the intersection of monopoly and contestable services. Rather, we question whether the objectives seeking to remove the DNSPs ability to use any natural economies of scale or scope are necessary or appropriate.

Previously when DNSPs were vertically integrated regulators did not take the approach of removing the natural economies of scales and scope as they recognised this delivered consumer benefits in terms of lower costs. The AER's proposed approach of restricting or removing the economies of scale may result in regulated customers experiencing electricity price increases as the portion of shared costs that was previously borne by the unregulated business would need to be moved back to standard control services. The costs associated with loss of synergies can be significant. When Ausgrid (formerly EnergyAustralia) retail business was sold in 2012, the costs associated with the loss of synergies in

having shared billing and IT systems, Contact Centre, and support services amounted to approximately \$37million.

Other market participants possess similar economies of scale

With respect to contestable metering, an indicator that economies of scale do not automatically confer an unfair advantage against other competitors is that a large number of competitors in this market will likely be retailers or have an affiliation with a retail business. Examples of this are Active Stream (AGL's contestable metering business) and Acumen (Origin Energy's contestable metering business). Their existing large retail customer base provides a ready market into which they can sell their contestable metering services. Both AGL and Origin are ASX listed entities in the largest 40 companies in Australia by Market Capitalisation. Whilst these organisations are not distribution network businesses, they are both vertically integrated organisations with large retail and generation arms, and have the option to access additional capital through their ASX listing. There is a strong argument that scale and scope benefits available to Ausgrid are similarly available to Origin and AGL, and hence their related businesses. These companies have a vested interest in lobbying the AER to restrict DNSPs participation in new and emerging markets, as it protects their market share and commercial interests.

Further, it should be noted that for DNSPs seeking to enter contestable markets, their lack of an existing direct relationship with customers places them at a competitive disadvantage compared to other large businesses. DNSPs do not have the same retail infrastructure or marketing channels, nor are they able to offer the advantages of combining services for customers as other businesses that have an existing direct relationship with customers. For example, other businesses seeking to compete in contestable markets are likely to have:

- Customer Relationship Management System and associated real time analytics to enable up selling products and services during customer calls – Ausgrid does not have any such systems;
- Contact Centre that have capacity to take multiple business streams calls – Ausgrid's Contact Centre was scaled down from 350 down to 50 staff post retail sale, and therefore only has capacity to respond to distribution related calls; and
- Online customer portal – Ausgrid does not have the capacity or the capability for online web portal for customers accessing their data and billing information.

Consequently, Ausgrid fails to see the need to restrict DNSP's natural economies of scale when retailers enjoy similar advantages from being vertically integrated. Rather, imposing onerous ring fencing to try and remove DNSP's natural economies of scale is in itself likely to stifle (rather than promote) competition. This is because DNSPs will not be constrained to operate only within their network boundaries, and will be free to compete against DNSPs in addition to other retailers and energy service providers. Having DNSPs in the market is likely to result in more competition rather than less.

Ring fencing does not need to be heavy handed to be effective

The NSW experience with contestable connection services demonstrates that heavy handed regulation is not required to enable competition. Rather, it shows how competition can flourish with less regulatory intervention as this allows market forces to determine the competitive mix in the market.

In NSW when contestability was first introduced, the Independent Price and Regulatory Tribunal (IPART) did not impose heavy handed regulation that prevented DNSPs from seeking to compete in this emerging market, nor did it seek to unduly restrict DNSPs from utilising their natural economies of scale. IPART decided to adopt a light handed and principle based approach to ring fencing that imposed targeted measures at preventing DNSPs from seeking to engage in anti-competitive behaviour. IPART decided that adopting this approach was appropriate having regard for the potential for harm to occur and its assessment of existing elements of the regulatory framework that protect against anti-competitive behaviour.

Despite a lack of onerous ring fencing provisions, the market for contestable services has developed to the point where there are over 1742 Accredited Service Providers (ASPs) accredited with the NSW Department of Industry.¹⁰

The ASP Scheme has been in operation in NSW for over 20 years.¹¹ Over that timeframe Ausgrid has participated in the contestable market for connection in varying degrees. In 2014-15 financial year Ausgrid undertook approximately 1% of Level 1 ASP reported contestable work; 2% of ASP Level 2 contestable work; and less than 1% of Level 3 ASP contestable work.¹²

Ausgrid's low level of participation in the contestable market is result of a commercial decision based on our assessment of our ability to compete and appetite to pursue commercial opportunities in this market rather than an outcome that was pre-determined by regulation.

Onerous ring fencing restrictions on DNSPs will have a distortionary effect on competition. Importantly, it may have the effect of picking "winners" and "losers" in markets by imposing additional compliance costs on DNSPs that hamper their ability to compete. Not only does this have the potential to artificially stifle the level of competition in the market by discouraging DNSPs participation, it also distorts efficient outcomes by not allowing competitive forces to determine who succeeds and fails in the market. This is likely to result in the costs of some services being higher than necessary, while other services will not be offered because it is not commercially viable to do so. It follows that imposing unnecessary ring fencing obligations in order to remove a participant's economies of scale will distort efficient market outcomes and likely give rise to outcomes inconsistent with the NEO.

1.2.3 DNSPs do not enjoy guaranteed cost recovery

Ausgrid notes that the AER's view that onerous ring fencing requirements are required is largely in response to stakeholder concerns that distributors enjoy 'guaranteed cost recovery' in the provision of regulated services, and this will provide an unfair competitive advantage in the provision of contestable metering and related services.

Ausgrid considers that this view is misplaced, as current regulatory arrangements prevent cross subsidies between regulated and unregulated activities, and do not provide 'guaranteed cost recovery' in relation to monopoly services.

Ausgrid's recent experience with its regulatory determination demonstrates this point. Our proposed revenue to recover our efficient costs in providing regulated service for the 2014-19 regulatory control period was reduced by 33% by the AER on the basis that it was inefficient. This highlights that DNSPs do not enjoy guaranteed cost recovery.¹³

The building block revenue requirement takes into account on a prospective basis the costs of a prudent and efficient provider. DNSP's costs are also assessed by the AER on an ex ante basis with capital expenditure also assessed on an ex post basis under the Capital Expenditure Sharing Scheme (CESS). Therefore, there is limited opportunity to 'pass through' actual costs to customers as the economic regulation of DNSPs under Chapter 6 of the NER is designed to allow DNSPs to recover their "efficient costs" from customers.

Further, if the concern is that a distributor will engage a related party to provide metering services and recover those costs through its regulated revenue, regard must be had to existing elements of Chapter 6 that address the potential for preferential treatment of related parties. Specifically, we note that in deciding whether to approve distributors proposed operating and capital expenditure, the AER must

¹⁰ Data sourced from NSW Department of Industry accreditation list 5 May 2016.

¹¹ The NSW Government introduced contestability for particular electricity distribution network connection services in 1995. The legislative framework established to support contestability includes a scheme to accredit businesses that are qualified to provide these services (the ASP Scheme), which is administered by the NSW Department of Industry.

¹² Refer to Ausgrid, *Electricity Network Performance Report 2014/15*, 24 November 2015.

¹³ See AER, *Final Decision Ausgrid distribution determination – Fact Sheet*, 30 April 2015, p 1.

explicitly have regard to related party expenditure and whether this has been incurred on an arm's length basis.¹⁴

We note that strict regulatory provisions governing the treatment of contracts between related parties have been developed through a number of regulatory reviews. For example in a report on this issue for the AEMC in 2012, it was noted that the arrangements should be regarded as robust¹⁵:

“There will be a high evidentiary burden on NSPs that use related parties but do not conduct competitive tenders to demonstrate that their contracts are consistent with arm's-length terms. In particular, evidence will need to bear directly on the pricing terms and not be confined to generalised efficiency arguments, benchmarking, or comparisons against internal guidelines for dealing with related parties.”

In light of the above analysis, Ausgrid considers that stakeholder concerns regarding distributors enjoying guaranteed cost recovery are misplaced and unsubstantiated. The regulatory regime already provides appropriate safeguards associated with procuring services either in-house or from a related party and addresses the potential for cross subsidisation through the Cost Allocation Principles, AER Cost Allocation Guideline and the DNSP's approved Cost Allocation Method (CAM).¹⁶

1.2.4 Risk of DNSPs influencing the price of contestable services.

Ausgrid considers that DNSPs do not have scope to influence the price of contestable services to the detriment of competition in these markets. . There is sufficient protection under the existing NER arrangements and the Competition and Consumer Act to prevent cross subsidisation without resorting to onerous ring-fencing. In addition, the AER has sufficient information gathering powers to monitor the behaviour of network operators and their conduct in contestable markets.

The cost structure of such services can be considered to comprise three components: a) capital costs of the asset b) installation costs and c) operation and maintenance. The majority of the costs are likely to be in the capital costs associated with purchasing the assets.

These three cost components will be determined by market forces, and it is not clear how a DNSP could use its regulated position to control such costs. For example, for solar PV installations and battery storage assets, the capital costs will be set by the manufacturers of such assets and international market conditions. DNSPs do not have any advantage with respect to the procurement of such assets compared to other businesses. Any competing service provider can make a commercial decision to buy in bulk and gain economies of scale.

Similarly for installation and operational costs, there is a ready supply of such skills in the market available to any service provider. Numerous electrical contractors compete in these services, especially in jurisdictions with contestable connection arrangements. For example, around 4,500 individuals have been accredited by the Clean Energy Council to install solar PV units. Therefore we question any inference that DNSPs have a monopoly on electrical skills.

DNSPs cannot influence the costs which are available to other competitive providers and therefore cannot use their regulated position to limit competition in such markets.

As explained above, the existing regulatory arrangements prevent any cross subsidisation of contestable services and therefore DNSPs cannot price at below costs in contestable markets in order to create a barrier to entry. In Appendix 2, we set out how Ausgrid complies with its Cost Allocation Principles in the NER and its Cost Allocation Method to prevent cross subsidisation occurring between regulated and unregulated.

¹⁴ See clause 6.5.6(e)(9) and 6.5.7(e)(9) of the National Electricity Rules (NER).

¹⁵ Covec Ltd, *Analysis of the Use of Related Parties by Electricity Network Service Providers – Report for the AEMC*, June 2012, p 15.

¹⁶ Refer to Appendix 3 for an explanation on how the application of Ausgrid's CAM mitigates the risk of cross subsidisation between regulated and unregulated activities.

Further, the existence of a regulated revenue stream based on an efficient regulated rate of return for the provision of regulated services, does not equip a DNSP to shoulder the additional risk of competitive, non-regulated services.

1.2.5 Risk of DNSPs restricting access or the quality of contestable services

Ausgrid questions whether there exists a credible risk that DNSPs can restrict access to, or the quality of, contestable services given the operation of existing access arrangements under the NER.

For some of the new emerging services, network connection and access will not dictate the quality of the services (i.e. battery and solar PV service without any export capability, load management technologies), while for other services, network access and connection will be an input to the quality of the services. For such services, existing arrangements under Chapter 5 and 5A of the NER, which set a clear and transparent process for connecting to the network, will prevent any misuse of regulated services by a DNSP to prevent competition in contestable markets. Consequently, under these arrangements Ausgrid (or any DNSP for that matter) is required to provide the same open access arrangements to all connection applicants. Ausgrid has a number of standardised connection agreements on its website for differing types of connections, and in addition publishes information on the connection process including standards and connection costs.¹⁷ This information provides greater guidance and transparency on connecting to Ausgrid's network and ensures that access is provided on an equal basis to customers and other market participants.

Concerns regarding AS/NZ 4777

Ausgrid notes that some stakeholders have expressed concerns regarding DNSPs restricting access through the imposition of technical requirements, specifically that the connection must comply with AS/NZ 4777. AS/NZ 4777 is the only Australian industry standard covering the application of inverters and as such it is reasonable for a DNSP to adopt this standard as it allows for connections to be processed in a more streamlined manner due to the standardisation of technical requirements. The technical requirements included in AS/NZ 4777 have been developed with the input from all industry and regulators.

