

DRAFT

Ring-fencing Guideline

Explanatory statement

August 2016

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Request for submissions

Interested parties are invited to make written submissions to the Australian Energy Regulator (AER) regarding this paper by the close of business 28 September 2016.

Submissions should be sent electronically to: [Ringfencingguideline2016@aer.gov.au](mailto:Ringfencingguideline2016@aer.gov.au)

Alternatively, submissions can be mailed to:

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Enquiries about this paper, or about lodging submissions, should be directed to the Network Regulation branch of the AER on (02) 9230 9133.

Shortened forms

|  |  |
| --- | --- |
| Shortened Form | Extended Form |
| AEMC | Australian Energy Market Commission |
| AER | Australian Energy Regulator |
| ACCC | Australian Competition and Consumer Commission |
| COAG | Council of Australian Governments |
| CAM | cost allocation method |
| DNSP | distribution network service provider |
| NEL | National Electricity Law |
| NEO | National Electricity Objective |
| NEM | National Electricity Market |
| NER or the rules | National Electricity Rules |
| NSP | network service provider |
| DSNP | distribution network service provider |
| TNSP | transmission network service provider |

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# Summary

Ring-fencing is the identification and separation of business activities, costs and revenues within an integrated entity associated with regulated monopoly services, from services provided in a competitive market. Ring-fencing obligations that apply to distribution network service providers (DNSPs) generally require the separation of the accounting and functional aspects of regulated distribution services from other services provided by a DNSP.

Ring-fencing protects the long term interests of consumers by avoiding cross-subsidies that could undermine the efficient costs of regulated services provided by DNSPs. This aligns with the National Electricity Objective (NEO). Ring-fencing also limits the ability of a DNSP to discriminate in favour of its own affiliates (related bodies corporate and other service providers). Ring-fencing therefore protects the long term interests of consumers more broadly by promoting competition in competitive markets. For example, a DNSP may be able to provide non-regulated services and possibly gain an advantage over other service providers through its provision of regulated services. Ring-fencing aims to prevent this. Ring-fencing levels the playing field in competitive markets by seeking to eliminate the advantage a DNSP or its affiliates may otherwise have in providing services.

The Draft Ring-fencing Guideline (Draft Guideline) sets out the obligations DNSPs must comply with to separate their regulated network services from the unregulated services they (or a related body corporate[[1]](#footnote-2)) offer to a competitive market. Ring-fencing is designed to limit the ability of a regulated service provider to confer an unfair advantage when it or a related body corporate (an affiliate) operates in a competitive market.

In April 2016 we published a Preliminary Positions Paper to highlight key issues and approaches that needed to be considered in drafting a new ring-fencing guideline.[[2]](#footnote-3) The new guideline will replace the existing state-based jurisdictional guidelines that have been in place since the early 2000s. As discussed in this Explanatory Statement, the jurisdictional guidelines are no longer fit for purpose. Instead, a revised and national approach is needed that can account for emerging technologies, such as battery storage and embedded renewable generation sources. The new ring-fencing guideline will continue to separate regulated monopoly networks from the competitive electricity generation and retail sectors. In addition, it will be broadened to address emerging technologies in a single ring-fencing framework. The new guideline, which will apply to all electricity DNSPs across the National Electricity Market (NEM), will come into effect on 1 December this year.

The Preliminary Positions Paper posed a series of questions about the objectives and implementation of ring-fencing for electricity DNSPs. We received 29 submissions from stakeholders including DNSPs, electricity retailers, third party service providers and representatives of large and small users of electricity. Submissions from DNSPs raised concerns that the ring-fencing obligations need to be better targeted and proportionate to the potential harm that ring-fencing is seeking to avoid. Concerns were raised that DNSPs may be excluded from participating in contestable markets if ring-fencing provisions were too stringent.[[3]](#footnote-4) Submissions from electricity retailers and consumer representatives, amongst others, raised numerous issues. In general terms, they were either satisfied with our Preliminary Positions Paper or else felt the obligations needed to be further strengthened if competition was to be promoted.

Key themes raised by submissions by DNSPs in their submissions included:

* the initial positions were not best practice
* there was language confusion
* the obligations were “unnecessary”, “disproportionate” and needed to better target harms
* a suggestion that we use a menu approach or establish ring-fencing principles rather than adopt a prescriptive approach
* the need to link existing regulatory instruments to ring-fencing (for example, our Cost Allocation Guideline,[[4]](#footnote-5) regulatory information instruments, incentive schemes, and so on)
* we disregarded the positive role DNSPs could play in new technology or services.

Retailers and consumer representatives, on the other hand, were supportive of the Preliminary Positions Paper, but suggested that we:

* impose more stringent ring-fencing measures
* require structural (ownership) separation of DNSPs from their affiliated businesses that operate in competitive markets
* ensure that compliance and enforcement is rigorous because without this the ring-fencing obligations were of little value.

The Draft Guideline and this Explanatory Statement have been prepared having regard to submissions and further consideration of the underlying purpose and objectives of ring-fencing. In particular, we have revised the ring-fencing objectives to better reflect the harms we are seeking to avoid or address. Our revised objectives are more focussed on dealing with two specific potential harms by DNSPs that we consider are fundamental to what ring-fencing is aiming to achieve:

* prevent DNSPs cross-subsidising between regulated and contestable services
* prevent DNSPs discriminating against other service providers.

Specifically, and with respect to cross-subsidies:

* to avoid the anti-competitive effects of cross-subsidies between the contestable and non-contestable activities offered by a network service provider (NSP) that would adversely affect markets for contestable services or the efficient provision of regulated services.

With respect to non–discrimination:

* to avoid a DNSP conferring a competitive advantage to its own service providers or related bodies corporate that provide competitive or contestable energy-related services
* to require a DNSP to treat and protect information it acquires through its regulated business activities.

In response to submissions that suggested the ring-fencing obligations in the Preliminary Positions Paper could be better targeted we have adopted a set of principles to assist in designing obligations that are targeted and proportionate.

The principles we have used were adapted from a COAG publication on best practice regulation.[[5]](#footnote-6) In particular, we have had regard to whether the obligations contained in the Guideline are:

* targeted – at markets, services, and behaviours of concern
* proportionate – with implementation, monitoring and compliance costs proportionate to actual or potential harm
* predictable – for DNSPs and other stakeholders
* promoting confidence – in markets and regulatory outcomes.

Ring-fencing obligations designed to address cross-subsidies

DNSPs have cost allocation methods (CAMs) that they use to attribute and allocate costs to the services that they provide. The CAMs impose a consistent approach to cost allocation by a DNSP. For a regulated business, like a DNSP, cost allocation is important because the prices of regulated services are determined by the costs of providing the services. The CAM therefore, is crucial to avoiding cross-subsidies between different distribution services. The cost allocation obligations strengthen existing cost allocation arrangements in other regulatory instruments by explicitly preventing a DNSP allocating or attributing to distribution services costs that properly relate to non-distribution services. The allocation and attribution must be consistent with the cost allocation principles in NER clause 6.15.2.

Cost allocation alone might be sufficient to prevent cross-subsidisation if a DNSP did not provide non-network services. Separate accounting obligations, through legal separation, are designed to complement cost allocation by imposing the requirement for a DNSP to establish and maintain separate accounts. The Draft Guideline states that a DNSP must only provide network services through a separate legal entity.[[6]](#footnote-7) As a consequence, other non-network services cannot be offered by a DNSP. This legal separation will assist further in keeping the costs of providing regulated network services separate from other services. While the Draft Guideline prevents a DNSP from providing non-network services, it does not prevent a related body corporate of a DNSP from providing these services.

The Draft Guideline provides that a DNSP may not apply for a waiver in relation to the obligations for legal separation. However, the requirement for legal separation is subject to a materiality threshold, recognising that there is a level below which the costs of strict application could outweigh the benefits achieved. The threshold does not excuse a DNSP from correctly allocating costs to network and non-network services.

Ring-fencing obligations designed to address discrimination

The Draft Guideline includes obligations that require a DNSP not to provide preferential treatment to its related body corporate or customers of its related body corporate. This is a broad obligation. In addition, the Draft Guideline gives a non-exhaustive list of instances where the general obligations not to discriminate may apply. A DNSP must:

* deal with its related bodies corporate on an arms' length basis and in good faith
* offer to deal with competitors of its related body corporate (including services with the same price, quality and reliability) as those for its related body corporate
* avoid providing, either directly or indirectly, information to its related body corporate that the DNSP has obtained through its dealings with a competitor of the related body corporate that may advantage the related body corporate
* avoid advertising or promoting, either directly or indirectly, the services provided by its related body corporate
* have independent and separate branding for its distribution services from a related body corporate that provides non-distribution services.

In the absence of these provisions there is a risk of a DNSP's related bodies corporate gaining an unfair advantage over their competitors in the markets for non-network energy-related services.

The Draft Guideline also includes two sets of specific obligations relating to discrimination. The first set of specific obligations relates to functional separation for related bodies corporate that offer energy-related services. The Draft Guideline includes two types of functional separation:

* physically separating a DNSP's offices from its related bodies corporate
* preventing staff sharing between a DNSP and its related body corporate.

The provisions include several explicit exceptions to functional separation and the potential for a DNSP to apply for a waiver from functional separation obligations. These are the only obligations in the Draft Guideline that are potentially subject to a waiver.

The second set of specific obligations in the Draft Guideline relate to the DNSP's use of information. We have maintained the DNSP obligations noted in the Preliminary Positions Paper about information protection, sharing and disclosure. In the absence of these provisions, we consider there is a high risk of a DNSP's related bodies corporate gaining an unfair advantage over their competitors in markets for competitive or contestable energy related services.

A summary of the Draft Guideline's obligations is provided in Table 1 below. The full obligations are set out in the Draft Guideline.

To help explain how the obligations are applied, a decision tree is provided in appendix B of this Explanatory Statement. A number of case studies of how the decision tree could be applied are also provided in appendix B.

Table Draft Ring–fencing Guideline—summary of obligations[[7]](#footnote-8)

| Harm affecting customers and markets | Ring-fencing obligation | |
| --- | --- | --- |
| Cross-subsidies | Legal separation of DNSP from other entities | A DNSP cannot provide any non-Network Services  (Subject to a materiality threshold)  (Network services are distribution services and/or transmission services) |
| Account separation / Cost allocation | Accounts – DNSP must establish and maintain accounts (in relation to Direct Control Services plus regulated Transmission Services). |
| Costs – DNSP must not allocate / attribute to Distribution Services costs that properly relate to non-Distribution Services. |
| Non-discrimination | Not discriminate | A general obligation on the DNSP that it will not discriminate (either directly or indirectly) in favour of a related body corporate or its customers. |
| No cross-promotion | A DNSP will not advertise or promote the services provided by its affiliate. |
| Functional separation | Physical separation – DNSP must operate independent and separate offices to a related body corporate or an affiliated service provider that provides non-network energy-related services |
| Staff sharing – DNSP must ensure that staff directly involved in the provision or marketing of a Direct Control Service or a regulated Transmission Service are not also involved in the provision or marketing of non-network energy-related services |
| Information access and disclosure | Protection – DNSP must protect information provided by a customer, prospective customer for Direct Control Services and / or regulated Transmission Services, and ensure its use is only for the purpose for which that information was provided. Similarly, a DNSP must protect information it acquires in the normal course of business. |
| Sharing – Where a DNSP acquires information in providing Direct Control Services and/or regulated Transmission Services, and shares this information with a related entity, it must provide access to others on the same price, quality and terms and conditions. |
| Disclosure – DNSP must not disclose information (acquired in providing Direct Control Services and/or regulated Transmission Services) to any party without the informed approval of the relevant customer or prospective customer to whom the information relates. |

Waivers from ring–fencing obligations

A waiver is a permission we may grant to a DNSP allowing it to not satisfy one of more provisions of the Guideline. Waivers were a key aspect of the approach to ring-fencing proposed in the Preliminary Positions Paper.

In revising the ring-fencing obligations, and in light of the design principles to better target the obligations, fewer waivers will be required under the proposed approach set out in the Draft Guideline. This is in part due to waivers now not being available in regard to most obligations, such as legal separation. We have also narrowed the obligations for functional separation to activities we consider pose an immediate risk of discriminatory behaviour. As a result, we anticipate there will be a much reduced need for ring-fencing waivers to be considered.

Where waivers are available, the process and assessment of a waiver application is discussed in section 5 of this explanatory statement. Essentially, we will need to be satisfied that the harm resulting from accepting a waiver does not exceed the likely costs to the DNSP, and hence distribution customers, of retaining functional separation.

Reporting, compliance and enforcement

The Draft Guideline proposes placing a range of reporting and compliance requirements on DNSPs. This will be supported by a requirement for DNSPs to engage independent third parties to annually assess their compliance with ring-fencing obligations. The main elements of the compliance requirements are for a DSNP to:

* establish and maintain appropriate ring-fencing procedures and practices
* demonstrate the adequacy of these procedures by an independent third party assessment
* report annually on its compliance with all or part of the Draft Guideline
* notify us in writing within five business days of becoming aware of a material breach of its obligations under the guideline.

With respect to compliance breaches by a DNSP, we may seek enforcement of the Draft Guideline by a court in accordance with the NEL.

Any interested party may make a complaint to us about a possible breach of the Draft Guideline by a DNSP. We will investigate complaints in accordance with our compliance and enforcement policy. At any time we may require a DNSP to provide a formal response to particular concerns about compliance with the Draft Guideline.

Transition to the new ring–fencing arrangements

We accept the need for a transition period to the new ring–fencing arrangements. This position generally was also accepted by stakeholders, though some called for a longer or a shorter period than one year. Given the likely implementation costs and complexity, we consider it reasonable to allow a transition period of up to one year for DNSPs to comply with legal separation obligations and six months to comply with obligations for functional separation.

In the Preliminary Positions Paper we suggested the possibility of 'grandfathering' existing waivers provided under existing jurisdictional ring-fencing arrangements. We consider grandfathering would create legal problems that cannot be adequately managed, as discussed in section 5. Instead we propose an alternative approach to grandfathering existing waivers. We intend to review each of the existing ring-fencing waivers before the Draft Guideline comes into effect. We propose undertaking a separate consultation process to jointly consider all existing jurisdictional waivers, which will provide an effective means of dealing with them.

# About the Ring-fencing Guideline

The Australian Energy Regulator (AER) is the economic regulator for transmission and distribution electricity and gas businesses in Australia's national electricity market (NEM). We are an independent statutory authority, our powers and functions are set in the National Electricity Law (NEL) and National Electricity Rules (NER).