We note that stakeholders appear to be concerned that the revised version of AS/NZ 4777 may give DNSPs the ability to control the operation of inverters that connect storage systems to the distribution network and that this may present a barrier to customers control over the operation of the storage device.

Ausgrid considers that stakeholder concerns regarding AS/NZ 4777 and the potential for DNSPs to control the device is essentially unfounded and may arise due to the lack of clear parameters in the NER regarding the circumstances in which the DNSP may control an inverter. We consider that any stakeholder concerns are more effectively addressed through clarifying the rule provisions in Chapter 5A of the NER rather than through the imposition of stringent ring fencing obligations.

It is not best practice to address a perceived failure in one area of the regulatory framework with the imposition of another regulation. We consider that clarifying and enforcing the current rules regarding connection arrangements would be more effective in providing confidence to new market entrants and militate against perceptions that NSPs are in a position to unfairly restrict access to their network.

1.2.6 AER information requirements unduly penalise DNSPs compared to other businesses

The AER has identified that one of the objectives of the ring fencing guideline is to avoid a DNSP providing a preferred or related party with an unfair advantage in offering contestable services that stem from information acquired in providing a regulated service. We support this objective.

¹⁷ <http://www.ausgrid.com.au/Common/Customer-Services/Business-and-commercial/Connecting-to-the-network.aspx>

What is missing from the position paper is the analysis to establish the case with respect to specific information flows within specific contestable markets. This missing analysis creates a gap between the objectives and the AER's preliminary positions which are therefore without reasoned foundations.

The possibility of DNSPs using such information in an anti-competitive manner is constrained given the arrangements under the NER. Additionally, existing provisions of the Privacy Act already constrain personal information from being used or disclosed for a purpose other than the primary purpose of collection and therefore strongly limit the ability of DNSPs to share customer's personal information with staff not involved in the business function for which the data has been collected.

A series of AEMC rules changes (on metering contestability, access to NMI standing data and customer access to information about their energy consumption) has ensured a common framework for access and use of data which applies to all parties, including DNSPs.

The AER should re-consider its preliminary position on ring fencing within the context of the AEMC rule changes and ensure that DNSPs are not unduly penalised compared to other businesses.

This can be explained with reference to the arrangements for metering co-ordinator (MC) business. Ausgrid is strongly of the view that the obligations on DNSPs that want to operate as metering co-ordinators should be same as those imposed on retailers. The AEMC rule change requires that the two entities – the retailer and the MC - are legally separate. Confidentiality provisions then apply, such that an MC could not pass on a customer's load information to its affiliated retailer.

For DNSPs, the AER's proposal would require the additional requirements by way of ring fencing:

- physical separation – which is more onerous than legal separation; and
- a blanket requirement to make available to the market all information that a DNSP provides to its ring fenced affiliate.

These additional provisions will not deliver benefits to customers and will simply add new costs to the market.

2. AER's proposed ring fencing obligations

This section sets out:

- key considerations that the AER should have regard to in determining the appropriate level of obligations that should apply under the guideline;
- Ausgrid's views on the proposed guidelines, including feedback on the likely costs involved in complying with the obligations; and
- possible implications arising from the AER's approach on other aspects of the regulatory framework.

2.1 The importance of undertaking a cost benefit analysis

Ausgrid is broadly comfortable with the AER's approach to apply a blanket approach to ring fencing via the classification of services. We recognise that adopting a default approach whereby ring fencing is by default beneficial to customers and the development of markets, is a straight forward and pragmatic position for the AER to take.

However, while Ausgrid is broadly comfortable with the AER's overarching approach we have fundamental concerns regarding the level of obligations that should apply by default under the guideline. While it is not incorrect to assume that ring fencing delivers benefits to customers and markets, whether this outcome is actually achieved is dependent upon the nature of obligations that are imposed. This is because if obligations are unduly onerous, restrictive or duplicative they are likely to impose costs that outweigh their associated benefits, resulting in outcomes that are inconsistent with the NEO.

In determining the level of ring fencing that should apply, Ausgrid considers that the AER should:

- identify the potential for anti-competitive behaviour to occur;
- assess this risk of anti-competitive behaviour occurring against existing mechanisms to determine what additional measures are required to protect against the risk; and
- assess the costs associated with proposed obligations against their likely benefits having regard to any other alternatives to ensure that obligations are only imposed if they deliver a net public benefit.

Ausgrid considers adopting this broad approach will assist the AER in developing guidelines which are fit for purpose and consistent with the NEO. Feedback to inform the AER's analysis on steps 1) and 2) is provided in section 1 and Appendix 3. We further note recommendation 2 of the AEMC's battery storage advice also provides useful guidance on the issues the AER should consider when making its assessment under these steps.

This section focuses on providing feedback to the AER on key considerations it should have regard to when undertaking step 3). We have provided this information as we note that in reaching its decision to impose onerous obligations the AER undertook a very simplistic cost benefit analysis that assumed that onerous obligations would benefit customers, and further that the DNSPs could avoid the costs of complying with such obligations by not engaging in activities that are subject to ring fencing.¹⁸

Ausgrid is concerned by this assessment. We question whether imposing onerous obligations aimed at restricting DNSPs ability to compete, or discouraging their participation in competitive markets, is consistent with policy objective for ring fencing -which is to prevent DNSPs from engaging in behaviour that might confer an unfair advantage over competitors from misusing its market power not prevent DNSPs from competing in competitive markets.

In reaching its position that onerous obligations will deliver the best outcomes for customers and the market, it is important to undertake a proper analysis to test the validity of this assumption. On this basis, we are unsure whether the AER lacked sufficient information to undertake a proper cost benefit analysis. Consequently, we hope that the following information provided in our response enables a more informed assessment as to whether onerous ring fencing obligations are required to give effect to the objectives of the guideline.

Ausgrid strongly refutes the assumption that the in the absence of DNSP entry, new and emerging markets will be highly competitive and deliver efficient outcomes for customers. In assuming this, the AER ignores any potential benefits of DNSP entry into such services, and as such fails to balance these benefits against its perceived concerns with NSP's presence in these markets. It is inappropriate for the AER to only have regard to the potential for DNSPs to cause harm without considering the potential benefits that DNSPs participation in markets can provide. As demonstrated by our analysis in section 1.2, there are a number of unintended consequences that are likely to arise if obligations are disproportionate to the harm the guideline is seeking to avoid, including:

- **Distorting efficient investment decisions** – by unduly restricting the ability of DNSPs to pursue least cost solutions to improve the utilisation of their assets the obligations are likely to constrain DNSPs ability to flexibly and innovatively manage their network and meet their licence conditions.
- **Artificially constrain the level of competition in the market and stifle innovation** – by discouraging DNSPs from participating in the market. DNSP participation can increase competition given that DNSPs will not be constrained by their traditional network boundaries in competitive markets and are therefore also competing against one another in the market. Further, DNSP participation in the market also puts additional competitive pressures on large retailers. Increased competitive pressure will drive lower prices and promote innovation, as

¹⁸ AER, *Electricity Ring-Fencing Guideline – Preliminary Positions*, April 2016, p. 31.

service providers will need to be efficient and innovative in order to succeed in the market. Therefore more competition in markets is likely to deliver better outcomes to customers.

- **Reduce customer choice** – DNSPs may be able to provide customers with different service and product offerings than other competitors in the market. Given their different interests and operating structure, DNSPs may seek to position themselves differently to competitors in the market by offering a different product and service mix to customers, thereby promoting increased customer choice.
- **Distort efficient market outcomes** – imposing unnecessary obligations on DNSPs will hamper their ability to compete in competitive markets, and will have the effect of picking “winners” in the market as opposed to letting market forces determine who succeeds and fails in the market.
- **Result in higher prices to consumers** – removing natural economies of scale and scope will constrain DNSPs from being able to pursue strategies to improve their productivity and utilisation of existing assets. Regulated customers will have to pay the full price for assets and bear the associated costs of the asset not being fully utilised, whereas if asset and service sharing were permitted regulated customers would pay a reduced price as a portion of the costs associated with shared assets and staff would be borne by the contestable business. Limiting the ability of DNSPs to share assets would also result in foregone benefits to regulated customers through the Shared Asset Guideline.
- **Scope creep** – imposing onerous obligations where there is no demonstrated need for such obligations may result in regulatory scope creep, whereby obligations under the guideline inadvertently conflict or undermine the operation of other parts of the regulatory framework.

Therefore, we recommend a more comprehensive cost benefit assessment of its proposed obligations.

In determining the level of ring fencing that should apply, the AER must carefully weigh the potential benefits from ring fencing against its costs to ensure that the obligations are not disproportionate or overly onerous in light of the risk the AER is seeking to address.¹⁹ In particular, it is important to recall that the most restrictive ring fencing strategies tend to also impose the greatest cost. For example, while ownership separation is the most restrictive form of ring fencing the costs with this obligation - such as loss of economies of scale and scope, and increased transaction costs – are significant and may make this option uneconomical and inconsistent with the NEO.

As noted by Helm and Yarrow:²⁰

The objective of regulation is to limit the abuse of monopoly power by encouraging entry or threats of entry, and to generate sufficient information to enable monitoring to take place. These objectives should be met without unduly undermining the management incentives towards the creation of comparative advantage through innovation and cost minimisation.

Consequently, there is a need to consider the potential upfront costs and disruption to the business, as well as the ongoing compliance requirements in determining the level of obligations that are imposed by the guideline. We note that the typical ring fencing costs include²¹:

- *Initial set-up costs* – for example, business restructuring.
- *Ongoing operational costs* – This includes compliance and monitoring costs, and losses of economies of scale and scope.
- *Limits on business choice* – This refers to costs incurred by restricting the electricity businesses’ ability to select their own business structure.

The benefits that can be attained by ring fencing must be weighed against the possibility that the guidelines will reduce customer benefits by eliminating existing economic efficiencies and/or imposing

¹⁹ Examples of the type of costs arising from ring fencing include: establishment, administrative and compliance costs, as well as potential losses of economies of scale/scope.

²⁰ Helm, D. & Yarrow, G. (1988). *The Assessment: Regulation of Utilities*. Oxford Review of Economic Policy, 4(2), p.x.

²¹ IPART, *Ring Fencing of New South Wales Electricity Distribution Network Service Providers*, Discussion Paper and Draft Ring Fencing Guidelines, p 4.

additional compliance costs. Without appropriate regard to this, the current approach risks prioritising the protection of market participants who operate in these markets, over the long term interest of customers.

2.2 Assessment of the AER's proposed obligations

Ausgrid notes that the AER's preliminary position is to adapt the obligations under the Queensland Competition Authority's (QCA's) ring fencing guideline. Specifically, the AER has proposed that:²²

A DNSP providing direct control services must:

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

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

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

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

Ausgrid broadly supports obligations (d) and (e). However, overall we find it difficult to provide feedback on the likely costs associated with complying with the proposed obligations as there is little guidance or clarity in the positions paper regarding what compliance with these obligations will entail, or whether the AER plans on specifying the obligations in greater detail.

Ausgrid strongly supports the AER's preliminary view of allowing NSPs to develop protocols and procedures as an alternative means of satisfying the ring fencing obligations. Given that ring fencing is to apply by default, it is important that the guideline provide flexibility for NSPs to meet their obligations in a manner which reduces costs. Having this ability in the guidelines will significantly improve the workability of the guidelines.

Ausgrid does not support the universal application of obligations (a) through (c) and (f) to (h), which are more onerous measures. Ausgrid considers that these obligations as currently drafted to be disproportionate in light of the costs that they impose and the risk of DNSP to cause harm to markets. In particular, we note that the AER observes that it does not have the power/remit to impose structural separation.²³ However, the imposition of obligations (b) and (c) in combination with obligation (a) in effect gives rise to a form of quasi-structural separation. Further, the proposed obligations with respect to "information" (obligations (f) to (h)) are extremely broad and would create considerable uncertainty

²² AER, *Electricity Ring-Fencing Guideline – Preliminary Positions*, April 2016, pp. 26-27

²³ AER, *Electricity Ring-Fencing Guideline – Preliminary Positions*, April 2016, pp. 14-15

with respect to their interaction with the well-established privacy principles in operation under the Privacy Act. Our views on why these measures are not appropriate are set out in further detail below.

2.2.1 Legal separation

As noted by the AER, *many of the services currently offered without waivers will need to be relocated under a separate legal entity*²⁴. This demonstrates that this obligation would go beyond what the majority of jurisdictional guidelines currently impose. It is not clear why such a measure is necessary or required. We acknowledge that in certain circumstances legal separation may be appropriate in some circumstances. Nevertheless, we are doubtful as to the effectiveness of legal separation relative to other obligations such as behavioural obligations (not explicit in the AER's list of obligations) or information²⁵ and accounting obligations²⁶.

Therefore, legal separation is unnecessary in many instances and would result in significant costs. The costs to initially restructure a DNSPs' activities would be passed through to direct control customers as it involves complying with a regulatory change. The costs of ring fencing on an ongoing basis would also be borne by regulated customers as ring fencing applies to the regulated activities.

Currently, Ausgrid earns unregulated revenue from the following key activities:

- **Lighting Solutions Business** – which installs and maintains flood lighting on public lighting assets for customers. Customers who seek this service are charged an initial installation fee and then an ongoing monthly rental fee.
- **Contestable Connection Services**– The *NSW Electricity Supply Act (1995)* provides that customers who are required to make a capital contribution to the cost of augmenting electricity networks may choose the service providers (ASP) who will do the work.²⁷ Ausgrid is able to provide the following contestable services to customers in its capacity as an ASP: designing network assets; extending or increasing the capacity of the network; connecting or disconnecting installations; installing and energising service lines; and installing meters.
- **Contestable Metering Business** - provides installation, maintenance and meter data provision for Type 1 to 4 metering across New South Wales, Queensland and Victoria. The metering business also provides a number of value added services such as a data web portal and specialist advice on helping customers manage their electricity costs.
- **Pole and line rental** – leasing of Ausgrid's pole and ducts to facilitate the roll out of the National Broadband Network (NBN).

The revenue we forecasted to earn from these activities for the 2014-2019 period accounts for 0.6% of our AAR (refer to Table 1), and as such does not meet the shared asset materiality threshold. However, we anticipate in the next regulatory period that our unregulated revenue may exceed the 1% threshold, resulting in benefits flowing through to regulated customers in the form of lower electricity prices from the AER reducing our ARR.

Table 1 - Materiality of shared asset use (\$ million, nominal)²⁸

| | 2014/15 | 2015/16 | 2016/17 | 2017/18 | 2018/19 | Total |
|--|---------|---------|---------|---------|---------|--------------------|
| Forecast unregulated revenue from shared asset | 13.0 | 13.2 | 13.5 | 13.8 | 14.0 | 67.4 ⁵³ |
| Smoothed revenue (prior to shared asset reduction) | 2,314 | 2,372 | 2,425 | 2,499 | 2,580 | 12,189 |
| Materiality percentage | 0.6% | 0.6% | 0.6% | 0.6% | 0.6% | 0.6% |

Network Management) Regulation 2014) whereby contractors are accredited to offer contestable services. These contractors are known as Accredited Service Providers (ASPs) and the services they provide are the design and construction services needed in order to connect to our network.

²⁸ Ausgrid' Regulatory Proposal 1 July 2014 to 30 June 2019, 30 May 2014, p 25.

As shown in Table 1, Ausgrid does not earn significant amounts of revenue from services it offers which are not subject to economic regulation under Chapter 6 of the NER.

The costs involved in having to legally separate each of the above business units from Ausgrid would be significant. Before implementing legal separation a series of decisions must be made regarding the structure of the business, the legal requirements, operational requirements, compliance issues, financial considerations and the new entity's trading identity. It would require Ausgrid having to decide and consult with its shareholders on the business model to implement independence of its contestable businesses from its regulated business activities. Further resources would be needed to review Ausgrid's current business practices to determine the effectiveness and efficiencies of various models within Ausgrid following legal separation. This process could cost Ausgrid in excess of \$1.42m to complete.

In addition, there will be up-front costs in developing and delivering the separation proposal to Ausgrid's shareholder or shareholders, setting up the new entity, ensuring that its constitution and governance arrangements comply with any relevant legislation, appointing a separate board and establishing secretariat functions. Legal services and registration fees during the set-up process could cost as much as \$ 71,000 - \$85,200 per contestable business.

Given that legal separation is not common under most existing jurisdictional arrangements and the increased scope in which ring fencing is to apply, the AER should reconsider applying this obligation by default. Instead, we recommend that the guideline contain a mechanism that enables the AER to apply additional ring fencing obligations, such as legal separation, where it considers that there is a justifiable need for this approach. The AER could make its assessment of the need for any additional ring fencing obligations that may need to apply to services offered by the DNSP as part of consultation on the Framework and Approach. This would enable the AER to tailor ring fencing obligations to reflect the potential for misuse of market power for different services or where circumstances warrant more onerous measures. Ausgrid notes an alternative approach the AER could adopt would be to apply a "layered approach" to ring fencing whereby different obligations applied based on broad categories of services (such as related businesses, separate services and excluded services).²⁹ Ausgrid considers that this approach would avoid many of the concerns noted in our submission that arise from having onerous obligations by default which are disproportionate to the risk of the DNSP causing harm. It would also avoid the number of waivers that would need to be made.

2.2.2 Obligation (b) - physical separation

Ausgrid does not support the requirement that the DNSP must not locate a ring fenced service at the same physical location as the DNSP. Under Ausgrid's existing ring-fencing arrangements we are required to physically separate our contestable and non-contestable operations. This can quite easily and effectively be achieved at the same location by locating staff on different floors that are access restricted. This kind of separation is commonplace in many industries and offices and is a common ring fencing measure.

It is entirely unreasonable and unnecessary to mandate that the separation be in the form of establishing offices in new and different locations. There are simpler and more cost-effective ways of achieving the objective of physical separation. We ask that the AER clarify that obligation (b) can be complied with by physically separating staff within an office.

2.2.3 Obligation (c) - restrictions on staff sharing

Ausgrid does not support this obligation in its current form because it is disproportionate to the underlying issue. It is important to ensure that DNSPs do not cross-subsidise their contestable activities by providing under-costed labour. However, we consider that obligation (e) protects against this without the need for a full prohibition of staff sharing.

²⁹ Refer to Ausgrid's response to Question 3 for further details.

We consider that a more targeted and cost efficient approach for achieving the objective of the guideline and preventing cost cross-subsidisation would be a combination of restricting the sharing of operational and marketing staff and imposition of cost allocation requirements rather than a blanket prohibition on staff sharing. Ausgrid considers that there is little risk of anti-competitive behaviour from sharing staff providing corporate functions such as HR, payroll, accounting etc. Additional obligations that the AER could consider imposing that would protect against preferential dealing without imposing the same level of costs as a full restriction on staff sharing include:

- **Communication requirements** – aimed at addressing the potential for preferential dealing. Some examples of the obligations that could be imposed include:
 - A DNSP must not, in the provision of *direct control services* to any person, whether a *customer* or otherwise, communicate with that person in a way that would favour the DNSP over another service provider in the provision of the contestable services to the person.
 - If a DNSP communicates to a customer located in that DNSP's distribution district that it can provide contestable services to the customer, then it must (at or about the same time) also communicate to the customer that contestable services may also be obtained from other service providers and inform the customer of how to contact or locate other service providers. This obligation would also apply to a DNSP's website communications to customers about regulated and contestable services).
- **Information separation** - requiring that DNSPs must implement reasonable security measures to ensure that DNSP staff that provide contestable services are unable to access (including access by means of shared computer systems) information of or derived from DNSP staff that provide specified services which relate to contestable services.

Labour should be fully utilised and productive where the opportunity exists. DNSP's staff have expertise and knowledge that can be used to provide both contestable and non-contestable services. This is a comparative advantage DNSPs enjoy which should not be negated by a ring fencing guideline. It is not anti-competitive to make use of available scale economies provided it is not done in a subsidised manner or where appropriate restrictions are in place to ensure that shared staff do not have means or the opportunity to access privileged information. The ring fencing guideline should not prohibit this sharing when it can quite easily be done in a competitively neutral manner.

2.2.4 Impact of the proposed obligations on Ausgrid's contestable activities

The associated costs of complying with obligations (a) to (c) are likely to be a deterrent from Ausgrid continuing to offer these services unless it was able to obtain a waiver from complying with these obligations. Ausgrid withdrawing from providing these services will have a negative impact on both unregulated and regulated customers. Unregulated customers would lose the option of choosing the services provided by the contestable business, while regulated customers may experience an increase in electricity prices as a result of productivity losses from the loss of economies of scale in activities provided by the DNSP.

For Ausgrid's contestable metering business the cost of funding duplicate human and physical resources would be significant. This would require Ausgrid to reconsider the contestable metering market in a similar manner as Endeavour Energy and Essential Energy who decided to exit the market. This scenario would likely result in an increase to the cost of standard control services as the proportion of fixed costs borne by the contestable metering business would need to be transferred to standard control services due to the absence of a contestable metering business.

Similarly, we note that the proposed obligations would force us to cease our services provided through our Lighting Solutions business unless a waiver from several of the proposed obligations was granted. In addition to Ausgrid losing the ability to earn unregulated revenue from its public lighting assets, it also deprives customers of a low cost alternative to having to pay for a pole to be installed on their premises in order to install flood lighting. Given the small level of market share Ausgrid has in this market and the

efforts it goes to ensure that its prices are competitively based, we argue that the AER's proposed obligations imposes costs which are not outweighed by the associated benefits.

Under the *Electricity Supply Act* NSW DNSPs have an obligation to provide connection services to customers, and as such would not be able to exit from this market. Consequently, the cost of complying with the proposed ring fencing obligations would significantly increase the cost of Ausgrid providing contestable connection services and would unfairly impact on customers located in rural areas whose only choice in service provider for the service is a DNSP. Ausgrid argues that the disproportionate level of obligations that the AER is proposing should apply by default is inconsistent with the NEO.

3. Interaction with other mechanisms

In developing the ring fencing guideline it is important that the AER takes a holistic view of the regulatory framework. This is necessary in order to ensure that obligations under the guideline are consistent with, and do not conflict with, other elements of the regulatory regime.

Ausgrid urges the AER to adopt a holistic approach when determining the obligations that apply under ring fencing to safeguard against the potential for ring fencing obligations to undermine other aspects of the regulatory regime. There are a number of issues raised in the positions paper which are unclear regarding how they will relate or apply to the guideline. Specifically, Ausgrid is concerned by and seeks clarification on the views in the position paper around the potential need:

- 1) to restrict or prohibit DNSPs from owning certain types of assets;
- 2) whether ring fencing should apply to research and development; and
- 3) the need to restrict or prohibit asset sharing.

We discuss each of these concerns in detail below.

3.1. Restriction on asset ownership

Ausgrid notes that there are strong calls from stakeholders for the AER to prohibit or restrict NSPs owning DER assets on the basis that this will deter competition. While the AER rightly identifies that it is not empowered under the NER or National Electricity Law (NEL) to prohibit certain types of asset ownership, it instead appears to have formed the view that it would be appropriate to impose onerous ring fencing obligations to address these concerns.