The Draft Guideline, once finalised, will establish a national ring-fencing approach to replace State based ring–fencing arrangements that have operated for more than a decade. Since 2008 we have administered ring–fencing arrangements that were established by jurisdictional regulators for each state and territory. To date ring–fencing has been largely focussed on separating regulated network services (poles and wires) from contestable services (electricity retail and generation). Now we are looking at its applicability more broadly to all contestable services, including metering, connection and decentralised energy resources, such as energy storage services. The need for a broader scope to ring-fencing was signalled in the Australian Energy Market Commission (AEMC) final rule determination on metering contestability.[[8]](#footnote-9) Our aim is also to bring together State and Territory based regimes under a consistent, national approach.

In 2015 the AEMC made changes to the NER following agreement by the Council of Australian Governments' (COAG) Energy Council (Energy Council) on reforms to metering, one of a number of changes recommended in its Power of Choice Review. The rule changes will lead to, amongst other things, greater competition in the provision of metering services. As a consequence the AER is required to develop a national ring–fencing guideline by 1 December 2016. The new guideline will underpin the increasingly important role third party service providers will play in the supply of metering and other network services to consumers. For example, distribution businesses previously provided residential customers with metering and connection services exclusively. Within a few years these services will be more contestable in most States and provide consumers with far greater choice. The ring-fencing guideline will support the development of these markets by separating regulated monopoly services from services offered competitively.

A nationally consistent ring–fencing guideline should facilitate the use of new technologies (such as the use of batteries for energy storage) and greater participation by all providers including DNSPs.

The COAG Energy Council announced last year that work between its officials and market agencies would include a review of ring-fencing arrangements in 2016.[[9]](#footnote-10) Stemming from this review, new ring fencing arrangements would:

* support the development of competitive markets in services which are or should be contestable
* provide clarity and certainty in the market for new investment
* provide a level playing field for all parties providing energy services
* accelerate innovation and efficient investment.

In April 2016 we published a Preliminary Positions Paper to highlight key issues to be considered in drafting a national ring-fencing guideline and provide some preliminary views on the scope and nature of ring-fencing obligations. The Preliminary Positions Paper posed a series of questions about the objectives and implementation of ring fencing for electricity distribution networks. We received 29 submissions from stakeholders including network businesses, electricity retailers, third party service providers and representatives of large and small users of electricity. The Draft Guideline and this Explanatory Statement are another step in the finalisation of the guideline later this year.

This Explanatory Statement describes the approach to ring-fencing set out in our draft electricity distribution ring-fencing guideline. The Draft Guideline has been revised in a number of significant ways compared with the approach set out in our Preliminary Positons Paper. The revisions reflect the many submissions from stakeholders and other interested parties as well as further consideration of how the guideline can work in a way that is targeted, proportionate, predicable and promotes confidence in markets.

We have had regard to all the issues raised in submissions—most of which are cited in this Explanatory Statement. In many instances, similar issues were raised in multiple submissions. It is also apparent that stakeholders hold divergent views on various aspects of ring-fencing. A full list of submissions is provided in appendix A

Table 2 Ring-fencing guideline timeline (indicative)

|  |  |
| --- | --- |
| Step | Date |
| AER published preliminary position | April 2016 |
| Submissions due | 30 May 2016 |
| Meetings with key stakeholders | May/June 2016 |
| AER issues draft Guideline and Explanatory Statement | August 2016 |
| Submissions on Guideline due | 28 September 2016 |
| Meetings with key stakeholders | September 2016 |
| Final Guideline (must be within 80 business days of draft guideline\*) | On or before 30 November 2016\* |

\* NER requirement

Updates

Stakeholders who wish to be advised of upcoming workshops or other ring-fencing related issues should subscribe to the AER website for notifications at [www.aer.gov.au/newsletter/subscribe](https://www.aer.gov.au/newsletter/subscribe) and indicate "ring-fencing" as a topic of interest to you.

## Reasons for this guideline

The existing State based jurisdictional ring-fencing guidelines have changed very little since they were first published in the early 2000s by individual state regulators. The current guidelines were designed to support the structural separation of retail, transmission, distribution and generation. The current guidelines do not adequately account for new and emerging technologies like solar PV, network energy storage or market reforms around metering and other service contestability. The need for a new ring-fencing guideline to replace the jurisdictional guidelines was noted in numerous submissions[[10]](#footnote-11) and was also the subject of an earlier AER consultation on new ring-fencing arrangements in 2011.[[11]](#footnote-12)

Furthermore, as an outcome of the AEMC’s Power of Choice review, changes made to the NER in December 2015 affect existing ring-fencing arrangements. In particular, we are now required to develop a ring-fencing guideline by 1 December 2016, which is one year ahead of the commencement of metering contestability. Once developed, the AER ring-fencing guideline would apply across the NEM and will replace existing jurisdictional ring-fencing arrangements.

Ring-fencing arrangements for transmission are not discussed separately in this paper. The AER guideline will pertain to distribution services, in part due to the differences in the way that prescribed transmission services are defined in the NER. However, we anticipate that future ring-fencing arrangements for transmission services will likely mirror the arrangements that will be put place for distribution. Therefore, in most instances we refer to 'network services' (as defined in the NER) in order to provide consistent application of the Guideline to a DNSP or TNSP. Variations would be likely only where there is an underlying need for any differences to be maintained.

### Rule requirements

The NER provides a framework for implementing a national approach to electricity ring-fencing. The guideline is legally binding, meaning DNSPs must comply with the guideline.

The NER sets out mechanisms through which we can establish a 'ring-fence' around a DNSP from its other business activities. The mechanisms referred to in the NER are legal, accounting and functional separation to limit information flows. However, we are not limited to these mechanisms.

The NER also states the ring-fencing guideline must be consistent, so far as practicable, with the transmission services ring-fencing guideline. The transmission guideline has not been revised since 2003. As a result, the need for consistency may highlight the need for revisions to the transmission guideline rather than limiting the development of the distribution guideline.

The relevant provisions of the NER relating to the AER ring–fencing guideline are paraphrased in table 3 below. The NER requirements are not prescriptive and do not identify the intended harm the guideline might seek to avoid.

Table 3 NER ring–fencing provisions

|  |  |
| --- | --- |
| NER clause | Description |
| 6.17.1 | All DNSPs must comply with the Guideline. |
| 6.17.2(a) | The AER may develop Guidelines that provide for accounting and functional separation between direct control services and other service provided by a DNSP. The application of the guideline may vary between jurisdictions. |
| 6.17.2(b) | The Guideline may include provisions for:  Legal separation  Separate financial accounts for standard control services (SCS), alternative control services (ACS) and other services  Allocation of costs between SCS, ACS and other services  Limitations on information flows  Provisions for ring-fencing waivers. |
| 6.17(c) | In developing the Guideline the AER must consider consistency between distribution and transmission. |
| 6.17.2(d) | The Guideline must be developed in accordance with the distribution consultation procedures. |

## What is ring-fencing?

Ring-fencing is the identification and separation of business activities, costs, revenues and decision making within an integrated entity associated with a regulated monopoly service, from those that are associated with providing services in a competitive market. Ring-fencing obligations that apply to distribution network service providers (DNSPs) generally require the separation of the accounting and functional aspects of regulated distribution services from other services provided by a DNSP.

Ring-fencing protects the long term interests of consumers by ensuring efficient costs for regulated services provided by DNSPs. This aligns with the National Electricity Objective. Ring-fencing also limits the ability of DNSPs to discriminate in favour of its own related bodies corporate. Ring-fencing therefore protects the long term interests of consumers more broadly by promoting competition in contestable markets. For example, a DNSP may be able to provide non-regulated services, and possibly gain an advantage over other service providers through its provision of regulated services. Ring-fencing aims to prevent this. Ring-fencing levels the playing field in competitive markets by eliminating the advantage a DNSP may otherwise have in providing that service.

A ring-fencing guideline sets out the obligations the network business must abide by to separate its regulated monopoly services from the contestable services it offers to a competitive market. Ring-fencing is designed to limit the ability of a regulated service provider to confer an unfair advantage when it or one of its affiliates operates in a competitive market. As noted by the AEMC, the following types of behaviours by NSPs result in harm that ring-fencing aims to avoid:[[12]](#footnote-13)

* cross-subsidising the affiliate’s services in the contestable market with revenue derived from its regulated services
* discrimination in favour of an affiliate operating in a contestable market
* providing the affiliate with access to commercially sensitive information acquired through the provision of regulated services
* restricting the access other participants in the contestable market have to the infrastructure services provided by the regulated entity, or providing access on less favourable terms than its affiliate.

Ring-fencing was initially used in the NEM to give effect to vertical separation between large segments of the electricity supply industry. For example, it was common for an electricity retailer and an electricity distribution business to have a single owner, although few of these now remain. Separation of the retail business from the distribution business was achieved through ring-fencing, which meant that staff, financial accounts and information flows were separated. However, there are significant differences between the jurisdictions with respect to ring-fencing obligations and reporting and compliance requirements.

In recent years, small customer connections and residential metering—once considered core to electricity distribution businesses—are now being opened up to competition. As a result, ring-fencing is being applied to these segments of the electricity supply industry. Other business activities that may be subject to ring-fencing include load control and management, network battery storage or meter data provision, to mention just a few.

We expect our Draft Guideline will aid the development of competitive markets where competition is feasible and support efficient incentive-based regulation of the monopoly networks where competition is not feasible.

### Remedies

As noted earlier, the broad objective of ring-fencing is to limit the ability of the regulated entity to confer an unfair advantage to itself, a related body corporate or another service provider operating in a competitive market. This is achieved by restricting the scope for cross subsidisation between the regulated and contestable business activities and by imposing requirements that prohibit discriminatory treatment by the DNSP. The extent of regulatory intervention can vary from light-handed to extensive. The choice depends on the potential harm that could result if regulated and contestable business activities are not separated.

The typical means of separating services through ring-fencing are well established: legal, accounting and functional separation, along with restrictions around information flows. To determine how best to use these means of separation efficiently, effectively and in the long term interests of consumers, we need to have a clear understanding of the objectives of ring-fencing. Indeed we need to be able to answer the questions: what is the potential harm that ring-fencing is intended to address and do the benefits of ring-fencing outweigh the costs of compliance?

Regulated DNSPs do not face the same costs or risks as unregulated businesses operating in competitive markets. Regulated businesses may also have exclusive access to information they gather as network operators. Furthermore, a DNSP could restrict access to its monopoly assets, favouring its affiliate over competitors. What this means is that a DNSP, a related body corporate or another service provider could gain an unfair advantage that limits the potential development of competitive markets, which can provide customers with better services and choices and at lower prices.

### Structural separation

Some stakeholders submitted that we should seek to structurally or fully separate DNSPs from businesses providing services into competitive energy markets.[[13]](#footnote-14) Structural separation essentially means full ownership separation. In effect it would mean requiring a DNSP to divest its interests (ownership) in certain business activities. As noted in our Preliminary Position Paper, the NER does not provide us with the authority to impose structural separation on a DNSP, such as would prohibit a business from engaging in certain activities.

In any case, structural separation may entail other costs. A DNSP may have certain efficiency advantages in the provision of a contestable service. This may be due to comparative advantage stemming from, for example, its scale and scope of network-related activities. If so, ring-fencing can seek to balance the competing objectives of promoting competition whilst at the same time providing DNSPs with a means (through a related body corporate) to offer services into a competitive market. That is, there may be merit in taking an approach that seeks to balance the costs and benefits of ring-fencing. The approach to ring-fencing in the Draft Guideline aims to strike an appropriate balance between such costs and benefits.

There is a broader issue around structural separation in regard to services stemming from emerging technologies that could affect the role of DNSPs in the future. This is ultimately a policy issue for governments through the COAG Energy Council and in our view would require changes to the NER and the NEL.

## Who is affected?

Several submissions suggested we needed to be clearer in regard to who is affected by the ring-fencing guideline and its obligations.[[14]](#footnote-15) We agree it is important to be precise about which entities are subject to and responsible for complying with the ring-fencing obligations. To avoid any doubt: DNSPs are subject the Ring-fencing Guideline and are responsible for complying with its obligations.

We will require a DNSP to provide network services through a separate legal entity from any other entity through which it conducts its business.[[15]](#footnote-16) This is represented in figure 1 below (green box on left). It is also evident that non-distribution services are provided through a different legal entity (orange box on right).

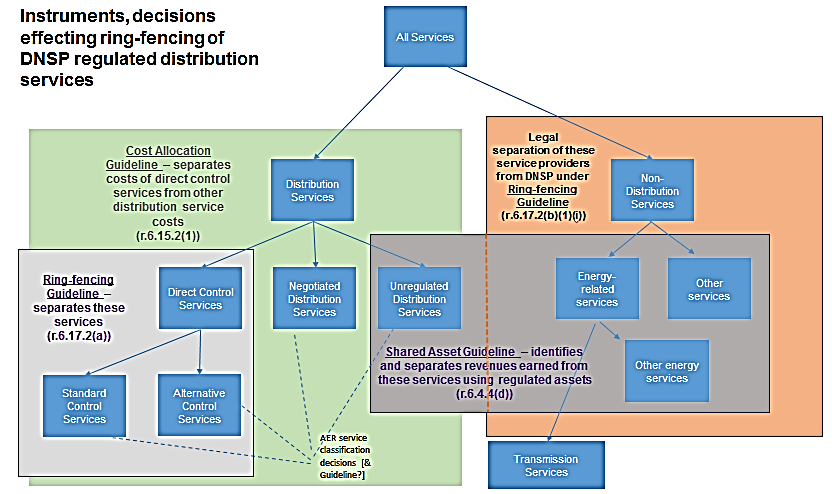
The cost allocation principles in the NER that underpin the AER Cost Allocation Guideline require the costs of providing distribution services to be attributed or allocated to the various types of distribution services. These services include standard control services (use of shared system), alternative control services (user requested fee based services), negotiated services (services for which disputes may be settled by the AER) and unclassified services (distribution services the AER considers do not require price regulation). The classification of a service into one of the service grouping occurs at the time of the AER's Regulatory Determination—typically once every five years. Importantly, the cost allocation provisions do not apply to any cost allocation between distribution services and other services, only between types of distribution services. This is discussed further below in relation to the need for legal separation.

Direct controls services (figure 1, light grey box), account for most of the revenue generated by a DNSP (close to100 per cent of revenue in some cases). Direct control services are monopoly services and are therefore subject to economic regulation. That is, we set the prices and/or revenue a DNSP may earn from these activities. The Draft Guideline applies to these direct control services.

Ring-fencing obligations for functional separation apply to the direct control services provided by a DNSP. Functional separation refers to the separation of staff and information where there is a risk that information prejudicial to competitive markets may be passed to an unregulated affiliate of the DNSP. This is discussed further in section 3.

The role that shared assets play in the provision of services is also shown in figure 1. When a DNSP uses an asset within its regulated asset base to provide services that generate unregulated revenue, a portion of this revenue (above a threshold) must be returned to distribution customers. Because ring-fencing is concerned with services, not assets, shared assets may continue to play a role in the provision of unregulated services. This means that customers will continue to receive benefits as set out for in the shared asset guideline.

Figure 1 - Network services linkage to ring-fencing



### Relationship to service classification

The Draft Guideline provides for accounting and functional separation of direct control services from other services. The ring-fencing treatment of a particular service is therefore stems from its service classification. The decision on service classification is settled at the time the AER makes its Regulatory Determination for a DNSP. Classification will settle the ring-fencing obligations for a particular service for a regulatory control period. With respect to figure 1 above, classification determines which 'box' a DNSP's services will fall into—light grey, green or orange.

Service classification for a forthcoming regulatory control period is first considered as part of the Framework and Approach (F&A), which is a preliminary process of consider key elements of the regulatory regime application to a DNSP. While classification is not finally settled until the Determination is made, the F&A provides an opportunity to review whether the regulatory arrangement applicable to each particular service offered by DNSP are still relevant for the next regulatory control period. For a DNSP, the F&A considers whether:

* a service is a distribution service and is therefore potentially subject to regulation under the NER
* the service is provided to all customers or subset of customers
* the potential for the service to become a contestable service and therefore subject to competition provision
* there are already alternative service providers making economic regulation unnecessary

From time to time, a DNSP may commence providing a new service that was not considered at the time the classification of services was finalised. Our approach to service classification is to classify services in groupings rather than individually. This obviates the need to classify services one-by-one and instead defines a service cluster, that where a service is similar in nature it would require the same regulatory treatment. A new service might simply be added to the existing grouping and hence be treated in the same way for ring-fencing purposes. Alternatively, a service that does not belong to any existing service classification is 'not classified' and would be treated as a non-network service and not regulated.

Links to other regulatory instruments

The Draft Guideline should be read in conjunction with:

* the AER's Regulatory Determination on the classification of the services to be provided by a DNSP in a regulatory control period, in accordance with clauses 6.2 and 6.12.1(1) of the NER
* NER clause 6.15, the Cost Allocation Guideline and the AER-approved CAMs;
* NER clause 6.4.4 of the NER and the Shared Asset Guideline.

Together, these instruments, plus the non-discrimination and separation obligations, contribute to the desired ring-fencing outcomes in the long term interest of consumers.

The AER's service classification decision determines the nature of the economic regulation, if any, applicable to a DNSP's specific distribution services. The classification affects the application of obligations in the Draft Guideline.

The Cost Allocation Guideline and a DNSP's CAM relate to the allocation and attribution of its costs between its distribution services. They complement the obligations in the Draft Ring-fencing Guideline, which relates to the allocation and attribution of a DNSP's costs to distribution services and to be able to distinguish these costs from any costs the DNSP or its related bodies corporate may incur in providing non-network services.

The Shared Asset Guideline enables the adjustment of a DNSP's revenues that it can recover from its distribution services where its CAM no longer accurately reflects how its assets are used. The shared asset mechanism therefore modifies the effect of the CAM.

The Regulatory Information Instruments can require a DNSP to provide information to the AER and to have this information certified and audited. This can include information that is subject to ring-fencing obligations under the Guideline.

## Preliminary Positions Paper and submissions

We published a Preliminary Positions Paper regarding ring-fencing in April 2016, which provided a preliminary view on the nature and scope of ring-fencing obligations. Our intention was to provide some guidance on an approach to ring-fencing as a means of engaging with stakeholders. We also proposed a number of questions for consideration that would be central to the development of the guideline. The Preliminary Positions Paper can be summarised as a framework built around three core elements:

1. **Services coverage**

Services subject to ring-fencing would be determined through ‘service classification’, which defines how services are regulated. Service classification is considered at the time the Regulatory Determination is made, which is typically every five years.

1. **Obligations**

Proposed obligations were reasonably onerous and encapsulating – everything other than direct control services were captured – full staff and physical separation were required

1. **Waivers**

Waivers could be sought for any or all obligations. The purpose was to be as flexible as possible subject to a default position that would require ring-fencing unless a waiver was accepted. It was proposed that fast track waivers and industry wide waivers would also increase flexibility.

In addition, the Preliminary Positions Paper also considered other aspects that would need to form part of the guideline to assist in implementation and compliance. In particular:

* transitions to compliance
* grandfathering of existing wavers
* reporting and enforcement to encourage transparency and compliance.

In response to the Preliminary Positions Paper, we received submissions from 29 interested parties. Key themes raised by DNSPs included:

* the initial positions were not best practice
* there was language confusion
* the obligations were “unnecessary”, “disproportionate” and needed to better target harms
* there was a suggestion that we use a menu approach or establish ring fencing principles rather than adopt a prescriptive approach
* we should more clearly link existing regulatory instruments to ring–fencing (e.g. the Cost Allocation Guideline, regulatory information instruments, incentive schemes, etc.)
* we had disregarded the positive role NSPs could play in promoting new technology.

Retailers and consumers representatives, on the other hand, were generally supportive of the Preliminary Positions Paper. However, it was suggested that we:

* needed to impose more stringent ring-fencing measures
* require structural separation of DNSP from their affiliated businesses that operate in competitive markets
* ensure that compliance and enforcement is rigorous because without this the ring-fencing obligations were of little value.

Submissions are discussed in more detail in subsequent sections of this Explanatory Statement.

## Our broad response to submissions

The submissions received from stakeholders have persuaded us to reconsider several aspects of our Preliminary Positions Paper. In particular we have:

* made clear the ring-fencing obligations apply to the regulated DNSPs (rather than non-network service providers)
* narrowed the obligations for functional separation to interactions we consider will lead to harm
* removed the potential for some of the obligations to be waived.

The general framework remains. That is, classification is used to determine how a DNSP will be affected by ring-fencing, based on the services that it provides. The ring-fencing objective remains essentially the same although it has been refined to provide a sharper focus on cross-subsidies and discrimination.

While the need for a robust monitoring and reporting regime is unchanged, more detail is provided in the Draft Guideline and in this Explanatory Statement.

We have clarified that the costs associated with ring-fencing will be met by the party that incurs the costs. Many of these costs are already met by the relevant party, such as ring-fencing compliance under the jurisdictional guidelines. Incremental costs associated with the Draft Guideline may fall to either the DNSPs or to other parties, depending on which party incurs the costs.

In developing the Draft Guideline, we have considered the objectives that were outlined in the Preliminary Position Paper that were drawn from the jurisdictional approaches to ring-fencing. Submission to the Preliminary Positons Paper supported our proposed ring-fencing objectives.[[16]](#footnote-17) Further, in light of submissions suggesting the guideline should focus more clearly on the regulated entity subject to ring fencing and to more directly address the harms that ring fencing seeks to avoid, we have further simplified the objectives without narrowing their scope or intent.

Ring-fencing statement of objectives

The objective of ring-fencing is to protect the long-term interests of consumers by avoiding cross-subsidies that could undermine the efficient provision of regulated network services provided by DNSPs. More broadly, the objective of ring-fencing is to protect the long-term interests of consumers by promoting confidence in markets for energy services in which a DNSP or its related body corporate compete. Ring-fencing, therefore, aims to limit the ability of DNSPs to discriminate in favour of its related bodies corporate.

We consider this statement of objectives aligns with the NEO.

Unpacking these objectives, ring-fencing aims to address two forms of harm: cross subsidies and discrimination

With respect to cross-subsidies:

* to avoid the anti-competitive effects of cross-subsidies between the network and non-network activities offered by an NSP that would adversely affect markets for contestable services or the efficient provision of regulated services.

With respect to discrimination:

* to avoid a DNSP conferring a competitive advantage to its own service providers or related bodies corporate that provide competitive or contestable energy-related services
* to require a DNSP to treat and protect information it acquires through its regulated business activities.

The remedies to these potential harms are contained as obligations under the Draft Guideline. The obligations we consider will best achieve the objectives are described in section 3. We agree with submissions that suggested a set of principles be used to design obligations that will best address the objectives.

In developing the proposed form and content of the Draft Guideline, we have been guided by the COAG Best Practice Regulation Principles (the COAG Guide),[[17]](#footnote-18) as well as relevant principles of good regulatory instrument and enforcement design.[[18]](#footnote-19)

We note that the COAG Guide and Australian Government Guide to Regulation[[19]](#footnote-20) (with its focus on cutting red tape) are targeted at regulatory impact assessments for new legislative or rule proposals. Nevertheless, the principles espoused are useful and relevant in the context of our developing a fit-for-purpose ring-fencing guideline that achieves its underlying policy objectives.

Broadly, the COAG Guide requires governments to ensure that regulatory processes in their jurisdiction are consistent with the principles summarised below:

1. Establish a case for action before addressing a problem.
2. Consider a range of feasible policy options and assess their benefits and costs.
3. Adopt the option that generates the greatest net benefit for the community.
4. Do not restrict competition unless it can be demonstrated that benefits of restrictions to the community as a whole outweigh the costs, and objectives of the regulation can only be achieved by restricting competition.
5. Provide effective guidance to relevant regulators and regulated parties to ensure that the policy intent, expected compliance requirements are clear.
6. Ensure that regulation remains relevant and effective over time.
7. Consult effectively with affected key stakeholders at all stages of regulatory cycle.
8. Action should be effective and proportional to the issue being addressed.

We have sought to develop ring-fencing obligations that are:

* efficient and effective in achieving the desired outcomes and objectives
* adaptive and flexible over time, and in accommodating different DNSP circumstances, new business models and technologies, and product innovation
* administratively workable and enforceable, from AER, DNSP and stakeholder perspectives
* consistent with and/or complement existing regulatory instruments
* transparent and accessible by all stakeholders.

After considering component parts of the Draft Guideline framework, we then considered whether the overall approach was:

* targeted – at markets, services, and behaviours of concern
* proportionate – with implementation, monitoring and compliance costs proportionate to actual or potential harm
* predictable – for DNSPs and other stakeholders
* promoting confidence – in markets and regulatory outcomes.

The obligations contained in the Draft Guideline and discussed in the next sections reflect these regulatory design principles.

## Revised approach to ring-fencing

The following sections outline and discuss the approach to ring-fencing we have adopted in the Draft Guideline. The obligations relating to cross-subsidies are set out in section 3, and those relating to discrimination are in section 4. The sections also outline the key issues that were raised in submissions and our response.

In appendix B is a decision tree that shows how the obligations would be applied to a DNSP and we have provided a number of case studies to assist in understanding how the Draft Guideline would be applied in practice.

# Measures targeting cross-subsidisation

As noted in section 2, ring-fencing aims to address two key harms: cross-subsidisation and discrimination. This section describes the content and rationale for provisions in the Draft Guideline that reduce the risk of cross-subsidisation by a DNSP.

The Draft Guideline includes a coordinated suite of measures to address cross-subsidisation. The measures cover legal separation, separate accounting and cost allocation. We consider that the proposed obligations represent a targeted, proportionate and effective regulatory response to the risks of cross-subsidisation.

The legal separation obligations require a DNSP to provide only network services, subject to a materiality threshold for non-network services.[[20]](#footnote-21) The Draft Guideline prevents a DNSP from providing non-network services but it does not prevent a related body corporate of a DNSP from providing these services subject to certain constraints.

The separate accounting obligations require a DNSP to establish and maintain appropriate internal accounting procedures to ensure that it can show the extent and nature of transactions between it and its related bodies corporate.

The cost allocation obligations strengthen existing cost allocation arrangements in other regulatory instruments by explicitly preventing a DNSP allocating or attributing to distribution services costs that properly relate to non-distribution services. The allocation and attribution must be consistent with the cost allocation principles in NER clause 6.15.2.

Importantly, we have assessed that the obligations that address cross-subsidisation will always be necessary and therefore waivers will not be permitted.

This section first summarises the approach to targeting cross-subsidies set out in our Preliminary Positions Paper. We then describe the positions in our Draft Guideline and our reasons for adopting them. We conclude the section by examining stakeholders' submissions by theme and describe how we have responded to their feedback.

## Preliminary Positions Paper

Our Preliminary Positions Paper[[21]](#footnote-22) identified that ring-fencing objectives aim to, inter alia, "avoid the anti-competitive effects of cross-subsidies between the contestable and non-contestable activities offered by an NSP that would adversely affect markets for contestable services or the efficient provision of regulated services".

The Preliminary Positions Paper proposed relevant DNSP obligations:

* not to carry on a ring-fenced service unless it is within a separate legal entity to the DNSP
* to establish and maintain separate accounts that clearly identify the extent and nature of transactions between the NSP and ring-fenced entity(s)
* to ensure there is no cross-subsidy between the ring-fenced entity and the DNSP.[[22]](#footnote-23)

## Draft Guideline position

Through provisions incorporated in the Draft Guideline, we are responding to specific concerns expressed by stakeholders set out in section 3.3 below in relation to the potential for a DNSP:

* providing non-network services that could be cross-subsidised by its network services
* inefficiently inflating its prices for Direct Control Services and regulated Transmission Services.

Section 3 of the Draft Guideline addresses cross-subsidy concerns by introducing obligations for:

* legal separation of the DNSP from other entities
* separate accounting
* cost allocation.

Each of these obligations is described in detail below.

The Draft Guideline builds on the Preliminary Positions Paper by clarifying and refining a number of points. In relation to legal separation, the Draft Guideline clarifies the services to which the obligation applies; it applies to services provided in all areas, and not only in the relevant DNSP's monopoly local service area;[[23]](#footnote-24) removes the potential for waivers; introduces for consultation the concept of a materiality threshold; and establishes transitional arrangements.

For separate accounting and cost allocation, the Draft Guideline clarifies the services to which the obligation applies, removes the potential for waivers and confirms that there will be no transitional arrangements.

Each of these changes reflects our application of the regulatory design principles outlined in section 2.7 above.

### Legal separation

The NER state that a ring-fencing guideline may include provisions defining the need for and extent of "legal separation of the entity through which a DNSP provides network services from any other entity through which it conducts its business".[[24]](#footnote-25)

The Draft Guideline states that a DNSP must provide only network services, subject to a materiality threshold for non-network services. The Draft Guideline prevents a DNSP from providing non-network services but it does not prevent a related body corporate of a DNSP from providing these services.

Legal separation provides a means through which the AER can require a DNSP to establish and maintain separate accounts specifically for the provision of network services to the exclusion of costs relating to non-network services. Separate accounting and cost allocation alone would not prevent cross-subsidisation if a DNSP was to provide non-network services. This is because the distribution cost allocation principles only apply to the allocation of costs to distribution services.[[25]](#footnote-26) In turn, the cost allocation principles underpin the operation of the CAM used by a DNSP to attribute costs within its CAM allocation. Rather, we must approve a CAM that gives effect to and is consistent with the cost allocation principles.[[26]](#footnote-27) While we are aware that some DNSPs account for cost allocation between network and non-network services, not all do and the AER has no other power to require CAMs to reflect the allocation and attribution of costs to non-network services.