As demonstrated in our analysis in section 1, (particularly section 1.2) concerns raised by stakeholders regarding the potential for NSPs to engage in anti-competitive behaviour are largely misconceived and/or overstated when considered in light of the other elements of the regulatory framework. Further, we note that some stakeholders concerns are driven by a vested interest in the AER imposing stringent obligations on NSPs as this assists in protecting their existing market share.

Ausgrid urges the AER to reconsider imposing onerous ring fencing obligations that may have the effect of restricting or discouraging NSPs from exploring non-traditional alternatives to network investments, as we note the potential for this to create tension with the operation of the RIT-D. If the AER is seeking to apply ring fencing in a manner which unduly restricts the DNSPs ability to utilise DER or other related assets it will constrain DNSP's ability to flexibly and innovatively manage its network at least cost and meet its license conditions.

It is important that ring fencing obligations does not unduly restrict a DNSPs ability to pursue least cost solutions to identified constraints on its network. Storage batteries could offer a potentially least cost solution for deferring or resolving network needs. For example the least cost solution to a network need might be a temporary or long term lease of a storage system or contracting with customers with storage to provide network support, or a network solution (longer term network support where owning the asset is a lower cost than leasing or network support agreements). In particular, if a battery solution is identified as the best technology to defer network investment, network connected large scale battery

storage is most likely to be the least cost solution compared to small scale customer owned storage. This is simply because battery storage technology tends to exhibit scale economies.

The AER's proposal to consider restricting ownership of certain assets implies that some assets can only be utilised efficiently when DNSPs are restricted from ownership. This pre-determines the market outcome and fails to allow market forces to discover the most efficient solution construct. We do not believe this is consistent with the NEO or the regulatory framework.

The highest-value opportunities for deferral can be in locations where relatively large distribution upgrades are required on feeders with modest or low load growth. Because incremental distribution investments (such as transformer and substation upgrades) are quite large, a modest-sized storage asset that is sufficient to meet a modest increase in load can deliver substantial economic benefits. An example of this might be the deployment of DNSP; customer; or market participant; owned (or leased) battery storage as an alternative to a traditional upgrade or network infrastructure.

In addition, DER assets are likely to have a higher option value compared to network assets given their relative shorter assets lives and ability to be used for non-network purposes.

The AER needs to have regard to whether its proposed approach towards ring fencing will lead to inefficient investment in poles and wires and higher network charges for customers.

Ausgrid notes that the AER has raised concerns regarding whether network devices installed behind the customer meter for demand management purposes should in the future should be classified as unregulated services rather than direct control services and therefore subject to ring fencing.

Ausgrid is significantly concerned by this proposed approach given the likelihood that this would capture our existing load control devices. Ausgrid has over 500,000 load control devices which are utilised to offer cheaper controlled load network tariffs predominantly for supplying electricity to residential electric hot water storage systems. Most of these load control devices utilise network asset control equipment located at our zone substations which send "ripple" control signals along the power lines to activate switches behind the customer's meter. By controlling customer load, it is estimated that Ausgrid's system peak load is reduced by approximately 300 MW in winter (~6% of the 2015 winter peak demand) and 100 MW in summer (~2% of 2015/16 summer peak demand). This reduces overall peak demand which benefits networks and other market participants in the long-term interests of electricity customers.

Regulatory changes which impose costs on the provision of this service would raise prices for customers.

Technologies such as demand response enabling devices (DREDs) or other forms of load control of customer appliances are typically installed behind the meter. Restrictions on DNSP activity with these technologies because of a view that the meter defines the point at which a network must not operate restricts the ability of DNSPs to meet the NEO at least cost, and presumes that other market actors will offer this service or that they offer the service at a lower cost.

Ausgrid's CoolSaver trial

Ausgrid's "CoolSaver" demand management innovation trial provides an example of how the market may not necessarily be more efficient and that DNSPs use of emerging technologies can provide benefits to customers.³⁰ Ausgrid's CoolSaver trial offered customers direct customer payments/incentives for allowing the DNSPs to activate the demand response mode on AS4755 compliant air conditioners on summer peak days. Participation in the trial was voluntary and targeted selected areas of our network in order to test the viability of this demand management solution as a potential non-network option.

This trial has tested different customer participation approaches and has found that direct offers by the DNSP to our customers has resulted in higher participation rates when compared to offering this

³⁰ See <http://www.ausgrid.com.au/Forms/CoolSaver-trial.aspx> for further information about the trial.

product through industry channels such as appliance retail stores and air conditioner installers. The preliminary outcomes indicate that leveraging market participants for the customer acquisition component of the trial has delivered a smaller demand reduction at a higher cost in comparison with the DNSP directed approach.

Other elements of the trial including equipment supply and installation, marketing services are often best supplied by appropriate market players, but trial results indicate that demand management outcomes can be more efficient when DNSPs play an important coordination and management role.

This outcome mirrors the AEMC views on the role of networks with respect to demand management in the draft rule determination for the Demand Management Incentive Scheme³¹:

“...the Commission notes that distribution businesses will always have a role in managing demand on their networks. More specifically, distribution businesses will always have a role as the decision maker in deciding how best to manage demand on their networks – that is, in deciding whether network or non-network solutions provide the most efficient means of meeting or managing peak demand, and meeting reliability standards.”

The AER must assess stakeholder concerns regarding the potential for DNSPs to create barriers to entry in the market for new and emerging technologies against the NEO. Constraining the ability of DNSPs to invest in or utilise DER assets in managing its network is unlikely to promote the NEO as opportunities for DER assets to defer network investment, improve network operations, and avoid outages may be missed - leading to inefficient investment, underutilisation of existing assets, and ultimately higher electricity prices for regulated customers.

3.2 Restrictions on research and development

In its position paper the AER has asked for feedback as to whether trials and investments in research and development (R&D) should be granted waivers or ring fenced.³² Ausgrid considers that this primarily depends on the purpose of the trial or R&D. If the trial or R&D is being undertaken primarily for commercial purposes than arguably it should be subject to ring fencing. However, if the trial or project is being undertaken for network management purposes such as the research funded under the Demand Management Innovation Allowance (DMIA), ring fencing should not apply as this is being undertaken for the purposes of providing direct control services.

It is important that the scope of ring fencing does not encroach beyond its intended purpose. Requiring DNSPs to comply with ring fencing obligations in order to undertake projects and trials under the DMIA is likely to undermine the effectiveness of the allowance and discourage DNSPs from undertaking such activities. While it is true that a DNSP could seek a waiver, the waiver process can be time consuming and burdensome – often requiring the DNSP to divert resources away from their business as usual activities to prepare detailed information to support the waiver application. Given the potential uncertainty associated with whether an application will be approved some DNSPs may instead opt to forego undertaking some types of R&D.

It is crucial that DNSPs are not constrained in exploring and undertaking trials to understand how new and emerging technology can improve network efficiency. Without an appropriate understanding of how disruptive technology can be safely integrated to the network, connecting these assets may be unnecessarily high. This is because DNSPs will need to impose additional safety and protection requirements in order to ensure the safety, reliability and security of electricity supply to all customers on its network. Consequently, Ausgrid fails to see how restricting DNSP's ability to undertake trials and projects under the DMIA would be consistent with the NEO.

3.3 Restricting asset sharing

Ausgrid is concerned by comments made by the AER that ring fencing obligations should be imposed to restrict asset sharing. The potential for cross subsidisation to occur as a result of asset sharing is

³¹ AEMC, *Draft Rule Determination, National Electricity Amendment (Demand management incentive scheme) Rule 2015*, Sydney, 28 May 2015, pp 18-19.

³² AER, *Electricity Ring-Fencing Guideline: Preliminary positions*, April 2016, p 33.

mitigated by the AER's Cost Allocation Guideline, the DNSP's Cost Allocation Method (CAM) which is approved by the AER, and the Shared Asset Guideline. We have provided an overview in Appendix 2 of how we comply with our existing ring fencing obligations and the CAM to highlight the robustness of measures Ausgrid has in place aimed at preventing cross subsidisation.

It is important that the AER not overlook the benefits that are provided to customers from DNSPs having the ability to share assets. The National Broadband Network (NBN) is an example of how DNSPs assets can be used to provide additional services that lower the cost of the provision of an unregulated service and also regulated services. Rather than build additional infrastructure to roll out the NBN, payments are made to DNSPs to rent pole and underground cabling. The ability to put assets to different uses has the scope to reduce the costs customers.

Of more significant concern is that fact that Ausgrid is obliged to make access to facilities available to carriers under Schedule 3 of the Telecommunications Act (1997) and there is no guarantee of any compensation under this regime. If the proposed ring fencing obligations restrict asset sharing it may make it impractical (unprofitable) for Ausgrid to continue operate a business providing facilities to telecommunication carriers and to retain staff expertise in this area. This could have the perverse effect of imposing a cost on the electricity customer where free access to facilities is then obtained by carriers. Ausgrid has recently had to use this expertise to prevent a carrier using their statutory powers to obtain free access to a significant number of Ausgrid assets and, over time, to convert this to a commercial agreement with corresponding revenue.

The sharing of systems (IT, financial, payroll, etc) is another example of how customers receive a benefit from asset sharing. Rather than having to pay for separate systems for each contestable service it offers DNSPs are currently able to utilise existing assets to provide these services with costs allocated appropriately between regulated and unregulated services. Regulated customers benefit from this arrangement as they do not fund the full cost of for the asset rather only the portion that is used for providing regulated services, and will in turn receive a reduction in electricity prices once the shared asset threshold has been exceeded.

Ausgrid is concerned that the AER's position to impose ring fencing to restrict asset sharing undermines and conflicts with the intent of the Shared Asset Guideline. Further this position also raises doubts as to whether DNSPs would be able to partner with retailers and other third parties to unlock additional revenue streams from existing assets. Ausgrid questions whether such outcomes would be consistent with the NEO. We consider that preventing DNSPs from seeking opportunities to improve the utilisation of their existing assets creates productive and allocative inefficiencies.

4. The need for a recalibrated approach

Our analysis in the previous sections demonstrates that there is a need for the AER to reconsider and recalibrate its position on a number of issues to ensure that its guideline achieves the objectives of ring fencing in manner which is consistent with the NEO.

Ausgrid considers it important that ring fencing provides a set of rules that safeguards competition and protects monopoly customers, while not unduly restricting the ability of DNSPs to pursue their commercial goals. Ausgrid considers comments provided by Kenneth Costello, an American economist, provide useful direction on the outcomes ring fencing should seek to achieve. In his paper, *Fair Trading in Retail Electricity Markets* Mr Costello made the following observation:³³

Efficient competition requires that all incumbent and prospective firms be given equal opportunities to compete for customers. Equal opportunities have different connotations among the different interest groups, as well as among economists. For example, a utility may interpret standard-of-conduct rules as overly restrictive, placing its affiliate at a disadvantage, while non-affiliates may regard these rules as necessary to avoid what they perceive as inherent favouritism towards the utility affiliate... In the context

³³ Costello, Kenneth (1998), *Fair trading in Retail Electricity Markets*, (National Regulatory Research Institute, June 1998), p.3.

of competitive sports, fair rules are supposed to show no partiality toward any team or individual. They should result in outcomes that depend solely on the skills of the participants – that is, the best should always win. In the marketplace, fair rules should produce winners on the basis of their ability to satisfy customers, nothing else. This means that new entrants should have the same opportunities as incumbents to succeed while, at the same time, incumbents are not unduly restricted in their market activities.