We consider that the proposed legal separation obligations represent a targeted, proportionate and effective regulatory response. They are a part of a coordinated approach to reduce the risk of cross-subsidisation. Specifically:

* the obligations are targeted to focus only on the DNSP and defined services
* anticipated costs associated with the obligations (implementation, administration and compliance) are proportionate to the potential harm
* the obligations will provide sufficient certainty and confidence in the markets for both non-network services and regulated services, and provide clarity and certainty to DNSPs in terms of compliance.

The reasons for the component parts of the legal separation obligation are as follows.

Network services and non-network services

A DNSP must be able to provide all distribution services, regulated and unregulated, as well as regulated transmission services (where relevant), in order to meet its obligations under the NER. There is no requirement for a DNSP to provide non-network services (although it may, of course, choose to do so).

By restricting a DNSP to provide only network services, we address concerns about the potential for a DNSP to cross-subsidise its non-network services through its network services, to the long term detriment of customers. We consider that this restriction is required to address this risk and that separate accounting and cost allocation, without legal separation, would not be effective.

NEM-wide application

A DNSP has a monopoly in providing regulated distribution services in its local area, creating a risk of the DNSP cross-subsidising non-network services if it is allowed to provide them in its local area. Therefore, as a minimum, the Draft Guideline should prevent a DNSP providing non-network services within its local area.

There is also the risk of a DNSP cross-subsidising non-network services that it might provide outside of its local area through the network services that it provides within its local area.

For the same reasons that the proposed new cost allocation and attribution requirements are essential but not of their own sufficient to address the risk of cross–subsidisation in its local area, the Draft Guideline prevents a DNSP providing non-network services in any area — whether inside or outside of its local area.

Materiality threshold

The Draft Guideline requires a DNSP to provide only network services, subject to a materiality threshold for non-network services. If the materiality threshold is reached, the relevant non-network services cannot be provided by the DNSP. Importantly, the materiality threshold does not exempt a DNSP from complying with the accounting separation and cost allocation obligations specified in section 3 of the Draft Guideline that target cross-subsidisation.

In developing this position, we considered both whether a materiality threshold is needed and the level of the threshold.

On balance, we consider a materiality threshold is required to enable a DNSP to provide limited non-network services that are incidental to, but necessary to support the provision of, its network services. The threshold should allow a DNSP to do the minimum necessary to support its network services, without having a materiality adverse impact on competition in the market for non-network services.

The annual materiality threshold is $500,000 of total costs incurred (comprising direct and non-direct costs), and would apply in any year when the non-network services provided by a DNSP exceed $500,000 of total costs. In determining this level, we considered first materiality thresholds for distribution pass through events under the NER, currently set at one percent of annual average revenue. That threshold, if applied to legal separation, would create inconsistencies across DNSPs, and could result in materially adverse effects on the markets for contestable services. Instead, a threshold based on a fixed dollar value would achieve a more balanced outcome.

We also considered whether a materiality threshold should apply to revenue or costs. Given that one of the objectives of the Draft Guideline is to ensure that there is no cross-subsidisation between regulated network services and non-network services we think that the materiality threshold should apply to total costs (comprising direct and non-direct costs). Though determining the materiality threshold can be subjective, the level should reflect the likely impact on the development of the contestable and competitive market. Relevant considerations include the confidence of parties other than DNSPs which are operating in the market for competitive services; and the importance of DNSPs not having an unfair advantage (whether that is cross-subsidisation or access to information).

On balance, if a DNSP provides non-network services below the proposed materiality threshold of $500,000 total costs per annum, such service provision by the DNSP is unlikely to have a materially adverse effect on the markets for contestable services, or on the efficient provision of regulated services (given the other ring-fencing obligations that will continue to apply). The threshold refers to the total of all non-network services offered by a DNSP.

It should be noted the existence of the materiality threshold for legal separation does not authorise a DNSP to cross-subsidise a non-network service below the threshold. A DNSP offering a non-network service must not attribute costs associated with a non-network service to a network service, or vice versa.

We may review this materiality provision in the future if evidence emerges that it is undermining the ring-fencing policy objectives.

No waiver

Apart from scope provided by the materiality threshold we consider no waivers should be allowed in relation to the legal separation obligation. Waivers could undermine certainty and therefore confidence in the market for non–network services, and customers' confidence in efficient prices for regulated services.

We consider that 12 months is a reasonable period for a DNSP to cease providing non-network services, including time to deal satisfactorily with its existing commitments.

### Separate accounting

The NER state that a ring-fencing guideline may include provisions defining the need for and extent of "the establishment and maintenance of consolidated and separate accounts for standard control services, alternative control services and other services provided by the DNSP".[[27]](#footnote-28)

The Draft Guideline states:

* A DNSP must establish and maintain appropriate internal accounting procedures to ensure that it can show the extent and nature of transactions between it and its related bodies corporate.

In the absence of these provisions, we consider there is a risk of cross-subsidisation of non-network services by network services. These obligations will promote transparency and accountability to reduce this risk. Further, the obligations will complement the legal separation and cost allocation provisions.

We think that our proposed separate accounting obligations represent a targeted, proportionate and effective regulatory response. The obligations can be targeted at the types of transactions that give rise to concern, that is, transactions between a DNSP and its related bodies corporate.

The anticipated costs associated with these regulatory obligations (including implementation, administration and compliance) are proportionate to the potential harm. We also consider that the obligations will increase transparency and disclosure of relevant transactions, and will improve accountability, certainty and confidence.

The reasons for the component parts of the separate accounting obligations are as follows.

Establish and maintain appropriate internal accounting procedures

Legal separation prevents a DNSP from providing non-network services, but does not prevent the DNSP's related body corporate from providing such services.

The separate accounting obligation is targeted at preventing cross-subsidisation between:

* direct control services and regulated transmission services
* other services.

In this context, the requirement for a DNSP to establish and maintain internal accounting procedures is intended to enable the DNSP to:

* isolate its costs associated with its direct control services and regulated transmission services
* expose transactions between a DNSP and its related body corporate, which might have the effect of transferring costs to the DNSP's regulated customer base.

Internal accounting procedures are necessary to enable a DNSP to respond accurately to any regulatory information instrument that may be served by us.

Report on transactions

The Draft Guideline foreshadows that we may serve a regulatory information instrument on a DNSP that requires the DNSP to report on transactions with its related bodies corporate.

This provision does not, of itself, create a separate obligation for a DSNP to provide information to us. Any reporting requirement would only arise under a regulatory information instrument served on the DNSP by us.

No waiver

We consider no waivers should be allowed in relation to the separate accounting obligations. These are essential elements of giving effect to objectives of transparency and accountability and therefore any waivers could undermine certainty and confidence in the market for non-network services, and customers' confidence in efficient prices for regulated services.

### Cost allocation

The NER states that a ring-fencing guideline may include provisions defining the need for and extent of "allocation of costs between standard control services, alternative control services, and other services provided by the DNSP".[[28]](#footnote-29) Cost allocation is an important sub-set of ring-fencing.

We acknowledge that existing regulatory instruments also deal with cost allocation, and in particular note NER clause 6.15, the Cost Allocation Guideline, the DNSP's approved CAMs and the Shared Asset Guideline. However, we consider that additional obligations are necessary in the Ring-fencing Guideline. For example, additional obligations address a gap created by legal limitations which currently limit the scope of the Cost Allocation Guideline and CAMs to the attribution and allocation of costs between categories of distribution services (i.e. not between distribution and non-distribution services).[[29]](#footnote-30)

Stakeholders have asked how existing instruments and new ring-fencing obligations will interact.[[30]](#footnote-31) These instruments should be read and operate together so that collectively, they achieve the desired ring-fencing outcome and avoid cross-subsidisation in the long-term interest of consumers.

Therefore, the Draft Guideline states that a DNSP must not allocate or attribute to distribution services costs that properly relate to non-distribution services. The allocation and attribution must be consistent with the cost allocation principles in NER clause 6.15.2.

We consider that in the absence of these provisions, there is a risk of cross-subsidisation between distribution services and non-distribution services. We consider that these obligations will improve certainty and confidence in the attribution and allocations of costs between distribution and other services. They will also promote economic efficiency in charges for regulated distribution services, as well as transparency and accountability to reduce the cross-subsidisation risk. They will complement the legal separation and separate accounting provisions.

The reasons for the component parts of the separate cost allocation obligations are as follows.

No allocation or attribution of non–distribution services' costs to distribution services

A DNSP should not allocate or attribute the costs or providing non–distribution services to distribution services. This obligation is designed to minimise the risk of cross–subsidisation by introducing an absolute prohibition on the attribution and allocation of costs to distribution services that properly relate to non-distribution services. It goes beyond the cost allocation provisions in NER clause 6.15, the current Cost Allocation Guideline and DNSP's CAMs, to cover the allocation and attribution of costs between distribution services and non-distribution services.

Without such an obligation, there is a risk that a DNSP may attribute or allocate costs to distribution services that properly relate to non-distribution services. This may lead to a DNSP's non-network services being cross-subsidised by its network services.

Cost allocation principles

This obligation requires a DNSP to attribute and allocate costs to distribution services in a manner that is consistent with the cost allocation principles in NER clause 6.15.2.

The cost allocation principles currently apply only to the attribution and allocation of costs between distribution services. However, these principles have equal relevance to the attribution and allocation of costs between distribution and non-distribution services. This is because the principles fundamentally are concerned with ensuring that only costs that properly relate to a service are attributed or allocated to it. The principles are widely accepted and are currently reflected in all DNSPs' CAMs.

We expect DNSPs to reflect this broader obligation into their CAMs at the next opportunity these are revised.

No waiver

We consider waivers should not be allowed in relation to the cost allocation obligation. Waivers could undermine certainty and confidence in the market for non-network services, and customers' confidence in efficient prices for regulated services.

## Submissions on Preliminary Positions Paper

Stakeholder submissions addressed each of the three areas relevant to cross-subsidies that we proposed dealing with in the Draft Guideline:

* legal separation of the DNSP from other entities.
* separate accounting.
* cost allocation.

### Legal separation

There were submissions that both supported and opposed legal separation obligations to prevent DNSPs providing regulated services.

Some stakeholders supported the Draft Guideline including legal separation obligations,[[31]](#footnote-32) including contestable services beyond the meter.[[32]](#footnote-33) Some submissions argued that this restriction should extend to affiliates of the DNSP[[33]](#footnote-34) while others argued that DNSPs should be prevented from establishing subsidiaries.[[34]](#footnote-35) Submissions also emphasised that legal separation needs to be supported by effective cost allocation.[[35]](#footnote-36) One submission suggested that the AER should consider only allowing DNSPs to provide contestable services outside of their local network areas.[[36]](#footnote-37)

Other stakeholders opposed Draft Guideline obligations that prevent a DNSP providing unregulated services, where unregulated services would need to be provided through a separate legal entity.[[37]](#footnote-38) Submissions raised concerns that these obligations would be disproportionate to the harm, reduce competition and increase costs and charges for regulated customers.[[38]](#footnote-39) Other submissions considered that these obligations could create problems where a DNSP is prevented from servicing a customer but no alternative supplier is available.[[39]](#footnote-40) One submission suggested that lower cost “Chinese walls” should be used as an alternative to legal separation.[[40]](#footnote-41) Another submission raised a concern about the risk of these obligations resulting in the DNSP creating separate wholly-owned subsidiaries over which the AER would have limited visibility.[[41]](#footnote-42)

In response to submissions, we reconsidered the potential for harm arising from a DNSP providing both network and non-network services. We concluded that legal separation is a necessary component of the suite of complementary measures that are required to address the potential for cross-subsidisation ─ the other measures are separate accounting and cost allocation. Importantly, we assessed that legal separation will always be necessary and therefore waivers will not be permitted. Instead, we have introduced a materiality threshold below which a DNSP can provide non-network services. This is a pragmatic response that balances DNSPs' concerns with the potential for harm raised by other stakeholders.

### Separate accounting

Stakeholders supported the Draft Guideline making it clear that the DNSP must maintain consolidated and separate accounts, including accounts that identify the extent and nature of transactions between the DNSP and related parties.[[42]](#footnote-43) Other submissions supported us relying in the first instance on accounting separation – rather than pursuing legal, physical or staff separation – and then drawing from a suite of other mechanisms, based on the specific circumstances of the DNSP.[[43]](#footnote-44)

Given the general support for separate accounting, we have retained this requirement in the Draft Guideline. Separate accounting is a cornerstone of measures to limit the potential for cross-subsidisation and therefore we have removed the potential for waiving this obligation.

### Cost allocation

Some submissions supported the existing cost allocation arrangements, while others argued that more prescriptive cost allocation was required.

Some stakeholders supported the view that the existing cost allocation and related regulatory arrangements (such as the regulatory determination process, the Expenditure Forecast Assessment Guideline, the Shared Asset Guideline, the RIT-D and Regulatory Information Notices) provide sufficient guidance to the DNSPs to manage the threat of cross-subsidies. They argued that if the AER considers that there are weaknesses in those arrangements then it should address them directly, rather than introduce new obligations in the Draft Guideline.[[44]](#footnote-45)

Other stakeholders supported the Draft Guideline providing greater prescription to the DNSPs about how they should allocate their costs,[[45]](#footnote-46) including because of a perception that DNSP can have a competitive advantage in supplying contestable services as a result of cross-subsidies between regulated and contestable services.[[46]](#footnote-47)

In response to submissions, we reflected on the limitations of current regulations. We concluded that it is necessary to include obligations targeted at the allocation of costs between distribution and non-distribution services, which are not addressed by any of the other requirements noted above relating to expenditure assessment, shared asset guidelines or the RIT-D process. There are no circumstances that would warrant waiving this obligation.

There were submissions on the related issues of “shared assets” or “asset sharing”. Stakeholders interpreted these concepts in two ways:

* a DNSP using assets for regulated and unregulated services, which gives rise to the application of the Shared Asset Guideline
* a DNSP sharing its assets with a related body corporate.

Some submissions argued that DNSPs should be encouraged to share assets between regulated and unregulated services as customers benefit from lower prices through the application of the Shared Asset Guideline.[[47]](#footnote-48)

Other submissions argued that the Guideline should restrict asset sharing between a DNSP and its related parties,[[48]](#footnote-49) although one submission cautioned that DNSPs should not be disadvantaged compared with retailers that enter contestable markets.[[49]](#footnote-50) A further submission noted that restricting asset sharing may help the AER to demonstrate a thorough approach to ring-fencing more than improve customer outcomes.[[50]](#footnote-51)

We support the efficient use of assets for regulated and non-regulated services provided that costs are allocated correctly or regulated revenues are adjusted accordingly. This is achieved through the cost allocation provisions introduced in the Draft Guideline, the Cost Allocation Guideline, the DNSPs' approved CAMs and the Shared Asset Guideline.