Our analysis in the previous sections has demonstrated that applying onerous ring fencing obligations by default to all unregulated services is disproportionate response to the risk of DNSPs causing harm and likely to give rise to a number of unintended consequences. Consequently, in adjusting its approach Ausgrid considers that the AER should consider where the deficiency driving stakeholder concerns arises from. Determining this will enable the AER to develop obligations that are more cost effective and targeted. For instance Ausgrid considers that the AER should examine whether the lack of stakeholder confidence arises from a perception that:

- **Enforcement and monitoring of the guideline is likely to be inadequate** - If this is the case then the AER should consider strengthening these arrangements under the guideline rather than imposing onerous obligations.
- **A lack of transparency around compliance** – this issue could be addressed by outlining how DNSPs are expected to report compliance with their obligations under the guideline, and include a requirement that any breaches of the guideline be reported publicly.
- **Ring fencing is ineffective at preventing anti-competitive behaviour** – existing jurisdictional guidelines have not been updated since first being established. Consequently, there are issues with the scope of existing ring fencing arrangements; however issue will be addressed as part of the establishment of new national ring fencing guideline.
- **This is a deficiency in another aspect of the regulatory framework** – where stakeholder concerns primarily stem from a deficiency in the operation of another part of the regulatory framework (i.e. where there is a lack of clarity or ambiguity surrounding obligations or responsibilities) this is more appropriately addressed via a rule change than through the imposition of onerous ring fencing obligations.

Consideration of the above factors should determine the appropriate level of ring fencing required. In some circumstances, such as where the market is emerging, or where there exists a greater potential for the DNSP to engage in anti-competitive behaviour than we consider that it is appropriate that more stringent obligations apply. However, where the market is mature or where the DNSP has little ability to influence the market a more light handed approach should be adopted. Consequently, whether a light or heavy regulatory touch is required will typically depend on market circumstances and the ability of the DNSPs in the particular market to influence the market. It is not appropriate to set the guideline at an extreme end of the spectrum to address circumstances that are likely to be small and isolated. This is because it will impose measures that are disproportionate to the vast majority of unregulated services currently offered and result in outcomes contrary to the NEO.

Rather, we consider a more practical approach to developing guideline would be impose more proportionate measures and to instead specify the circumstances in which the AER is likely to impose additional more stringent measures to a particular service as part of its decision in the Framework and Approach. We outline further views on how the AER can improve the workability of the guideline in the following section.

5. Practical and implementation issues

This section seeks to highlight practical and implementation issues that will need to be resolved in order for the guideline to be effective. Specifically this section seeks to:

- 1) provide feedback on the workability of waivers and transitional arrangements; and

- 2) highlight areas of the guideline that require further clarification.

5.1 Waivers

As noted previously in our submission, the AER's position to impose onerous obligations by default on all unregulated services imposes obligations which are disproportionate to the risk of the DNSP causing harm. Subsequently, this is likely to create an undue reliance on the need for waivers in order for DNSPs to manage their compliance obligations under the guideline.

We consider that this approach imposes unnecessary costs on the DNSPs as applying for waivers involves diverting resources away from their normal business as usual business activities to prepare waiver applications. Further, given that DNSPs would need to apply for waivers in order to continue to offer the existing unregulated services this will likely impose additional administrative costs on the AER to process the increased number of waivers applications.

While we note that the AER seeks to manage this issue by having different types of waivers such as a bulk waiver process and fast track waiver process it is difficult to provide comments on the feasibility or workability of this approach without further details. Our preference would be to avoid the need to manage issues associated with applying ring fencing obligations that are too onerous in the first place.

However, if the AER were to proceed with its current approach we consider that grandfather arrangements would be required for existing waivers and that bulk waivers would be required for all unregulated services currently offered by DNSPs where the requirements under the guideline represent a more onerous obligation than existing ring fencing arrangements. Having such arrangements in place would assist in managing the compliance costs associated with the AER's proposed obligations.

Rather than to seek to manage scope issues that arise as a result of applying a blanket approach solely through the use of waivers, Ausgrid urges the AER to consider including additional measures in the guideline such as:

- **Provisions to allow for obligations to altered or varied** – this would provide flexibility for the DNSPs to seek to manage their compliance obligations in a more cost effective manner without diluting the intended protections under the guideline.
- **Provisions to allow the AER to impose additional obligations** - and the factors it will have regard to in deciding that additional obligations are required will assist in ensuring that guideline is applied flexibly and that stringent measures are capable of being applied when the circumstances merit that a more heavy handed approach is required.
- **Exemption provisions to cater for jurisdictional differences** – where jurisdictional differences exist this would allow the AER to tailor obligations under the guideline without requiring each DNSP in the jurisdiction to submit separate waiver forms for complying with certain obligations.

Or alternatively, the AER could consider adopting a layered approach to ring fencing, whereby different obligations applied to different categories of services, thereby allowing the AER to better tailor ring fencing obligations to risk of harm in a streamlined manner.³⁴ Adopting a layered approach to ring fencing will likely lessen the need to rely on waivers to manage scope issues associated with applying a blanket approach to ring fencing.

5.2 Transitional arrangements

It is vital that the guideline contain appropriate transitional provisions, given the shift to a national approach and the increase in the guidelines scope that will capture services that were previously not subject to ring fencing.

The obligations proposed under the guideline are a significant change from existing ring fencing arrangements; therefore sufficient time must be afforded to DNSPs to:

³⁴ For further details on "layered approach" to ring fencing refer to Ausgrid's response to Question 3.

- assess its compliance obligations under the guideline to determine the program of work that it will need to complete in order to comply with the guidelines;
- apply for waivers from complying with certain obligations if its assessment reveals that this is too onerous or difficult to achieve under the circumstances;
- implement changes to allow the DNSPs to comply with its obligations; or
- exit the market for the provision of the unregulated service.

Further transitional arrangements must not just be limited to when the guideline is first established but must also apply where the AER changes the classification of a service from direct control to unregulated.

5.3 Areas requiring further clarification

Ausgrid considers that there are a number of areas in the positions paper that require further clarification in order for the Ausgrid to properly assess the associated implications. These include:

- whether the AER intends to further specify requirements under the obligations or keep the high level drafting of obligations;
- the need for further guidance on how the AER anticipates DNSPs are to comply with the obligations, as the obligations (as currently drafted) lack clarity and give rise to regulatory uncertainty;
- clarification as to whether the AER is intended to apply the guideline to projects under the DMIA and DMIS;
- whether the AER will seek to impose restrictions on asset sharing;
- guidance on whether through ring fencing the AER seeks to restrict the types of assets that DNSPs can own - this seems to be implied by the positions paper but is not reflected in the resulting obligations; and
- guidance on the reporting requirements that are likely to apply under the guideline.

Appendix 1 – Responses to the AER’s questions

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

Ausgrid considers the IPART 2003 Ring Fencing Guideline principle based approach to ring fencing has been highly successful at promoting competition and delivering confidence to the market without the need to impose onerous obligations.

The obligations outlined under the IPART Ring Fencing Guideline are broadly grouped into the following categories:

- **Access requirements** – which specify obligations aimed at ensuring that access to infrastructure and services is provided on an equal basis and that the DNSP does not engage in any preferential treatment of its contestable business.
- **Cost allocation requirements** – sets out the obligations that ensure that cross subsidisation between the DNSP’s regulated and unregulated business does not occur by specifying how costs are to be allocated between the businesses.
- **Communication requirements** – sets out how the business is to communicate with customers to ensure that the DNSP does not favour its contestable business over other competitions and to ensure that customer’s choice of service providers is protected.
- **Functional separation requirements** – sets out level of separation that must apply between the DNSPs regulated and unregulated business such separation of offices, operational and marketing staff and information access.

These obligations are well targeted and proportionate at addressing the potential for DNSPs to engage in cross subsidisation, restrict access, inappropriately share information, engage in preferential or discriminatory dealings. While the obligations are principle based they provide more guidance on the conduct required to ensure that the DNSP does not contravene its obligations than the obligations proposed by the AER without being prescriptive or onerous.

Consequently, Ausgrid considers that the IPART Ring Fencing Guideline strikes a more appropriate balance between the regulated businesses interests and ensuring fair competition than the obligations proposed by the AER. Importantly, the IPART Ring Fencing Guideline recognises the benefits that customers receive from DNSPs having economies of scale and does not try to unduly restrict this more than what is required to achieve the objectives of the guideline. For example rather than requiring the NSW DNSPs to locate their contestable business in separate physical locations (as proposed under the AER’s guideline), the NSW ring fencing guideline only requires physical office separation with appropriate access restrictions.

Similarly, rather than impose legal separation and prohibit staff sharing, the NSW Ring Fencing Guideline only prohibits staff sharing between operation and marketing staff - as the risk of preferential dealing or inappropriate information sharing occurring is higher with these staff than other support staff such as HR or payroll. While the IPART Ring Fencing Guideline does not require as onerous separation requirements as proposed under the AER’s position paper it manages to achieve the same outcomes by imposing additional behavioural obligations regarding communications and information sharing to further protect against the risk of DNSPs engaging in preferential dealing.

Imposing restrictions that are more targeted at preventing the risk of harm occurring allows DNSPs to retain the benefit of natural economies of scale and scope which are in turn passed through to customers. Ausgrid argues that the obligations under the IPART Ring Fencing Guideline are more appropriate than the obligations proposed by AER as they achieve the objectives of the guideline without imposing unnecessary costs and facilitate (rather than distort) efficient market outcomes.

Another key feature of the IPART Ring Fencing Guideline is that it allows DNSPs to flexibly meet their obligations under the guideline. For example, Ausgrid complies with its obligations for information separation through establishing “chinese walls” with its IT systems and developing appropriate information protocols and staff training. For further information on how Ausgrid complies with its obligations under the IPART Ring Fencing Guideline refer to Appendix 2.

In our opinion, ring fencing arrangements in NSW coupled with complementary regulatory and legislative controls have worked effectively to prevent DNSPs from engaging in anti-competitive behavior that may have inhibited the development of a competitive market. This is evident by the high number of competitors in the market (1742 ASPs) and the significant amount of contestable work that is undertaken by external parties, as shown by comparing the number of contestable jobs completed by external ASPs (as shown by Table 2) compared to Ausgrid’s contestable connections business (as shown by Table 3). As illustrated by the tables, Ausgrid undertakes a small proportion of contestable connection work. In 2014-15 financial year Ausgrid undertook 1% of Level 1 ASP reported contestable work; 2% of ASP Level 2 contestable work; and less than 1% of Level 3 ASP contestable work.³⁵

The trend for Ausgrid to only undertake small portion of contestable connections work is a fairly consistent trend over the years. It is important to note that this trend is not a by-product of regulation but is rather a business decision made by Ausgrid based on its assessment of our contestable business’ ability to compete effectively in the market and appetite to pursue commercial opportunities in this market. Consequently, the IPART Ring Fencing Guideline, in applying a light handed principle based approach to regulation, has fostered the development of competition in contestable markets by allowing market forces rather than the regulator to determine who succeeds in the market.

Ausgrid urges the AER to consider adopting a similar approach to avoid some of the distortionary effects we have identified its proposed obligations are likely to have.

Table 2: Contestable Work Trend – Work undertaken by external ASPs³⁶

| Category | Year | | | | | | | |
|--|---------|---------|---------|---------|---------|---------|---------|---------|
| | 2007/08 | 2008/09 | 2009/10 | 2010/11 | 2011/12 | 2012/13 | 2013/14 | 2014/15 |
| Network Work (ASP Level 1) | | | | | | | | |
| Project Approvals | 379 | 444 | 461 | 557 | 449 | 486 | 602 | 695 |
| Number of completed projects inspected | 219 | 294 | 384 | 393 | 415 | 392 | 272 | 449 |
| No. of projects inspected with initial defects | 80 | 108 | 74 | 95 | 110 | 64 | 161 | 216 |
| Customer Connections Work (ASP Level 2) | | | | | | | | |
| Notifications (NOSW) | 51,158 | 53,015 | 59,067 | 94,463 | 63,971 | 66,878 | 65,897 | 56,383 |
| Projects inspected by the DNSP | 15,628 | 16,542 | 24,474 | 56,345 | 25,951 | 19,437 | 21,376 | 14,733 |
| No. with initial major defects | 219 | 195 | 243 | 281 | 291 | 232 | 269 | 367 |
| Network Design Work (ASP Level 3) | | | | | | | | |
| Design Certification | 328 | 327 | 438 | 451 | 552 | 638 | 594 | 727 |

³⁵ Refer to Ausgrid, *Electricity Network Performance Report 2014/15*, 24 November 2015.