# Measures targeted at discrimination

Section 3 addressed the first of the two key harms that are the focus of the Draft Guideline - cross-subsidisation. This section describes the content and rationale for provisions in the Draft Guideline designed to reduce the risk of the second key harm ─ discrimination by the DNSP.

The Draft Guideline includes complementary sets of general and specific obligations on a DNSP not to discriminate, or otherwise provide favourable treatment to its related bodies corporate. In developing the obligations, we considered the relationship between DNSPs and related bodies corporate, the kinds of services that each might provide, and the circumstances that could give rise to preferential treatment by the DNSP. We consider that the proposed obligations represent a targeted, proportionate and effective regulatory response to the risks of discrimination by a DNSP.

The general obligations in the Draft Guideline prevent a DNSP from providing discriminatory or otherwise favourable treatment (either directly or indirectly) to its related body corporate or customers of its related body corporate. In the absence of these obligations, we consider that there is a risk of a DNSP's related bodies corporate gaining an unfair advantage over their competitors in the markets for competitive or contestable energy-related services.

The first set of specific obligations relates to functional separation. The Draft Guideline includes obligations in two areas:

* physically separating a DNSP's offices from its service providers or related bodies corporate
* preventing staff sharing between a DNSP and its related body corporate.

The provisions include several explicit exceptions, and the potential for an individual DNSP to apply for a waiver. These are the only obligations in the Draft Guideline that are potentially subject to a waiver.

The second set of specific obligations in the Draft Guideline relates to the DNSP's use of information. We have maintained the DNSP obligations raised in the Preliminary Positions Paper about information protection, sharing and disclosure. In the absence of these provisions, we consider that there is a risk of a DNSP's related bodies corporate gaining an unfair advantage over their competitors in the markets for competitive or contestable energy-related services.

This section first summarises the approach to targeting discrimination by DNSPs set out in our Preliminary Positions Paper. We then describe the positions in our Draft Guideline and our reasons for adopting them. We conclude the section by examining stakeholders' submissions by theme and describe how we have responded to their feedback.

## Preliminary Positions Paper

As noted in section 2.2.1 above, an objective of ring-fencing is to limit the ability of the regulated entity to confer an unfair advantage to itself or to an affiliate operating in a competitive market.

Our Preliminary Positions Paper[[51]](#footnote-52) proposed relevant DNSP obligations to:

* not locate a ring-fenced service at the same physical location as the DNSP
* not share staff between the ring-fenced entity and the DNSP
* protect information provided by a customer or prospective customer and ensure its use is only for the purpose for which that information was provided
* ensure that information provided to a ring-fenced entity is also available to third parties on an equal basis
* 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.

## Draft Guideline position

The discrimination objective is to be achieved by provisions in section 4 of the Draft Guideline that provide for:

* general obligations not to discriminate
* specific obligations for functional separation
* specific obligations for controls on information access and disclosure.

The Draft Guideline builds on the Preliminary Positions Paper by clarifying and refining a number of points. The general prohibition on a DNSP discriminating in favour of its related body corporate, or customers of its related body corporate, is new. This was not specifically discussed in the Preliminary Positions Paper. It targets a DNSP discriminating (either directly or indirectly) in favour of its related body corporate or customers of its related body corporate. The non-exhaustive list of requirements in the Draft Guideline illustrates the kinds of circumstances in which the obligation applies.

The proposed obligation will assist to minimise the potential for a DNSP to provide an inappropriate competitive advantage to its related body corporate that provides competitive or contestable energy-related services.

For functional separation, the Draft Guideline:

* clarifies the services to which the obligation applies
* introduces a list of industry-wide exceptions
* confirms that a DNSP can apply for a waiver in relation to this obligation
* confirms the transitional arrangements.

The controls on information access and disclosure are largely consistent with the Preliminary Positions Paper, although the Draft Guideline clarifies the services to which the obligation applies, removes the potential for waivers, and confirms that there will be no transitional arrangements.

We consider that the anticipated costs associated with these regulatory obligations (including implementation, administration and compliance) are proportionate to the potential harm.

Each of the changes reflects our application of the regulatory design principles outlined in section 2.7.

### General non-discrimination obligations

The NER states that guidelines must be developed by us for the accounting and functional separation of the provision of direct control services by DNSPs from the provision of other services by DNSPs.[[52]](#footnote-53) Clause 6.17.2(b) of the NER provides a non-exhaustive list of the matters that ring-fencing guidelines can contain.

It is appropriate for the Guideline to require DNSPs not to discriminate or provide favourable treatment to their related bodies corporate or to customers of their related bodies corporate. As set out in the Draft Guideline, a DNSP must:

* deal with its related body corporate on an arms' length basis
* deal with competitors of its **related body corporate**, or customers of those competitors, with respect to the quality of service provision on substantially the same terms and conditions as those for its **related body corporate**
* avoid providing information to its **related body corporate** that the **DNSP** has obtained through its dealings with a competitor of the **related body corporate** that may advantage the **related body corporate**
* avoid advertising or promoting, either directly or indirectly, the services provided by its **related body corporate**
* have independent and separate branding for its **distribution services** from a **related body corporate** that provides non-distribution services.

In the absence of these provisions, there is a risk of a DNSP's related bodies corporate gaining an unfair advantage over its competitors in the markets for competitive or contestable energy-related services.

The reasons for these obligations are as follows.

Not favour related body corporate or its customers

The obligation prevents a DNSP from providing discriminatory or otherwise favourable treatment (either directly or indirectly) to its related body corporate or customers of its related body corporate.

This obligation is targeted at preventing a DNSP taking action that would:

* give its related body corporate a financial benefit that is not available to its competitors
* give customers of its related body corporate a financial or non-financial benefit that would not be available to them if they were customers of a competitor of the related body corporate
* advantage its related body corporate in competing to provide competitive or contestable energy-related services.

This obligation is necessary to minimise the potential for a DNSP to undermine competition in the markets for competitive or contestable energy-related services in which its related body corporate competes.

Specific obligations not to discriminate

The Draft Guideline gives a non-exhaustive list of instances where the general obligations not to discriminate may apply.

In the first instance, a DNSP must deal with its related body corporate on an arms' length basis. We expect a DNSP to contract with its related body corporate on a commercially efficient basis, as if it were dealing with a non-related third party. This is intended to be consistent with, and to complement, the approach set out in our Expenditure Forecast Assessment Guideline and its treatment of related party contracts and margins.

In the second instance, a DNSP must offer to deal with competitors of its related body corporate (or customers of those competitors) with respect to the quality of service provision on substantially the same terms and conditions as those for its related body corporate (or customers of its related body corporate). This prevents a DNSP giving preferential treatment to its related body corporate, or customers of its related body corporate, over a competitor, or customer of a competitor, of its related body corporate. It promotes a level playing-field in the competitive and contestable energy-related markets in which a DNSP's related body corporate competes.

In the third instance, a DSNP must avoid providing to its related body corporate information that it has obtained from a competitor of its related body corporate. This is intended to avoid a related body corporate receiving an unfair advantage in the competitive and contestable energy-related markets in which it competes by virtue of its relationship with the DNSP, and the access the DNSP has to information from many parties.

In the fourth instance, a DNSP must avoid advertising or promoting the services provided by its related body corporate. This is intended to avoid the DNSP encouraging, or being perceived to encourage, the use of its related body corporate, in preference to competitors in markets for competitive and contestable energy-related services. In our view, a DNSP should not use its role as a monopoly provider of regulated network services to advertise or promote any individual service provider in another market, including its related body corporates.

The last instance relates to a DNSP's independent and separate branding of its distribution services from a related body corporate that provides non-distribution services. This complements the fourth instance about advertising and promoting, requiring a DNSP and its related body corporate to be distinct, stand-alone identities so that customers do not confuse the services that each provides. This obligation is important to ensure that a DSNP does not, intentionally or unintentionally, influence customers' choices in competitive and contestable energy-related markets in which a DNSP's related body corporate competes.

No waiver

No waivers are allowed for these general obligations not to discriminate, as waivers could undermine competition in the market for non–network services. We consider this approach will support establishment of a level playing field for provision of non–network services.

### Specific obligations for functional separation

The NER state that guidelines must be developed by us for the accounting and functional separation of the provision of direct control services by DNSPs from the provision of other services by DNSPs.[[53]](#footnote-54)

The Draft Guideline introduces functional separation obligations in two areas:

* physically separating a DNSP's offices from its service providers or related bodies corporate
* preventing staff sharing between a DNSP and its related body corporate.

The obligations complement the general obligations not to discriminate and the information access and disclosure obligations. They are targeted so that a DNSP does not benefit its related body corporate or customers of its related body corporate. The noted exceptions incorporated in the Draft Guideline, and the potential for a DNSP to apply for a waiver, will ensure that these obligations are targeted and proportionate.

The obligation should assist to minimise the potential for a DNSP to provide an inappropriate competitive advantage to a related body corporate that provides competitive or contestable energy-related services.

In the absence of these provisions, there is a risk of a DNSP's related bodies corporate gaining an unfair advantage over their competitors in the markets for competitive or contestable energy-related services. This may include other entrants being deterred from offering to provide services, thereby undermining a competitive market.

The reasons for the component parts of the functional separation obligations are as follows.

Physical separation/co-location

The DNSP will be required to operate independent and separate offices for providing direct control services and regulated transmission services. These must be separate from offices used to provide competitive or contestable energy-related services by other service providers or related bodies corporate.

The Draft Guideline includes, by way of example, a requirement that the DNSP must operate in a different building, and prevent staff from mixing in the normal course of undertaking work activities.

The obligations for functional separating will keep apart a DNSP from its affiliates offering services into competitive markets. Affiliates include both related bodies corporate and third party service provider operating on behalf of the DNSP or its relates bodies corporate. This will prevent the businesses and their employees from mixing and sharing, inadvertently or otherwise, commercially sensitive information. The commercial incentive to share this information suggests a proactive obligation aimed at prevention, such as functional separation, is warranted to reduce this risk. This obligation is particularly targeted at preventing an affiliate from gaining an advantage in the market for competitive or contestable energy-related services. The Draft Guideline provides two exceptions to the general requirement for physical separation.

First, the Draft Guideline provides an exception for staff who are not directly involved in the provision of direct control servicesand regulated transmission services and who, therefore, do not have access to information about electricity customers and services. This exception includes staff exclusively performing corporate roles such as payroll and human resources.

This exception is warranted because we consider there is a low risk of (and incentives for) such staff assisting a related body corporate or a service provider to gain an inappropriate competitive advantage in the market for competitive or contestable energy-related services.

Second, the Draft Guideline provides the opportunity for a DNSP to seek a waiver in relation to the physical separation obligation where there is a clear justification.

Section 5 of the Draft Guideline deals with how a DNSP would apply for any such waiver and how we would assess it. In assessing a waiver application, we would consider the National Electricity Objective, the impact on discrimination in relevant markets and the costs and benefits to electricity consumers.

Staff sharing

The Draft Guideline requires a DNSP to ensure that its staff directly involved in the provision of a direct control service or a regulated transmission service are not also involved in the provision or marketing of a non-network energy-related service by a related body corporate.

This obligation complements and supports the physical separation obligation, discussed above. It is designed to prevent a DNSP's staff from using information that they acquire in directly providing regulated network services to advantage a related body corporate that provides a non-network energy-related service. In this way, it is targeted at minimising the potential for a related body corporate gaining an inappropriate competitive advantage.

The Draft Guideline details four circumstances in which the general requirement for staff separation does not apply.

First, the Draft Guideline does not apply to a member of staff who is a senior executive of both a DNSP and a related body corporate - rather, it targets staff with day-to-day access to information. It may be appropriate for a chief executive and a small number of other senior executives to work for both a DNSP and a related body corporate. However, this does not excuse these senior executives from complying with the rest of the non-discrimination obligations in the Draft Guideline, or from the competitive advantage restrictions.

Second, the Draft Guideline does not apply to staff who are not directly involved in providing direct control servicesand regulated transmission services, and who therefore do not have access to information about electricity customers and services. This includes staff exclusively performing corporate roles, for example in payroll and human resources.

We consider that this carve out is warranted given the likely low risk of (and incentives for) assisting a related body corporate or a service provider to gain an inappropriate competitive advantage in the market for competitive or contestable energy-related services.

Third, the Draft Guideline does not prevent a DNSP's staff being directly involved in both:

* direct control services and regulated transmission services
* negotiated distribution services and unregulated distribution services.

All such services fall within the range of services that a DNSP is able to provide under the NER.

Finally, the Draft Guideline allows a DNSP to seek a waiver in relation to the physical separation obligation in limited circumstances, as described in Section 5 of the Draft Guideline.

The Draft Guideline precludes a DNSP from giving incentives to staff (other than a staff member who is a senior executive of both the DSNP and a related body corporate) based on the performance of a related body corporate.

### Specific obligations for information access and disclosure

The NER state that ring-fencing guidelines may include provisions defining the need for and extent of:

* limitations on the flow of information between the DNSP and any other person[[54]](#footnote-55)
* limitations on the flow of information where there is the potential for a competitive advantage between those parts of the DNSP's business which provide direct control services and those parts which provide any other services.[[55]](#footnote-56)

The Draft Guideline requires a DNSP:

* to protect information provided to it for direct control services and/or regulated transmission services, and ensure the information is used only for the purpose for which that information was provided.
* to share information that it acquires in providing direct control services and/or regulated transmission services on an equal basis.
* not to disclose information acquired in providing direct control services or regulated transmission services to any party, including a related body corporate, without the explicit informed consent of the relevant customer or prospective customer to whom the information relates.

In the absence of these provisions, there is a risk of a DNSP's related bodies corporate gaining an unfair advantage over its competitors in the markets for competitive or contestable energy-related services.

The obligations are designed to complement the general obligations on a DNSP not to discriminate.

We consider that the obligations will assist to minimise the potential for a DNSP to provide an inappropriate competitive advantage to its related body corporate that provide competitive or contestable energy-related services.

The reasons for these proposed obligations are as follows.

Protection of information

A DNSP must protect information provided by a customer, prospective customer or service provider for direct control services and/or regulated transmission services and ensure the information is used only for the purpose for which it was provided.

This imposes a positive obligation on a DNSP to protect the information it receives. We consider this obligation is necessary because a DNSP might otherwise share information it receives with a related body corporate and achieve an inappropriate competitive advantage in the provision of competitive or contestable energy-related services.