³⁶ Ibid.

Table 3: Contestable Work Trend – Work undertaken by Ausgrid’s contestable business³⁷

| Category | Year | | | | | | | |
|--|---------|---------|---------|---------|---------|---------|---------|---------|
| | 2007/08 | 2008/09 | 2009/10 | 2010/11 | 2011/12 | 2012/13 | 2013/14 | 2014/15 |
| Network Work (ASP Level 1) | | | | | | | | |
| Project Approvals | 56 | 24 | 24 | 12 | 10 | 4 | 3 | 5 |
| Number of completed projects inspected | 46 | 31 | 23 | 10 | 3 | 4 | 3 | 11 |
| No. of projects inspected with initial defects | 3 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Customer Connections Work (ASP Level 2) | | | | | | | | |
| Notifications (NOSW) | 5,963 | 5,426 | 4,742 | 12,041 | 8,340 | 3,023 | 1,913 | 1,012 |
| Projects inspected by the DNSP | 1,500 | 1,763 | 2,176 | 4,401 | 1,877 | 718 | 584 | 357 |
| No. with initial major defects | 11 | 8 | 7 | 43 | 28 | 0 | 1 | 0 |
| Network Design Work (ASP Level 3) | | | | | | | | |
| Design Certification | 161 | 106 | 13 | 13 | 42 | 12 | 2 | 2 |

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

Ausgrid supports the AER’s proposed objectives, and considers that the objective correctly identifies the types of anti-competitive behaviour that ring fencing should be aimed at preventing. However, with respect to the harm the AER has identified that the guideline should be aimed at avoiding Ausgrid is concerned that the AER seems to prioritising objective 4 (promoting an even playing field to encourage market entry) over the long term interests of customers.

As demonstrated in our analysis in 1.2, the harm the AER has identified in its positions paper is largely overstated or misconstrued. Consequently, as the AER has not appropriately identified the harm that the guideline seeks to avoid and, the proposed obligations to achieve the guidelines objective are overly onerous and disproportionate to the risk of DNSPs causing harm in competitive markets. This is likely to give rise to unintended consequences.³⁸ Further, whilst the AER identifies the benefits of an even playing field it fails to have appropriate regard to the benefits associated from DNSPs participation in competitive markets, or the benefits that economies of scale can provide to customers. Without appropriate regard to this, AER risks prioritising the protection of market participants who operate in these markets, over the long term interest of customers.

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

Ausgrid refers the AER to our comments in section 5.1.

While Ausgrid agrees that the classification may be a pragmatic approach for determining the application of ring fencing, applying a blanket approach towards ring fencing gives rise to scope issues. Ausgrid considers that the workability of the guideline would be significantly improved if the

³⁷ Ibid.

³⁸ See sections 2.2 and 2.3 for further details.

AER recalibrated its approach to developing ring fencing obligations and considered alternative measures (such as those outlined in our response to Question 5) for achieving the objectives of the guideline.

Applying more proportionate measures as the default position under the guideline would reduce the need for waivers.

Another alternative that the AER could consider is applying a layered approach to ring fencing, using broad categories of unregulated services that are subject to differing levels of ring fencing obligations (such as accounting separation, functional separation, behavioural separation and legal separation). Different separation requirements would apply to some or all of the categories of unregulated services, depending on the relevant market conditions.

IPART in developing the ring fencing guidelines to apply in NSW was initially considering applying a layered approach that sought to tailor the ring fencing obligations to different categories of service to recognise their individual characteristics and hence recognise that not all services require the same level of ring fencing obligations to address the potential for harm.

Table 5 below is an extract from IPART's draft report ³⁹ seeks to illustrate how this might work and shows accounting separation requirements applying to all three categories, while functional and behavioural separation requirements will apply to related business and separated services, and legal separation requirements will apply only to related businesses. We refer the AER to this report for further details.

Table 5 – Separation requirements based on type of unregulated service

| | Related business ⁴⁰ | Separated services ⁴¹ | Excluded services ⁴² |
|------------------------|--------------------------------|----------------------------------|---------------------------------|
| Accounting separation | Y | Y | Y |
| Functional separation | Y | Y | - |
| Behavioural separation | Y | Y | - |
| Legal separation | Y | - | - |

Ausgrid considers that this may allow the AER to tailor the level of obligations that apply under the guideline so that they are more proportionate to the risk of harm occurring. In order for this approach to work the AER would need to broadly define the nature of services that fall within each category. We consider that this approach would be most effective if the AER specified the services, as part of the Framework and Approach the AER determined what category of ring fencing applied to the unregulated services provided by the DNSP. However, we note that implementing this approach may require a rule change to clause 6.8.1 of the NER to specify that the application of ring fencing is a specified matter. We consider that this is a minor and uncontroversial rule change that could be handled under the AEMC's expedited process in a manner that is similarly being contemplated by the AER for delaying the development of the DMIS, DMIA and its review of the rate of return guideline.

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

³⁹ IPART, Ring fencing of NSW electricity distribution network service providers, Draft Report, June 2001, pp 18-22

⁴⁰ Ibid, p 18. IPART defined "related businesses" as producing or selling electricity, marketing of network services, services in industries other than the electricity industry.

⁴¹ Ibid, p 19. IPART defined "separated services" as contestable works (i.e. contestable

⁴² Ibid, p 22. IPART defined "excluded services" as services which were not related businesses services or separate services and provided the example of a customer seeking a higher level of reliability. We consider that NBN would be another example of an excluded service.

We consider the proposed obligations are unnecessarily restrictive and may distort competition in certain markets (inclusive of DER). See section 1.2.1, 3.3.1 and 3.3.2 for further details.

More specifically, section 1.2.1 sets out our views on the development of the DER market. We do not consider DNSP involvement in DER will be detrimental to the development of the contestable market. Our comments in relation to section 1.2.2 further highlight that DNSPs participation in competitive markets can be beneficial.

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

Ausgrid considers that rather than imposing legal separation, location separation and prohibition on staff sharing, it would be preferable for the AER to consider applying less restrictive obligations that are more targeted at preventing the potential for anti-competitive behaviour to occur and supplementing these obligations with additional behavioural obligations.

As noted in our response to Question 1, existing ring fencing obligations are less onerous in NSW than the obligations proposed by the AER. The success of ring fencing in NSW demonstrates that ring fencing arrangements do not need to be onerous in order to be effective. Rather, they need to be targeted at addressing the risk of harm occurring having regard to the whether the benefits associated with the obligation outweigh their associated costs, and must provide sufficient guidance to enable DNSPs to comply with their obligations under the guideline. Measures can be effective without being onerous and costly. It is important that the AER explores other potential measures that could achieve the objectives of the guideline without imposing significant costs on DNSPs or unduly restricting natural economies of scale and scope that can deliver benefits to customers.

Alternative measures the AER should consider imposing instead of full separation include:

- **Staff separation** - A DNSP must ensure that with the exception of staff involved in back office shared computer and similar systems, DNSP staff that provide direct control services do not also provide contestable services.
- **Communication requirements** – governing how the DNSP communicates with customers and notifies customers that they have a choice in service providers. Example obligations could include:
 - i. A DNSP must not, in the provision of direct control services to any person, whether a customer or otherwise, communicate with that person in a way that would favour the DNSP over other service providers in the provision of contestable services to the person; and
 - ii. If a DNSP communicates to a customer located in that DNSP's distribution district that it can provide contestable services to the customer, then it must (at or about the same time) also communicate to the customer that contestable services may also be obtained from other service providers and inform the customer how to contact or locate other service providers. This would also apply where a DNSP uses its website to communicate to customers about both its regulated services and contestable services.
 - iii. Specifying requirements for appropriate training and staff guidance material to ensure compliance with communication obligations under the guideline.
- **Information separation** - A DNSP must implement reasonable security measures to ensure that DNSP staff that provide contestable services are unable to access (including access by means of shared computer systems) information of or derived from DNSP staff that provide regulated services which relate to the provision of contestable services.
- **Physical separation of offices** - A DNSP must ensure that the offices from which DNSP staff provide regulated services (the "first offices") are separate from the offices from which

DNSP staff provide contestable services (the “second offices”). Under the NSW Ring Fencing Guideline, first offices and second offices will be regarded as separate only if:

- i. the first offices and the second offices are in different buildings; or
- ii. the first offices and the second offices are on different floors of the same building; or
- iii. the first offices and the second offices are protected by a security system that prohibits occupants of the first offices from accessing the second offices and vice versa; or
- iv. if other measures to separate the first offices from the second offices has been approved as an alternative measure under the guideline.

Ausgrid considers that the above measures effectively target the potential for any inappropriate information sharing, preferential dealings or discriminatory behaviour to occur.

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

Ausgrid considers that complying with the AER’s proposed obligations will entail significant costs. This applies particularly to the separation requirements of separate legal entities, physical separation and restriction on staff sharing.

As noted in section 2.2, these are significant compliance obligations and will require costly business restructuring and duplication of systems and resources. The costs associated with complying with the proposed obligations will increase significantly if the AER imposes restrictions on asset sharing (as noted in our response to Question 7 below). We consider less excessive obligations could be developed by the AER to achieve the guideline objectives that would reduce the compliance costs imposed on DNSPs.

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

Ausgrid considers that ring fencing should not restrict asset sharing between regulated and contestable service provision, as we consider that the operation of the cost allocation principles, cost allocation guideline and DNSP’s cost allocation method approved by the AER provide appropriate safeguards that ensure the proper attribution of costs between regulated and unregulated activities.

Further, as noted in our comments in section 3.3.3, restricting asset sharing between regulated services and contestable services undermines the operation of the shared asset guideline and reduces the ability of DNSPs to improve the utilisation of their assets. It is important to recall that asset sharing also delivers benefits to customers in terms of price reductions.

Ausgrid notes that the AER’s current position is to permit the sharing of assets between the regulated and unregulated business, as legal separation is only to apply to the provisions of services.⁴³ Ausgrid notes that the costs associated with complying with legal separation will increase if asset sharing is not permitted. Complying with this obligation would require duplicate investment in human resources as well as the shared technical infrastructure, including but not limited to Databases, Data Centres, ICT Network and Telecommunications, Server Infrastructure, Backup Infrastructure, Facilities Management Monitoring, Operating Systems (including licencing) and Desktop Administration. We estimate that this duplication in systems may cost \$8-15 million in initial capital investment⁴⁴, and an ongoing cost of \$6-\$8 million per annum.⁴⁵ Importantly, the ongoing cost of the existing resources would need to be borne solely by the regulated line of business, requiring an overall increase in the

⁴³ AER, *Electricity Ring-Fencing Guideline – Preliminary Positions*, April 2016, p. 28.

⁴⁴ This would cover the cost of application for licences, database licencing, data centres infrastructure, ICT network and telecommunications infrastructure, server infrastructure, backup infrastructure, operating system software licencing.

⁴⁵ This cost covers application support resources, technical support resources, infrastructure facilities management and software maintenance costs

standard control cost base given that the portion of shared costs borne by Ausgrid's contestable businesses would no longer be funded.

We also note the potential for this to undermine the operation of the Shared Asset provisions in the NER, and the Shared Asset Guideline.

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

Ausgrid agrees that the factors outlined in Recommendation 2 of the AEMC's battery storage advice captures relevant considerations, the AER should have regard when deciding waivers. However we note that their intended use was to guide the AER in determining the level of ring fencing that should apply under the guideline.

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

Regulated customers are likely to bear any costs associated with restricting the business to comply with the guideline's obligations. They are also likely to experience increased costs from reduced productivity and efficiency caused from the loss of economies of scale in the DNSP's operations that are likely to arise from the AER's ring fencing guideline. Regulated customers will also bear the associated costs of reporting under the guideline as ring fencing applies to direct control services rather than unregulated services.