This obligation supports and complements the obligations in relation to the sharing and disclosure of information.

Sharing of information

Where a DNSP acquires information in the course of providing direct control services and/or regulated transmission services, and shares this information with a related body corporate, it must provide access to that information on an equal basis with third parties competing with the related body corporate.

This is a positive obligation on a DNSP to make available to others on an equal basis the information that it provides to its related body corporate. The obligation is necessary to prevent a DNSP providing information only to its related body corporate, thereby giving an inappropriate competitive advantage in the provision of competitive or contestable energy-related services.

This obligation will support and complement the obligations in relation to the protection and disclosure of information.

Disclosure of information

A DNSP must not disclose information acquired in the course of providing direct control services or regulated transmission services to any party, including a related body corporate, without the explicit informed consent of the relevant customer or prospective customer to whom the information relates.

This obligation is necessary because a DNSP might otherwise disclose information to a related body corporate and so give it an inappropriate competitive advantage in the provision of competitive or contestable energy-related services.

This obligation will support and complement the obligations in relation to the protection and sharing of information.

## Submissions on our Preliminary Positions

Stakeholders' submissions relevant to discrimination addressed each of the areas that the AER deals with in the Draft Guideline, being:

* general obligation not to discriminate
* functional separation - physical separation / co-location
* function separation - staff sharing
* controls on information access and disclosure.

### General non-discrimination obligation

Submissions argued that DNSPs should ensure that their activities do not provide an unfair advantage to affiliated ring-fenced entities, including in the provision of “new energy technology” services.[[56]](#footnote-57) Submissions also noted that it was inappropriate for a DNSP to promote unregulated activities through regulated channels[[57]](#footnote-58) and that DNSPs should not be allowed to cross-brand or advertise related parties.[[58]](#footnote-59) One submission argued that all parties should be able to access a DNSP’s services on an equal basis.[[59]](#footnote-60)

In contrast, other submissions argued that existing competition laws are adequate to address any competition issues and that no additional provisions are necessary in the Guideline.[[60]](#footnote-61)

One submission cautioned that imposing too onerous obligations in the ring-fencing regime risks sacrificing potential benefits that DNSPs and affiliates can provide to customers.[[61]](#footnote-62)

We considered the relationship between DNSPs and related bodies corporate, the kinds of services that each might provide, and the circumstances that could give rise to preferential treatment by the DNSP. We concluded that the risk is sufficient to justify including targeted regulatory obligations in the Guideline that address the specific areas of concern.

### Functional separation - physical separation/co-location

Some stakeholders supported functional separation obligations that restrict a DNSP co-locating with a related body corporate.[[62]](#footnote-63)

Other stakeholders opposed obligations that restrict a DNSP co-locating with a related body corporate, including on the basis that:

* they are “unreasonable and unnecessary”[[63]](#footnote-64)
* restrictions on co-locating of physical premises “are potentially not workable”[[64]](#footnote-65)
* they would be extremely costly and onerous with no demonstrative benefit[[65]](#footnote-66)
* co-location contributes to lower regulated costs and charges[[66]](#footnote-67)
* there are simpler and more cost-effective ways of achieving the objective, in particular through restrictions on staff sharing[[67]](#footnote-68) and “Chinese Walls”[[68]](#footnote-69)
* there are existing regulatory controls to achieve appropriate functional separation to meet RF objectives in most circumstances.[[69]](#footnote-70)

Our view is that co-locating gives rise to real risks of discrimination that need to be addressed. However, we recognise some valid concerns were raised in submissions about the costs and workability of an inflexible prohibition on co-location. Accordingly, we have included in the Draft Guideline exceptions that we anticipate apply across all DNSPs ─ this promotes transparency of DNSPs' obligations. We have also allowed for individual DNSPs to apply for waivers from the obligations.

### Functional separation—staff sharing

Some stakeholders supported functional separation obligations that restrict a DNSP sharing staff with a related body corporate,[[70]](#footnote-71) in particular staff with marketing and operational knowledge, although one submission noted that DNSPs should not be disadvantaged compared with competing retailers that enter contestable markets.[[71]](#footnote-72)

Other stakeholders opposed the Draft Guideline including functional separation obligations that restrict a DNSP sharing staff with a related body corporate, including on the basis that:

* restrictions do not have a sound theoretical basis and would unfairly treat DNSPs compared to other competitors[[72]](#footnote-73)
* restrictions on co-locating of physical premises “are potentially not workable”[[73]](#footnote-74)
* co-location contributes to lower regulated costs and charges[[74]](#footnote-75)
* restrictions could be disproportionate to the underlying harm[[75]](#footnote-76)
* staff sharing can be dealt with through cost allocation obligations[[76]](#footnote-77)
* staff separation obligations are too onerous and there are simpler and more cost-effective ways of achieving the objective, in particular through “Chinese Walls”[[77]](#footnote-78)
* there are existing regulatory controls to achieve appropriate functional separation to meet RF objectives in most circumstances.[[78]](#footnote-79)

Stakeholders argued that if there are to be restrictions then the Draft Guideline should:

* specify which types of staff that cannot be shared[[79]](#footnote-80)
* focus on the sharing of operational and marketing staff.[[80]](#footnote-81)

In response to submissions, we have reconsidered staff sharing opportunities and their implications for discrimination. While we consider that there are real risks of discrimination arising from sharing staff, we have constrained the obligation. It now includes several exceptions and allows individual DNSPs to apply for waivers from the obligations.

### Controls on information access and disclosure

Some submissions supported the AER including obligations in the Guidelines that limit inappropriate information sharing by a DNSP.[[81]](#footnote-82) Other submissions supported obligations requiring the DNSP to make available information to all parties on an equal basis,[[82]](#footnote-83) subject to customer consent[[83]](#footnote-84) and confidentiality requirements.[[84]](#footnote-85)

Other stakeholders noted that DNSPs are already subject to information restrictions and obligations, including under Chapter 7 of the NER, the Privacy Act 1988 and their distribution licences. They argued that the AER should rely on existing information sharing provisions, rather than introducing new obligations in the Draft Guidelines, unless it considers that they are inadequate.[[85]](#footnote-86)

We have not changed our position on these obligations. The Draft Guideline addresses specific concerns in relation to the potential for a DNSP to:

* provide an inappropriate competitive advantage to its own service providers or related bodies corporate which provide competitive or contestable energy-related services
* ensure a DNSP treats and protects appropriately any relevant information it acquires.

These obligations cannot be waived under the Draft Guideline.

# Waiver provisions

Our Draft Guideline sets out a simplified approach to waivers compared with the approach set out in our Preliminary Positions Paper. We have moved away from granting extensive industry wide waivers. Instead, the Draft Guideline now specifies some industry wide exceptions to ring fencing obligations. Our revised approach to waivers promotes transparency, simplicity, predictability, flexibility and reduced regulatory burden.

The Draft Guideline provides for waivers only in relation to functional separation of either accommodation and/or employees. Core ring-fencing obligations for legal separation, cost allocation and information protection cannot be waived.

We will assess waiver applications with respect to the potential for cross–subsidisation, discrimination and with a view to the net benefits in terms of the long term interests of consumers.

We consider that our revised approach to ring fencing waivers means many, if not most, of the concerns expressed by submissions on our Preliminary Positions Paper are no longer applicable.

In this section we first summarises the approach to waivers set out in our Preliminary Positions Paper. We then describe the approach set out in our Draft Guideline before setting out our reasons for adopting that approach. We go on to discuss stakeholder submissions and describe how we have responded to that feedback. We then describe the waiver application process and our considerations in assessing a waiver application. We conclude this section by discussing the duration of a waiver and how a waiver may be varied.

## Preliminary Positions Paper

Our Preliminary Positions Paper proposed waivers to excuse a DNSP from meeting one or more ring-fencing obligations, where the cost of ring-fencing exceeds the benefit to consumers (measured against the NEO and ring-fencing guideline objectives). Waivers would be granted with sunset provisions.

We noted the need to provide guidance on ring-fencing waivers such as guidance on:

* the circumstances in which a DNSP may be exempted from meeting one or more or all ring-fencing obligations
* the process for a business to seek a waiver
* whether and how we would consult on any applications
* the basis for our waiver decisions.

Further, in deciding whether or not to grant a waiver, we said that we would need to examine the nature of the service, the costs of ring-fencing and the ring-fencing objective (waiver processes).

In coming to our decision on whether to grant a waiver, we proposed considering at least the following factors:

* the potential harm to be avoided by ring-fencing
* whether the cost of complying with ring-fencing obligations exceeds the benefits defined by the ring-fencing objectives
* safety issues (established by a proper authority) that result in service provision being restricted to a DNSP
* jurisdictional restrictions (such as a licence condition or other barrier to entry by third parties) that mean a service is not subject to competition
* whether a service has been classified for a reason other than the potential for development of competition (such as a user-specific network service).

## Draft Guideline position

We have simplified our proposed approach to waivers compared with the approach set out in our Preliminary Positions Paper. We have moved away from granting extensive industry wide waivers, instead proposing that the guideline itself specifies any industry wide exceptions (see section 4 of this Explanatory Statement for a more detailed discussion).

Our revised approach provides better transparency, reduces reliance on waivers and deals with concerns raised by stakeholders in submissions on our Preliminary Position Paper (see section 5.3 of this Explanatory Statement).

Our revised approach to waivers is as follows:

* Waivers will be available only in relation to functional separation of either accommodation and/or employees.
* Core ring-fencing obligations in relation to legal separation, cost allocation and information protection cannot be waived.
* We will assess waiver applications against the NEO, consider the potential for cross subsidisation and discrimination, and take account of the net benefits. The DNSP making the application must be able to demonstrate why the waiver should be granted with reference to these matters.
* The duration of a waiver will be limited to the (then) current regulatory control period and upcoming regulatory control period.

Our revised approach to waivers allows flexibility in how we process and assess a waiver application, including enabling us to review a waiver within a regulatory control period.

In submissions on our Preliminary Positions Paper, there was general concern at the lack of detail on the process for applying for a waiver and our assessment of an application. Also with respect to the effect on incentives for DNSP innovation and that the waiver process needs to engage with stakeholders.[[86]](#footnote-87) Our more targeted approach to the ring-fencing requirements in the Draft Guideline means that we have simplified our thinking on waivers accordingly.

In developing the waiver framework for the Draft Guideline, we have considered the following design matters:

* the need for predictability, and simplicity, of the waiver process for DNSPs and other stakeholders
* the need for flexibility in how we assess a waiver application
* transparency about the information we expect in an application and how it will assess an application
* the aim to minimise regulatory burden.

The specific regulatory obligations are set out in section 5 of the Draft Ring-fencing Guideline, and described in more detail below.

## Submissions on Preliminary Positions Paper

The overall message in submissions on our Preliminary Positions Paper was that the waivers approach was too excessive and costly, created too much unpredictability, and that the process and basis on which they would be granted was unclear. There was a view that too many waivers would be required given the proposed blanket application of obligations.

We consider the simplified approach set out in our Draft Guideline addresses many of the concerns raised by stakeholders in response to our Preliminary Positions Paper. In particular, we have responded to stakeholder concerns that our initial waiver approach was excessive, costly and uncertain.

Below, we describe the major themes raised by submissions in respect of waiver provisions and how we have responded to submissions in our Draft Guideline.

****Ring–fencing obligations are too broad****

Stakeholders submitted that the proposal to ring-fence all contestable activities, rather than focusing on the obligations on the regulated part of a network’s business, would result in broad and onerous obligations which may only be removed through a process of waivers.[[87]](#footnote-88)

In response to submissions, we have changed our approach so that the Draft Guideline itself now specifies some industry wide exceptions to ring–fencing obligations. Scope for waivers is now limited to functional separation of accommodation and employees. We consider our revised approach better focusses ring–fencing on the obligations on the regulated business, rather than on the waiver process.

The waiver process is unclear and imposes undue regulatory burden

Stakeholders submitted that our proposed waiver process was unclear, administratively complex, not transparent and time and resource demanding.[[88]](#footnote-89)

In response to submissions, the Draft Guideline provides a waiver process that is transparent, flexible and imposes a lower regulatory burden on DNSPs.

Too many waivers will be required

Stakeholders submitted that imposing ring–fencing obligations broadly and relying on waivers to exclude a wide range of services meant that a lot of waivers would be required, transferring the weight of effort to the waiver process and imposing high costs on DNSPs.[[89]](#footnote-90)

In response to submissions, the Draft Guideline excludes from ring fencing obligations a range of non-network services and limits the scope for waivers to functional separation of either accommodation and/or employees.

Waivers should be granted sparingly and for limited periods

Non–network stakeholders submitted that waivers, if granted at all, should be used only in limited circumstances, such as for services already subject to waivers under jurisdictional ring fencing arrangements.[[90]](#footnote-91) Also, that when a waiver application is submitted we should consult with stakeholders as part of our decision making process.

In response to submissions, the Draft Guideline specifies that waivers will not be available for legal separation, cost allocation and information protection. The Draft Guideline limits scope for waivers to functional separation of either accommodation and/or employees. When a waiver application has potentially significant implications for the provision of competitive services, the Draft Guideline specifies that we will undertake formal consultation and publish the reasons for our decision.

We have dealt with other stakeholder concerns in the specific obligations below.

## DNSP application for a waiver

The Draft Guideline allows a DNSP to apply in writing for a waiver under clause 4.2. A waiver may permit a DNSP to not comply with obligations to:

* physically separate or locate its direct control services and regulated transmission services from the offices from which a related body corporate provides contestable or competitive energy related services
* ensure that its staff directly involved in the provision of a direct control service or a regulated transmission service are not also involved in the provision or marketing of a competitive or contestable energy-related service by a related body corporate.

A waiver application must include all necessary information and materials to enable us to assess the application, including:

* the service, or services, subject to the waiver application
* the waiver sought (the obligation/s to be waived) and the period for which the waiver is to apply
* costs/benefits associated with the waiver being either granted or refused
* any alternative measures proposed
* a demonstration of how the waiver better achieves the NEO
* identification of the potential for cross subsidisation and discrimination.

### AER consideration of a waiver application

Matters we will consider

In considering whether to accept or reject a waiver application, we will at least consider whether a waiver would better achieve the NEO and the potential for cross-subsidisation and discrimination if the waiver is granted. Depending on the circumstances of the waiver sought, we may consider such other matters we think are relevant. For example, for a DNSP offering network and non-network services in a rural area, we are likely to consider whether any competitive services are available. We will also consider whether the benefit, or any likely benefit, to electricity consumers of the DNSP's ring-fencing compliance with the guideline will be outweighed by the cost to the DNSP of complying.