Contestable customers will bear the costs of initial set up of systems and processes to comply with the guideline and will pay a higher cost than if the DNSP was permitted to retain its natural economies of scale and scope.

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

The costs associated with ring fencing compliance could be reduced by revising the proposed ring fencing obligations so that they are less onerous. Our discussion in section 3 and 4 is aimed at assisting the AER in determining the appropriate level of ring fencing that should apply under the national guideline.

A more proportionate set of measures would reduce compliance and administration costs. Ausgrid notes that the AER's proposed measures are more onerous than the majority of existing jurisdictional arrangements. It is not clear why more stringent and restrictive measures are required. As noted in our response to Question 5 there are alternative measures that the AER could use to achieve the guidelines objectives that would significantly reduce the cost of compliance to DNSPs' and allow customers to retain the benefits from DNSPs economies of scale – while not eroding the strong protections the guideline is intended to provide.

As demonstrated in our response to Question 1, less prescriptive measures can be highly effective. Ausgrid has complied with the NSW guidelines and helped develop effective competition in customer connection works and other markets such as demand management.

A relaxation of the 'all-in' approach may also help reduce costs. An 'all-in' approach may result in a burdensome waiver application and assessment process. This could be resolved by the bulk-waiver process (although more detail and examples are required) or by other measures such as enforceable undertakings, protocols or applying more onerous obligations in limited circumstances. An alternative would be for the AER to apply the 'layered' approach to ring fencing as outlined in our response to Question 3.

As noted in our comments in section 3, providing flexibility for the DNSPs to meet their obligations under the guideline will also assist in lowering compliance costs. An outline of how Ausgrid meets its existing obligations under the IPART Ring Fencing Guideline is provided in Appendix 2.

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

Transitional arrangements will be necessary to allow DNSP's to identify the implications to their operations from the establishment of a national ring fencing guideline, and to implement any necessary structural, processes and procedural changes to its business to enable it to comply with its new obligations.

In addition, adequate transitional arrangements such as grandfathering will be required, where as a result of the AER making a change to classifying a service (i.e. from direct control to unregulated).

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

As noted in our comments in section 2 and our response to Question 1, ring fencing does not have to be onerous in order to be robust and effective. The experience in NSW with respect to the opening up of connections to contestability through the establishment of the ASP Scheme demonstrates that ring fencing can be more effective when it is targeted and proportionate to the risk of harm. Whilst this example relates to the opening up of a market whereby the DNSP was a sole service provider it is still useful guide on how a more light handed approach to ring fencing of new services (i.e. in markets where DNSPs are not traditional a market participant e.g, solar PV or battery storage) can be effective in achieving the objectives of ring fencing.

Our comments in section 1.1.2 note that market confidence is most likely to be promoted through ensuring that there is robust reporting, compliance monitoring and enforcement. We consider that this provides a targeted response to the underlying issues behind stakeholders' lack of confidence in ring fencing to act as a deterrent from DNSPs engaging in anti-competitive behaviour.

Ausgrid considers that market confidence is likely to be promoted if compliance with the guideline is regularly and transparently reported through either the DNSP's annual report or via the AER's annual RINs. Any breaches in compliance should also be reported publicly on the AER's and DNSPs respective websites. We consider the reputation damage associated with the publication of breaches acts as a strong deterrent from engaging in anti-competitive behaviour. Ausgrid also considers that imposing fines for breaches may have merit if this helps to deliver market confidence.

Further, as noted in our comments in section 1.2.5 and section 4 it is important that ring fencing does not try to address deficiencies in other parts of the regulatory framework. Where the underlying cause of stakeholder concern arises due to a lack of clarity or ambiguity in the NER, this problem is best addressed via a rule change. It is not best practice to address a perceived failure in one regulation with the imposition of another regulation.

Appendix 2 – Ausgrid’s compliance measures

The following section provides an overview of how Ausgrid currently complies with its obligations under IPART’s Ring Fencing Guidelines. Compliance with these obligations is tracked through Ausgrid’s Licence Compliance Management System. Compliance is reported six monthly internally, and breaches are reported annually to the Board and to IPART which publishes an annual compliance report.

Access Requirements

Access to services

A DNSP must provide a prescribed distribution service (i.e. direct control services) to an independent accredited service provider on terms that are no less favourable than the terms on which it provides that direct control service to that part of the DNSP’s business which provides contestable services.

Ausgrid complies with this obligation by: 1) identifying a list of services where there would be a potential for preferential or discriminatory behaviour to occur; 2) identifying staff that provide these services and communicating the requirements of this obligation to them with appropriate guidance and training; 3) undertake regular monitoring to track compliance with this obligation.

The list of services that Ausgrid has identified that this obligation applies to includes:

- Provision of design information to a Level 3 service provider to prepare a design drawing and submit it for certification;
- Certifying designs;
- Inspection of Level 1 contestable work;
- Inspection of Level 2 contestable work;
- Provision of Access (such as, the request, programming the work, control room work, fitting and removal of earths, switching, identifying customers affected, low voltage switching and paralleling of substations that permits high voltage work without disrupting supply to other customers);
- Substation Commissioning;
- Administration of Level 1 work;
- Notification of Arrangement;
- Re-inspections of installation work and Level 1 or 2 work;
- Providing Access to switch-rooms, substations for accredited meter and service providers,
- Authorisations.

A DNSP must not treat a customer more or less favourably than another because the customer engaged or elected not to engage the DNSP to provide it with contestable services.

Ausgrid ensures compliance with this obligation through training of staff and ensuring policy and processes reflect equal treatment of customers who have chosen external service providers or Ausgrid’s contestable business for their contestable works.

Specifically training programs that we run aimed at preventing preferential treatment of Ausgrid’s contestable business over competitions is through our online e-learning modules on Anti-Competitive Conduct and Competition and Consumer Law training which has been specifically developed for Ausgrid and includes Ausgrid specific examples of potential scenarios that may give rise to anti-competitive conduct. All staff are required to undertake this training and must undertake a re-fresher on an annual basis.

Access to information

A DNSP must provide information relating to or derived from the provision of direct control services to an independent accredited service provider on terms that are no less favourable than the terms on which that information is made available to that part of the DNSP's business that provides contestable services.

Customer / Site Information

Ausgrid seeks to make as much information about its operations publicly available on its website. We believe in operating openly and transparently.

Most customer and site information in Ausgrid's network relevant to the regulated metering business is owned and maintained by metering services providers, albeit held in the centralised meter management system. A significant quantity of this information is also populated in MSATS for the retailer and/or proposed metering services providers to access.

Ausgrid regularly reviews MSATS standing data with a view of ensuring customer and site specific information is complete and accurate. This ensures this information is equally available to intending metering services providers, but also reduces the need for the DNSP to provide this information through alternate methods.

In addition, Ausgrid ensures that its internal policies reflect the need for information regarding its operation to be provided to external service providers on an equal basis and subject to confidentiality and privacy provisions.

Audit Framework

Regular audits are conducted by the NSW Government Audit Office and AEMO. The scope of audit regularly includes the effectiveness of application, database and infrastructure security arrangements as well as AEMO procedures including ring-fencing.

Cost Allocation Requirements

Ausgrid is required to comply with cost allocation principles under the National Electricity Rules as well as part of the licence conditions.

A DNSP must ensure that an item referred to in the workbook that relates to a distribution service (including costs incurred and revenues derived) is fully allocated by the DNSP to either direct control services or excluded distribution services on a causation basis.

For the purposes of clause causation basis means one of the following relationships:

- a) a directly traceable cause and effect relationship between the item and the provision of the service; or***
- b) a verifiable relationship between the item and the provision of the service; or***
- c) a direct relationship with a pool of common costs or revenue, with the allocation of that pool on the basis of a relevant, reliable and verifiable factor.***

6.15 Cost allocation

6.15.1 Duty to comply with Cost Allocation Method

A *Distribution Network Service Provider* must comply with the *Cost Allocation Method* that has been approved in respect of that provider from time to time by the *AER* under this rule 6.15.

6.15.2 Cost Allocation Principles

The following principles constitute the *Cost Allocation Principles*:

- (1) the detailed principles and policies used by a *Distribution Network Service Provider* to allocate costs between different categories of *distribution services* must be described in sufficient detail to enable the *AER* to replicate reported outcomes through the application of those principles and policies;
- (2) the allocation of costs must be determined according to the substance of a transaction or event rather than its legal form;
- (3) only the following costs may be allocated to a particular category of *distribution services*:
 - (i) costs which are directly attributable to the provision of those services;

- (ii) costs which are not directly attributable to the provision of those services but which are incurred in providing those services, in which case such costs must be allocated to the provision of those services using an appropriate allocator which should:
- (A) except to the extent the cost is immaterial or a causal based method of allocation cannot be established without undue cost and effort, be causation based; and
 - (B) to the extent the cost is immaterial or a causal based method of allocation cannot be established without undue cost and effort, be an allocator that accords with a well accepted cost allocation method;
 - (4) any cost allocation method which is used, the reasons for using that method and the numeric quantity (if any) of the chosen allocator must be clearly described;
 - (5) the same cost must not be allocated more than once;
 - (6) the principles, policies and approach used to allocate costs must be consistent with the *Distribution Ring-Fencing Guidelines*;
 - (7) costs which have been allocated to a particular service cannot be reallocated to another service during the course of a *regulatory control period*.

Note:

The *Cost Allocation Guidelines* are required by clause 6.15.3 to give effect to and be consistent with, the *Cost Allocation Principles*.

Ausgrid prepares a cost allocation method (CAM) that give effect to the cost allocation principles and complies with the AER's cost allocation guidelines. This CAM was approved by the AER on 2 May 2014 after receiving advice from an independent reviewer KPMG.⁴⁶

The purpose of the CAM is to ensure accurate allocation and reporting of the costs of providing regulated and unregulated services so that cost-subsidisation between regulated and unregulated services are prevented. The underlying principle of cost allocation is (a) direct attribution of costs to the relevant service where that costs were incurred wholly to provide that service and (b) where costs are incurred for the provision of more than one services, allocation is to be based on causation basis.

Ausgrid's financial system is set up in a way that allows for the direct attribution of costs to regulated and unregulated services using various cost capturing objects (service orders, plant and maintenance orders etc.) to enable the direct attribution of costs of the services that incurred these costs. In this way (by direct attribution) there is no scope of cross subsidisation of costs between services.

For shared costs, these are allocated using an appropriate allocation basis that reflects the underlying driver of the costs. For example, cost of running a human resource department is allocated to regulated and unregulated services based on the number of Full Time Equivalent (FTE) resources. The allocation percentages are updated annually to reflect the most up to date underlying data (e.g. latest number of FTE engaged in regulated or unregulated services), ensuring that the costs of providing the various services reflect accurately the underlying resources.

By giving effect to the cost allocation principles as embodied in the AER's cost allocation guidelines, through the use of cost capturing objects that enable direct cost attribution and the use of causal drivers, Ausgrid ensures that there are no or very little scope of cross subsidisation of costs between services.

Communication Requirements

Communicating with customers

A DNSP must not, in the provision of direct control services to any person, whether a customer or otherwise, communicate with that person in a way that would favour the DNSP over an independent accredited service provider in the provision of contestable services to the person.

Ausgrid complies with this obligation in the following manner:

⁴⁶ Ausgrid's approved CAM can be found at <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/cost-allocation-method/ausgrid-cost-allocation-method-2014>

- When we are providing monopoly services our letters, calls and publications with customers must be equitable, without favouring either an ASP or Ausgrid's contestable business in undertaking a contestable job.
- Ausgrid has specific anti-competitive and Competition and Consumer Law training aimed at preventing any preferential dealing.