AER assessment of the waiver application

We expect some waivers will be inconsequential in nature, while others may have more far reaching implications in the development of contestable or competitive energy related services. In assessing a waiver application it is important that we have flexibility in how we choose to assess an application on a case by case basis, to ensure that we provide natural justice for each application, while minimising unnecessary administrative and compliance burdens.

For minor matters, we are likely to adopt a simple approval process with no or limited public consultation. For matters we consider likely to attract stakeholder interest, or with potentially significant impacts on the provision of contestable or competitive energy services, we will conduct formal consultation and publish the reasons for our decision.

In all cases, we will publish the terms and conditions of any waiver granted.

We note AGL Energy and the Australian Energy Council did not support a fast track waiver approval process. Ergon Energy noted the current Queensland jurisdictional arrangements do not allow for a fast track process. While we are not proposing a specific fast track approval process, our proposed process above provides us with flexibility to consider and decide minor matters efficiently.

### Duration of a waiver

There are a range of views on the duration of a waiver. In its submission on our Preliminary Positions Paper, Energy Australia agreed with us that any waiver should apply for a defined period of time. Ergon Energy noted the operational impact of durability of a waiver, including on staff and investment in systems and equipment. On the other hand, Essential Energy submitted that waivers should be for an indefinite period of time.

It is possible that over time, as circumstances change and the market develops, the basis upon which we grant any waiver application is no longer valid. Therefore, we think that it is prudent to include a sunset date on any waiver, to ensure we reassess the appropriateness of any waiver after a reasonable period of time.

On balance, we consider a sunset period should be linked to a DNSP's regulatory control periods on the basis that if a change to a waiver is made, it enables the DNSP to consider the treatment of any cost implications in its revenue proposal. Also, the regulatory determination process provides a sensible trigger to review any waivers.

We note that the circumstances necessitating a waiver may arise during a regulatory control period. If a waiver application is made towards the end of a regulatory control period and the sunset date for a waiver is set for the current regulatory control period, the waiver might apply for a very short period of time before requiring the DNSP to reapply for the waiver at the next regulatory control period. This is likely to create unnecessary regulatory burden for DNSPs. We consider a more practicable and balanced approach is to allow a waiver to be set for the current and next regulatory period. This would mean that a waiver will apply for at least one whole regulatory control period and potentially up to two regulatory control periods.

### Revising a waiver within a regulatory control period

Given our proposal for waivers to cease by the end of the current or next regulatory control period, we consider it is necessary to be able to review a waiver within a regulatory control period, to enable us to reassess the appropriateness of any waiver. This would most likely only occur if new information came to light, or circumstances changed, which would change our views on the need for the waiver.

If we trigger a review of an existing waiver, we would give the affected DNSP at least three months' notice of our intent, invite the DNSP to submit a written application to us, conduct public consultation if appropriate and consider a transition period for compliance if we revoke the waiver.

### Treatment of existing jurisdictional waivers

In the Preliminary Positions Paper, we suggested the possibility of 'grandfathering' existing waivers or exemptions under current jurisdictional ring-fencing obligations. Having now refined the scope and approach of the proposed guideline, we consider grandfathering would create problems that cannot be adequately managed. Our reasoning is:

* jurisdictional ring-fencing obligations will be superseded by the new guideline (existing waivers could not be enforced under the new ring–fencing approach)
* ring-fencing obligations warranting application to all DNSPs have been specified in the Draft Guideline
* the compliance transition period will give DNSPs sufficient time to apply for new waivers where necessary
* circumstances where waivers may be justifiable have been identified and there will be a fit-for-purpose process for DNSPs to obtain waivers.

We now propose an alternative approach to grandfathering existing waivers. We intend to review each of the existing ring fencing waivers before the Draft Guideline takes effect. As part of our review we will:

* seek advice from DNSPs (in responding to this paper) in regard to any existing waivers they consider are still required under our Draft Guideline
* publish a discussion paper setting out our views with respect to each existing waiver and seek submissions
* indicate at the time the final guideline is published how existing waivers will be treated.

This will provide the DNSPs, at the very least, with opportunity to apply for a new waiver during the transition period, if necessary.

# Reporting, compliance and enforcement

The Draft Guideline establishes a base level of monitoring and reporting but additional requirements may be imposed on a DNSP to address specific concerns, should they arise. Ensuring effective compliance with the Draft Guideline's obligations will be important to promote confidence in the outcomes.

The Draft Guideline requires a DNSP to establish and maintain internal procedures to ensure compliance with its ring-fencing obligations. We may require a DNSP to demonstrate the adequacy of these procedures and to report on its compliance with ring-fencing obligations. We may make ring-fencing compliance reports publicly available.

The Draft Guideline requires a DNSP's compliance with ring-fencing obligations to be independently verified annually and a report submitted to us within four months of the end of a financial year. Also, a DNSP must self-report to us a material breach of its ring-fencing obligations within 5 days of the breach occurring. We may seek enforcement of ring-fencing obligations by a court in the event of any breach of those obligations by a DNSP.

Any interested party may submit a complaint to us about a possible breach of ring-fencing obligations by a DNSP. We will investigate complaints in accordance with our compliance and enforcement policy.

In this section we first summarises the approach to reporting, compliance and enforcement set out in our Preliminary Positions Paper. We then describe the approach set out in our Draft Guideline. We conclude this section by discussing stakeholder views on reporting, compliance and enforcement.

## Preliminary positions paper

Our Preliminary Positions Paper contemplated:[[91]](#footnote-92)

* placing the onus on DNSPs to satisfy us that they have complied with the Draft Guideline
* each DNSP being required to report annually:
* its compliance with respect to each ring-fencing obligation[[92]](#footnote-93)
* compliance breaches and remedies
* an independent third party audit of its compliance
* summary financial accounts for each ring-fenced entity,[[93]](#footnote-94) indicating the size and nature of transactions with the DNSP
* to aid transparency, annual reporting requirements being published on DNSP and AER websites
* our ability to seek court enforceable compliance with ring–fencing obligations.

## Draft Guideline position

We remain of the view that a robust ring-fencing regime requires rigorous monitoring and reporting arrangements. In the absence of these measures, the development of contestable markets may be undermined by lack of confidence and predictability.

In developing the reporting, compliance and enforcement framework for the Draft Guideline we have considered a range of principles. These include that an effective reporting, compliance and enforcement regime should encourage compliance by DNSPs. It should also detect and redress any areas of non-compliance.

We consider there is sufficient justification for annual reporting of a DNSP's compliance with its ring–fencing obligations, supported by an independent third party assessment. There is also a case for real time obligations on DNSPs to self-report incidents of non-compliance. Strategies adopted should strive to achieve the highest possible levels of compliance, while keeping the costs and regulatory burden as low as possible. Associated costs can be minimised by avoiding unnecessary regulatory prescription and instead allowing DNSPs to establish and maintain their own appropriate internal procedures.

The Draft Guideline binds DNSPs that provide direct control services. Therefore, ring-fencing obligations, monitoring and reporting requirements will focus on the DNSP, rather than on other entities and contestable markets.

Public confidence will be enhanced by transparency about DNSP compliance and the ability for customers and service providers in competitive markets to raise concerns about DNSP non-compliance with us.

Existing enforcement mechanisms appear adequate to redress non-compliance.

The revised compliance reporting and enforcement obligations in section 6 of the Draft Guideline are described below.

Maintaining compliance

A DNSP must establish and maintain appropriate internal procedures to ensure it complies with its obligations under the Draft Guideline.

In addition to annual compliance reports, we may require the DNSP to further demonstrate the adequacy of these procedures upon reasonable notice.

Compliance reporting

We will require a DNSP to prepare an annual ring-fencing compliance report and submit it to us within four months of the end of a financial year.

Annual compliance reports must describe measures taken to ensure compliance with ring–fencing obligations, identify any breaches and address non–network activities in accordance with 3.1(b) of the Draft Guideline.

Annual compliance reports must be accompanied by an assessment of compliance by a suitably qualified independent authority.

Annual compliance report will be made publicly available by the AER.

Compliance breaches

A DNSP must notify us in writing within five business days of becoming aware of a material breach of its ring–fencing obligations.

We may seek enforcement of the Draft Guideline by a court in the event of any breach of ring–fencing obligations by a DNSP, in accordance with the NEL.

Any interested party may make a complaint to us about a possible breach of ring–fencing obligations by a DNSP, and we will investigate complaints in accordance with our compliance and enforcement policy.

At any time, we may require a DNSP to provide a formal response to particular concerns about its compliance with its ring–fencing obligations.

## Submissions on Preliminary Positions Paper

In our Preliminary Positions Paper we asked stakeholders to comment on how to ensure the ring-fencing compliance framework is robust and effective without imposing excessive costs that may ultimately be borne by consumers. We also asked whether pecuniary (financial) penalties for non-compliance with ring–fencing obligations would be appropriate.

Stakeholder responses varied considerably. Non–DNSP stakeholders generally focussed more on the potential long term harms created by permitting DNSPs to establish barriers to competition in competitive markets. These stakeholders were less concerned by the potential costs imposed on DNSPs by rigorous reporting, compliance and enforcement measures. In contrast, DNPs were concerned about the potential regulatory burden associated with reporting, compliance and enforcement of ring–fencing obligations.

Below, we describe the major themes raised by submissions in respect of reporting, compliance and enforcement.

DNSPs must be prevented from establishing barriers to competition

Retailers, third party service providers and some other stakeholders asserted that compliance monitoring and enforcement is critical.[[94]](#footnote-95) Also, that preventing DNSPs establishing barriers to competition is more important than costs incurred by DNSPs in complying with ring-fencing obligations or adhering to reporting requirements.[[95]](#footnote-96) Further, that existing ring–fencing reporting, compliance and enforcement mechanisms (under jurisdictional ring–fencing arrangements) should be improved.[[96]](#footnote-97)

Compliance costs must be balanced against potential benefits

Most DNSPs considered that existing monitoring and enforcement arrangements are adequate and effective.[[97]](#footnote-98) Also, that benefits associated with any increased regulatory measures must exceed the costs of compliance.[[98]](#footnote-99) One DNSP advocated use of annual reporting Regulatory Information Notices to collect non–compliance information.[[99]](#footnote-100)

The costs of compliance must be paid for

DNSPs and the Energy Networks Association proposed that costs incurred by DNSPs in complying with ring–fencing obligations, or in reporting to us, would ultimately be recovered from customers through higher network charges. In contrast, non–DNSP stakeholders submitted that compliance costs should be borne by DNSP shareholders rather than consumers.[[100]](#footnote-101)

Monitoring contestable markets for evidence of DNSPs establishing barriers to competition

CitiPower, Powercor and SA Power Networks submitted that we should monitor market activity and competitiveness in contestable markets where concerns arise about DNSPs establishing barriers to competition.[[101]](#footnote-102)

Pecuniary penalties for ring–fencing non–compliance

Some non-DNSP stakeholders called for pecuniary penalties for non-compliance with ring-fencing obligations.[[102]](#footnote-103)

# Implementation and transition issues

The Draft Guideline’s obligations will create costs for DNSPs as they amend their corporate processes and structures to comply with the new arrangements. Some of the Draft Guideline’s obligations will take time to implement.

We consider most implementation costs are likely to be associated with legal and functional separation. We expect implementation costs will vary across DNSPs because of the difference between their existing jurisdictional ring-fencing obligations and the Draft Guideline’s obligations.

Responsibility for costs relating to non-discrimination measures will sit with the affected entity. However, staff not directly involved in providing services, like payroll, that were previously prohibited in the Preliminary Positions Paper unless a waiver had been obtained, can now be shared

We propose to allow a transition period of up to 12 months for ring-fencing obligations relating to legal and functional separation. We propose to enforce from 1 December 2016 the obligations relating to separate financial accounts, customer information protection and non-discrimination.

## Costs of implementation

Our analysis and stakeholder views suggests that most implementation costs are likely to be associated with obligations for functional separation (section 4.3 of the Draft Guideline) and to a lesser extent, legal separation (section 3.1 of the Draft Guideline).[[103]](#footnote-104) These conclusions were based on our Preliminary Positions Paper in which we suggested full separation of staff and business operations would be required.

The revised ring-fencing obligations target the potential ring-fencing risk more directly and will not require separation of staff unless directly engaged in the provision of network services. We consider the costs of our revised approach will be significantly less than would have been the case under the approach set out in our Preliminary Positions Paper because the obligations have been refined.

Responsibility for costs relating to non-discrimination measures will sit with the affected entity. This means contestable entities related to a DNSP will not be able to obtain an advantage from sharing staff with a distribution business. However, staff not directly involved in providing services, like payroll, that were previously prohibited in the Preliminary Positions Paper unless a waiver had been obtained, can now be shared.

Stakeholder views on the magnitude of DNSP implementation costs vary considerably.[[104]](#footnote-105) We note that transition costs may vary across individual DNSPs.

## Transition to compliance

As flagged in the Preliminary Positions Paper, we consider DNSPs may be unable to comply with all aspects of the Draft Guideline from its initiation on 1 December 2016. This position generally was accepted by stakeholders though some called for a longer or a shorter period than one year.[[105]](#footnote-106)

Given stakeholder expectations of implementation costs and complexity, we consider it reasonable to allow a period of up to one year for DNSPs to comply with functional and legal separation obligations.

However, we will enforce the following Draft Guideline provisions from commencement on 1 December 2016:

* obligations to establish and maintain separate accounts for direct control services and regulated transmission services (section 3.2 of the Draft Guideline)
* barriers to allocation or attribution to distribution services those costs that properly relate to non-distribution services (section 3.2 of the Draft Guideline)
* customer information protection, sharing and disclosure obligations (section 4.4 of the Draft Guideline)
* non-discrimination obligations (sections 4.1 and 4.2 of the Draft Guideline).

Appendix A − List of submissions

Submissions to the AER Electricity Ring-Fencing Preliminary Positions Paper were received from:

| **Author** | **Date received** |
| --- | --- |
| Energy and Water Ombudsman SA | 25 May |
| United Energy | 27 May |
| ERM Power Ltd | 27 May |
| Regional Electricity Micro-Grids Pty Ltd | 30 May |
| Small Business Commissioner SA | 30 May |
| Endeavour Energy | 30 May |
| Ergon Energy | 30 May |
| TasNetworks | 30 May |
| CitiPower/Powercor/SA Power Networks | 30 May |
| ENGIE and Simply Energy | 30 May |
| Ausgrid | 30 May |
| ActewAGL | 30 May |
| Essential Energy | 30 May |
| Ergon Energy Qld (Retail) | 30 May |
| Metropolis | 30 May |
| Clean Energy Council | 30 May |
| AGL | 30 May |
| Origin Energy | 30 May |
| Energex | 30 May |
| EnergyAustralia | 30 May |
| ENA | 30 May |
| AusNet Services | 30 May |
| Jemena | 30 May |
| University of Sydney | 31 May |
| Red Energy and Lumo Energy | 30 May |
| Total Environment Centre (jointly with others) | 1 Jun |
| Stanwell | 3 Jun |
| Australian Energy Council | 3 Jun |
| Energy Consumers Australia | 7 Jun |

Appendix B − Ring fencing Guideline case studies - using the decision tree

To apply the Draft Ring-fencing Guideline to a particular service, we need to know about the nature of the service, the classification of the service (if this has been determined) and the legal status of the entity through which the service is provided.

Figure A1 provides a decision tree to address these matters.

To start with, we need to know what service classification the service belongs to or whether the service has not been classified by the AER. This tells us about the regulatory treatment of the service and whether is it is:

* a network service (a distribution service or a prescribed transmission service), or
* a non-network service that is not subject to regulation by the AER.

If the service is a non-network service, the Draft Guideline requires the service to be provided by a separate legal entity, which may be an affiliate, to the DNSP. However, this requirement is subject to a materiality threshold. A DNSP that has an affiliate that provides non-network services must maintain separate accounts for its network services that clearly indicate transactions with all other entities.

Even if the affiliate is a legally separated entity, there are other obligations the DNSP must still comply with. If the affiliate provides non-network energy related services, the DNSP must not share its offices with the affiliate.

In addition, DNSP staff directly involved in providing network services may not be shared with the affiliate if the DNSP staff in question are directly involved in provision of network services. For example, DNSP’s marketing and sales staff, call centre, technical and maintenance staff with access to information about a DNSP (such as the location of network constraints) must not be shared. A DNSP may seek a waiver from these functional separation obligations. Also, staff performing corporate roles such as payroll or HR services are exempt from the staff separation obligation (though cost allocation applies to such staff as usual).

Further, the DNSP must deal with its related body corporate in an arm’s length manner. That is, it must provide its services at prices, service levels and on terms that are substantively the same as for other service providers. Finally, a DNSP must ensure it does not offer incentives to its operational staff that are linked to the performance of the non-network business.

Figure A. – Applying the Ring-fencing Guideline to a service



The remainder of this appendix applies the Draft Guideline, and the decision tree in figure A.1, to a series of hypothetical case studies. These are intended to be indicative only. The application of the Draft Guideline to a DNSP will depend on the specific circumstances, such as the service classification applicable to a particular DNSP and any jurisdictional considerations, amongst other things.

Case study 1—DNSP regional depot

A DNSP has a regional depot from which it provides regulated connection services and unregulated metering services (assuming that the DNSP exceeds the materiality threshold). Can the DNSP continue to provide the service with a single truck and crew under the Draft Guideline?

While the DNSP can continue to offer connection services, the Draft Guideline requires the DNSP to offer the unregulated metering services through a separate legal entity to the DNSP. This is because connection services for this DNSP are standard control services while unregulated metering services are non-network services.

The Draft Guideline requires the DNSP to provide non-network services from a separate location. However, a waiver could be sought. If the costs of having separate offices exceed the likely benefits, the AER may grant a waiver from either or both of the accounting and staff separation obligations. The same test would apply to any sharing of field staff involved in offering the connection and metering services.

If we assume there are no prospects of competition in this regional location, the AER might grant a waiver. However, the requirement for legal separation and cost separation would remain to minimise the potential for cross-subsidies.

If there were prospects for competition, the AER might not grant a waiver. This could result in two trucks needing to visit the customer—one to deal with connection while the other installs a new unregulated meter. However, if the DNSP was able to be flexible and allowed the metering service provider (either its affiliate or a third party) to provide the connection services on its behalf, only one truck visit would be required. The DNSP would have to pay the service provider to perform the connection as the customer has already paid for this service through their electricity charges.

So irrespective of whether or not there are prospects for competition, only a single truck visit is likely to be required (if the DNSP is willing to be flexible in providing for the needs of its regional customers).

Case study 2—Shared call centre

Assume a call centre is shared between several DNSPs and also provides call centre services for unregulated energy and non-energy matters. The call centre is owned by a separate legal entity to any of the DNSPs. How will the Draft Guideline affect this call centre?

As the call centre is not part of a DNSP, any ring-fencing issues only relate to discrimination. The DNSP will need to make sure the call centre, as its representative, does not breach any of the ring-fencing obligations around discrimination and information protection, sharing and disclosure.

The DSNPs should not be co-located with the call centre if the call centre is involved in the provision of non-network energy services. The DSNPs’ staff should not be shared with the call centre if the call centre is involved in the provision of non-network energy services.

Case study 3—Corporate services (payroll, IT support or HR)

Can corporate services be shared across a DNSP and an affiliate?

Yes. These business activities, which are internal business activities are not services offered to customers. The only issue is correct cost allocation, which is otherwise dealt with through the CAM and legal separation of the affiliate. There are no discrimination issues to be considered, provided information is managed appropriately.

Case study 4—Isolated networks

Let's assume an isolated network is not part of the National Electricity Market. Therefore, the isolated network does not contribute to providing network service as defined in the NER and is therefore (somewhat counter-intuitively) being used to provide a non-network service. The isolated network uses staff, assets and buildings belonging to the DNSP. How is the isolated network affected by the Draft Guideline?

As the isolated network service is a non-network service it must not form part of the legal entity providing network services. Subject to this, and as long as proper cost allocation is correctly adopted, assets and resources can be shared in the normal way.

DNSP staff will be subject to the provisions of the Draft Guideline around discrimination. Staff directly involved in providing network services should not also be included in the provision of energy related non-network services. The DNSP can apply for a waiver in relation to functional separation obligations. We would consider a waiver application in the context of the costs and benefits to customers and the potential impact on competitive markets, consistent with the ring-fencing objective.

Case study 5—IT infrastructure

Can a DNSP share its IT infrastructure with related bodies corporate?

The principle concern with IT infrastructure is the potential for information obtained by the DNSP relating to the network services being disclosed to a related body corporate that provides competitive non-network services.

The DNSP will need to satisfy the AER that it can properly protect the information in its IT systems, including supported by independent audits of its IT systems. A failure to satisfactorily demonstrate these protections will result in a requirement for separate IT systems.

Case study 6—High load escorts

This service relates to a DNSP that is asked to plan and potentially escort a vehicle along street where dangerous contact with network wiring is possible. How does the Draft Ring –fencing Guideline affect these services?

Let's assume this service has been classified as an unregulated distribution service. As a result, a DNSP providing this service is not affected by the Draft Guideline. The service could continue to be provided by the DNSP.

Case study 7—Watchman lights

Same as for case study 6.

Case study 8—Installation of smart meters (not in Victoria)

A smart meter is a type of meter that (outside of Victoria) is not provided by DNSPs. Therefore, a smart meter installation in these jurisdictions is a non-network service.

A DNSP wishing to install these meters would need to do so through a related body corporate that is separate to the DNSP.

DNSP staff directly involved in providing network services may not be shared with a related body corporate that installs smart meters.

Case study 9— Connection and metering services

It is assumed that a DNSP provides standard control connection services and alternative control metering services.

As both services are direct control services, there are no ring-fencing implications for the DNSP.

Case study 10—Installation of type 4 and 6 meters by a single staff member

The type 4 metering services (smart meter) are not distribution services outside of Victoria, while type 6 metering services are distribution services. The type 4 metering service cannot be provided by a DNSP but can be provided by a related body corporate.

In addition, staff of the DNSP may not be shared with the related body corporate. This would preclude one DNSP staff member from providing both services.

However, the DNSP could engage a (suitably qualified) third party to provide both services, which could include its own related body corporate, as long as it did not discriminate between alternative services providers. In this case, a single person could provide both services.

Case study 11—Operational support

Assume that a DNSP provides operational support to a related body corporate (say a generator), which involves maintenance and administrative services.

Assuming cost allocation issues are properly addressed, the main concern is whether there are any discrimination issues. If the staff being used to support the related body corporate are not involved in the direct provision of non-network services, there is no ring fencing problem.

(More information is needed to understand this scenario as the meaning of ‘operational support’ is unclear.)

Case study 12—emergency response for other networks

In this situation, DNSP staff are lent to other DNSPs due to an emergency event. What are the ring-fencing implications?

Presumably, this is not a service offered to customers but rather a matter of resource sharing around emergency events and related to regulated services. The service is most likely to be a distribution service and is consistent with existing direct control classification groupings. Therefore, there are no ring-fencing implications for the DNSP.

It would be worth clarifying the precise nature of this service at the time of classification.

Case study 13—training of staff for regulated services and other services

A DNSP trains staff to undertake distribution services. The DNSP pay also train third parties to gain accreditation to work on or near the DNSP's distribution network. The ring-fencing implications will depend on the classification of these services.

It is likely, but not certain, that training courses that do not relate to the provision of a distribution service would not be classified as a distribution service. If this was the case, the training course could not be provided by the DNSP. Instead the courses would need to be provided through a related body corporate.

Case study 14—Pole and duct rental

A DNSP can rent out space in its underground ducts or on pole tops to third parties. If so this is a service that should be classified (including being classified as an unregulated service).

The ring-fencing treatment of this service will depend on its classification. If the service is a distribution service, there are no ring-fencing implications. The Shared Asset Guideline may apply in this situation.

Case study 15—Contestable connections

Connection services that are open to competition are not likely to be network services. These services should be provided by a separate legal entity to the DNSP. The non-discrimination provision of the Draft ring-fencing Guideline would apply.

****Case study 16—solar PV cells on DNSP depot roof****

How will the solar PV cells installed on a DSNP depot roof be treated?

The issue here is what service the solar PV cells are providing and how that service is classified. It could be argued that the solar PV cells provide:

* generation services to the wholesale electricity market, or
* an input to distribution services.

The answer may well depend on the scale of the solar PV installation. A small roof top solar PV might be regarded as an input to a distribution service. A large scale solar PV array might be regarded as a non-network service. The ring fencing implications are very different. Ultimately, it will come down to how the service is classified that the asset is used for. Assets alone are not classified—only services are classified.

1. A related body corporate is an entity that is related to a DNSP (in this instance), by virtue of the Corporations Act 2001 (Cth). [↑](#footnote-ref-2)
2. AER, Electricity Ring-fencing Guideline, Preliminary Position Paper, April 2016. [↑](#footnote-ref-3)
3. Refer section 2.4. [↑](#footnote-ref-4)
4. AER, Electricity distribution network service providers – Cost allocation guidelines, June 2008. [↑](#footnote-ref-5)
5. COAG, Best Practice Regulation: A guide for Ministerial Councils and National Standards Setting Bodies, October 2007, p. 4. [↑](#footnote-ref-6)
6. As defined in the NER, Network services are collectively distribution services offered by a DNSP and transmission services offered by a TNSP. Other than where the NER specifically requires us to refer to distribution services, we use the term 'network service' throughout this paper. [↑](#footnote-ref-7)
7. Refer to the Draft Guideline for the complete list of obligations. [↑](#footnote-ref-8)
8. AEMC, National Electricity Amendment (Expanding competition in metering and related services) Rule 2015, p. 78. [↑](#footnote-ref-9)
9. COAG Energy Council, Meeting Communique, 4 December 2015. [↑](#footnote-ref-10)
10. See, for example, ENA, Submission to Preliminary Positions Paper, p. 1, Ausgrid, Submission cover letter, Essential Energy, Submission cover letter, or Clean Energy Council, Submission to Preliminary Positions Paper, p. 4. [↑](#footnote-ref-11)
11. AER, Position Paper, Electricity Distribution Ring-fencing Guideline, September 2012, p. 13. [↑](#footnote-ref-12)
12. AEMC, National Electricity Amendment (Expanding competition in metering and related services) Rule 2015, December 2015, p. 399. [↑](#footnote-ref-13)
13. See for example, Red Energy, Submission to Preliminary Positions Paper, 2016, p. 3 or Origin Submission to Preliminary Positions Paper, 2016, p.1. [↑](#footnote-ref-14)
14. See for example Energex, Submission to Preliminary Positions Paper, 2016, p. 6. [↑](#footnote-ref-15)
15. NER, cl. 6.17.2(i). [↑](#footnote-ref-16)
16. For example, see Submissions to the Preliminary Positions paper from: Energy and Water Ombudsman South Australia, p. 1, Essential Energy, p. 1 or Energy Network Australia, p. 9. [↑](#footnote-ref-17)
17. COAG (2007) Best Practice Regulation: A guide for Ministerial Councils and National Standards Setting Bodies, October 2007, p. 4. [↑](#footnote-ref-18)
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19. The Australian Government Guide to Regulation (2014) Available at: <http://www.cuttingredtape.gov.au/handbook/australian-government-guide-regulation>. [↑](#footnote-ref-20)
20. “Legal separation” refers to a requirement that network services be provide by one legal entity, and that other services be provided by one or more other legal entities (see clause 6.17(2)(b)(1)(i)) of the NER). [↑](#footnote-ref-21)
21. AER, Electricity Ring-Fencing Guideline, Preliminary positions, April 2016, p. 16. [↑](#footnote-ref-22)
22. AER, Electricity Ring-Fencing Guideline, Preliminary positions, April 2016, p. 27, items (a), (d) and (e). [↑](#footnote-ref-23)
23. 'Local area/local' is defined in Chapter 10 of the NER as the geographical area allocated to a Network Service Provider by the authority responsible for administering the jurisdictional electricity legislation in the relevant participating jurisdiction. [↑](#footnote-ref-24)
24. NER cl. 6.17.2(b)(1)(i). [↑](#footnote-ref-25)
25. NER cl. 6.15.2(1). [↑](#footnote-ref-26)
26. NER cl. 6.15.4(b). [↑](#footnote-ref-27)
27. NER cl. 6.17.2(b)(1)(ii). [↑](#footnote-ref-28)
28. NER cl. 6.17.2(b)(1)(iii). [↑](#footnote-ref-29)
29. NER cl. 6.15.2 refers. [↑](#footnote-ref-30)
30. See for example submissions by United Energy, Ergon Energy, Citipower Powercor and SAPN, Ausgrid, AusNet Services, Jemena, Essential Energy. [↑](#footnote-ref-31)
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33. Origin, Electricity Ring-fencing Guideline, 30 May 2016, pp. 2 and 3 [↑](#footnote-ref-34)
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91. AER, Electricity Ring-Fencing Guideline, Preliminary positions, April 2016, p. 34. [↑](#footnote-ref-92)
92. Expressed at that time as being 'for each ring-fenced service'. [↑](#footnote-ref-93)
93. This proposed obligation should have referred to ring-fencing obligations on the DNSP, and not on a DNSP's related entities. [↑](#footnote-ref-94)
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