Notifying customers they have a choice of service providers

If a DNSP communicates to a customer located in that DNSP's distribution district that it can provide contestable services to the customer, then it must (at or about the same time) also communicate to the customer that contestable services may also be obtained from an independent accredited service provider and inform the customer how to contact or locate an independent accredited service provider. This requirement also applies where a DNSP uses one website to communicate to customers about both its direct control services and its contestable services.

Ausgrid complies with this obligation through a series of policy documents, business processes, inductions and training. Examples of processes and documents where this is reflected include:

- Connecting / moving is most common contact (ie connecting supply);
- Applications for Connection and Request for Quotation forms;
- Contact Centre scripting (+IVR) and CSO training was previously used to ensure Ausgrid staff do not misled customers to think they have to use Ausgrid's contestable business to carry out the requested work;
- Regional Counter Service areas to reflect principle (including shared offices ie Oatley and Erina) – targeted training and notification at Ausgrid's Contestable Business Counters/locations; and
- Website

Requirements relating to customer support services

A DNSP must:

(a) ensure that DNSP staff involved in customer service (including DNSP staff at a call centre) correctly identify whether the primary purpose of a customer enquiry relates to prescribed distribution services or contestable services;
(b) provide DNSP staff involved in customer service (including DNSP staff at a call centre) with training sufficient to ensure compliance with Part 4 of these Guidelines; and
(c) provide DNSP staff at a call centre with established pro-forma responses for different types of enquiries.

- Contact Centre processes and documentation
- Contact Centre processes and guidance material ensure proper, non-preferential allocation of contestable work.
- Staff in regions to undertake the "Fair Go" video training or the computer based training to ensure correct identification and handling of customer inquiries.

Functional separation requirements

Physical separation of offices

A DNSP must ensure that the offices from which DNSP staff provide specified services (the "first offices") are separate from the offices from which DNSP staff provide contestable services (the "second offices").

Meter Data Agency, Contestable Connection and Sales and Marketing staff are accommodated in a physically separate office locations requiring key-tag access . Only authorised staff have access to these facilities.

Information Separation

A DNSP must implement reasonable security measures to ensure that DNSP staff that provide contestable services are unable to access (including access by means of shared computer systems) information of or derived from DNSP staff that provide specified services which relate to an independent accredited service provider.

Ausgrid has utilised a number of full and partial approaches to achieve compliance with this obligation. Full Ring-Fencing initiatives to prevent inappropriate information sharing from shared use of systems include:

- Staff operating in the Sales and Marketing function of the Metering Business are not allocated any access to applications that show energy usage data for sites not under contract. For example, these staff are not granted access to meter data for any Ausgrid Network sites not under contract. A customer data portal (known as Webgraphs) to view energy usage data is provided solely for the use of the contestable business.
- Sales and Marketing Staff operate a customer relationship management application solely for the use of the Contestable business.
- Ausgrid has developed protocols for its contestable connections business for ensuring that information is provided on an equitable basis to ASPs.

Indirect ring-fencing initiatives to prevent inappropriate information from shared use of systems include:

- Application-level security authorisations prevent view and use of data outside of the required business unit. For example, the Metering Business System (MBS) allows an Ausgrid Contestable Metering to view and update data relating to those sites under contract but prevents the view of other business unit or non-Ausgrid (software as a service) related data within the application.
- Shared Technical Infrastructure secured to only allow authorised staff to maintain technical components. These technical components include:
 - Databases
 - Data Centres
 - Information Communication and Technology (ICT) Network and Telecommunications
 - Server Infrastructure
 - Backup Infrastructure
 - Facilities Management Monitoring.
 - Operating Systems
 - Desktop Administration
- Where metering business units are required to perform functions that span regulated and contestable metering, training and confidentiality agreements are utilised.

Compliance Training Programs

To ensure Ausgrid complies with the Privacy Act and Australian Competition and Consumer Law the organisation ensures that staff undertake mandatory training and regular refresher training in the following areas:

- Information Security Policy Awareness
- Competition and Consumer Law
- The Privacy Act
- Ant-Competitive Conduct

DNSP staff separation

A DNSP must ensure that DNSP staff that provide specified services do not also provide contestable services.

Ausgrid has a partial waiver from IPART from complying with this obligation in rural areas of its network such as Maitland and Muswellbrook.

Appendix 3 – Overview of existing mechanisms

An essential step in developing robust ring fencing arrangements is to identify the potential for harm that the guideline is seeking to address and assess the adequacy of existing arrangements that may protect against the potential for harm. Undertaking this analysis helps to mitigate the risk of unnecessary or disproportionate obligations being imposed.

This section is intended to provide a summary of existing mechanisms that address the potential for anti-competitive behaviour to occur. Included in this section is analysis of:

- 1) existing mechanisms in the regulatory framework that prevent anti-competitive behaviour; and
- 2) other mechanisms external to the regulatory framework that protect against DNSPs engaging in anti-competitive conduct.

It is important to note that Ausgrid considers ring fencing to be a supplementary, rather than the primary, measure for protecting customers against the effects of anti-competitive behaviour. The primary mechanism is the Competition and Consumer Act. The Australian Competition and Consumer Commission (ACCC) has strong investigative and enforcement powers under the Competition and Consumer Act that ensure compliance with the Act's provisions. In particular, we note that the ACCC has the ability to impose significant fines on companies (up to \$10 million) for breaching the provisions of the Act. This is a strong deterrent for companies to engage in anti-competitive conduct or abuse their market position in any way. The prohibitions under the Act with respect to misleading and deceptive conduct are also relevant in that they comprise strong sanctions against DNSPs failing to properly explain to customers that they have a choice in provider in contestable markets.

Existing mechanisms in the regulatory framework

In addition, to the service classification and form of control provisions, the existing regulatory framework contains the following elements that obviate the need for onerous ring fencing obligations:

- **Part F of chapter 6 of the rules regulates cost allocation** - The purpose of Part F is to establish cost allocation arrangements aimed at ensuring that costs are allocated appropriately between the various service classifications, to prevent cross-subsidy of contestable and potentially contestable activities by regulated activities (Refer to Appendix 2).
- **AER Expenditure forecast assessment guidelines**- The guidelines describe the process, techniques and associated data requirements for the AER's approach to setting efficient expenditure allowances for the regulated activities of network businesses. Amongst other things, the guidelines set out a rigorous approach to the assessment of related party costs, to ensure that costs arising under a related party transaction reflect arms-length commercial arrangements. These requirements mitigate the risk of a distributor favouring a related party in the procurement of services.
- **Regulatory Information Notices (RINs) for category analysis data requirements.** Category analysis refers to the economic analysis the AER will use to assess regulatory expenditure proposals of TNSPs and DNSPs. The Guideline explains that assessment of expenditure by the AER will generally include examining forecast expenditure in relation to defined categories of capital and operating expenditure. The AER also issues RINs to inform the price reset process, as well as annual RINs which are subject to third party auditing. This mitigates the risk of preferential dealings between related or affiliated businesses, cross subsidisation between regulated and unregulated activities and prevents guaranteed cost recovery.
- **Shared Asset Guideline** - The Rules empower the AER to reduce the annual revenue requirement for a DNSP or TNSP to reflect the costs of the regulated assets that the DNSP or

TNSP uses in providing an unregulated service. This ensures that regulated customers share in the benefits from NSPs pursuing opportunities to improve the utilisation of existing assets.

- **Chapter 5 and 5A** – These chapters set out a comprehensive and transparent process for connections. In particular, it sets out the basis in which fees can be charged, and also the timeframes in which distributors must respond to connection enquiries and applications and includes provisions that enable a connection applicant to dispute technical requirements if they consider them to be unreasonable or overly onerous. Therefore, these provisions constrain the ability for DNSPs to unfairly restrict access to their infrastructure.
- **Chapter 7** – provides a comprehensive framework governing the collection, use and disclosure of customer data and therefore mitigates the risk of inappropriate information sharing.
- **Chapter 5 Distribution annual planning process** – A component of DNSPs annual planning process is the requirement to publish a Distribution Annual Planning Report which sets out detailed information about the DNSPs network, demand forecasts, consideration of non-network alternatives and location of constraints on the network. DNSPs are already required to publish substantial information about their network, which reduces the potential for a DNSP to confer information which would unfairly advantage its affiliate business over competitors.

The above elements of the regulatory framework are focused on ensuring appropriate cost allocation between the regulated and other activities of network businesses, and providing the AER with detailed information on the costs incurred by network businesses in delivering regulated services. In light of these existing mechanisms it is not necessary to impose onerous ring fencing obligations.

Other mechanisms

In addition to the regulatory framework, Ausgrid notes that there are a range of other mechanisms that aimed at protecting against the potential for NSPs to engage in anti-competitive behaviour. These include:

- **Competition and Consumer Act– section 46** prohibits corporations that have a substantial degree of market power from taking advantage of that power for the purpose of eliminating or substantially damaging a competitor, preventing the entry of a person into a market or deterring or preventing a person from engaging in competitive conduct. We consider the penalties associated with breaches of section 46 provide a strong deterrent against the potential for DNSPs to engage in anti-competitive behaviour. Specifically, we note if a corporation is found in breach of this provision it could face a fine of up to \$10million. We consider that the deterrent effect of this section of the Act would not be affected by implementation of the “Harper Review” changes. Section 46 is the primary deterrent against DNSPs engaging in the conduct at which ring fencing guidelines, both those past and proposed have been directed . The requirements of s46 continue to be at the core of Ausgrid’s compliance and training framework for managing the risk of anti-competitive conduct in contestable energy markets.
- **Competition and Consumer Act** - Section 18 of the Australian Consumer Law (which is contained in the Competition and Consumer Act) prohibits a person, in trade or commerce, from engaging in conduct which is misleading or deceptive or is likely to mislead or deceive. This prohibition is the subject of considerable enforcement activity by the ACCC and provides a significant deterrent against DNSPs failing to properly communicate to customers that energy related services are contestable rather than monopoly offerings.
- **Ministerially imposed licence conditions**⁴⁷ – clauses 4.3 and 4.4 of Ausgrid’s license conditions require separation of accounting and business records, and permits asset sharing in the provision of unregulated services if costs are allocated on the same basis as an

⁴⁷ *Schedule Listing of Ministerially Imposed Licence Conditions for Distributor Network Service Provider.*

unrelated legal entity sharing resources on a commercial arm's length basis.⁴⁸ Compliance with license conditions is monitored and enforced by IPART. Ausgrid reports its compliance with its licence conditions to IPART annually, with IPART publishing an annual report of its findings in its Energy Distribution Licence Compliance Report.

- **National Energy Customer Framework (NECF)** - The NECF establishes the energy specific customer obligations and arrangements for regulating the sale and supply of electricity and gas to consumers. It covers a range of matters, including contractual relationships between retailers and consumers and associated rights and obligations, consumer protection measures, including in relation to marketing and informed consent, and security and privacy provisions. There are also provisions that relate to the relationship between distribution businesses and consumers, specifically for customer connection services.
- **Privacy Act 1988 (Cth)** - governs the collection, use and disclosure of the personal information of customers and others.

Given the significant existing mechanisms aimed at protecting against the potential for DNSPs to engage in anti-competitive behaviour we do not consider that a need for heavy handed regulation has been established, nor that such an approach is required in order to achieve the objectives of ring fencing.

Consequently, based on the evidence we have provided in this section and in sections 1 and 2 we consider that there is a strong need for the AER to recalibrate the level of obligations imposed by ring fencing in order to ensure that guideline promotes outcomes that are consistent with the NEO.

⁴⁸ **Clause 4.3** The *Licence Holder* must keep separate accounting and business records for its distribution system operation functions. **Clause 4.4** The *Licence Holder* may use any resource for both its distribution system operation affairs and any of its other affairs, provided that resource is allocated and costed between those affairs in the same way as it would be allocated and costed between separate unrelated legal entities sharing that resource on a commercial arm's length basis.