



## **ELECTRICITY DISTRIBUTION RING-FENCING GUIDELINE**

Response to the AER Draft Guideline  
28 September 2016

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## EXECUTIVE SUMMARY

The Energy Networks Association (ENA) welcomes this opportunity to provide a submission in response to the Australian Energy Regulator's (AER) Draft Ring-Fencing guideline for electricity distribution businesses.

The ENA supports the efficient delivery of network services and the contribution networks make to enabling existing and emerging competitive energy service markets.

Network businesses have an important role to play in fostering new and emerging markets such as energy storage services. New markets do not form and develop in a vacuum – they can greatly benefit from the experience and skills that network businesses are well-placed to provide.

The ENA recognises that the Ring-Fencing Guideline has a role in promoting confidence in markets for competitive energy services. The challenge is to strike an appropriate balance to mitigate the risk of networks exercising any undue power in a way that would undermine competitive outcomes. To this end, the ENA supports the development of a Ring-Fencing Guideline which is proportionate to identified concerns.

However, in the ENA's view the obligations in the draft guideline exceed proportionality and necessity principles. The guideline as drafted runs the risk that efficient services provided to customers will be negatively impacted, in many situations where 'harm' is not a material consideration.

The current drafting of the Ring-Fencing Guideline is unlikely to promote the *National Electricity Objective*, as it:

- does not clearly describe and delineate the scope of services that are subject to ring fencing obligations;
- is not capable of being implemented without undue costs or risk of misinterpretation; and
- does not provide sufficient guidance to facilitate compliance.

The ENA has concerns that the current drafting of the guideline would lead to unintended consequences. The final Ring-Fencing Guideline needs to provide greater scope for the realisation of network-related economies of scale and scope, while protecting the integrity of new and emerging markets.

The ENA considers that the following considerations are paramount to achieving this objective:

- **Focusing on benefits to customers.** The focus should be on delivering benefits to customers from increased choice, quality of services and innovation. Where the practical result of the guideline is higher costs to customers, without definable current benefit, this is a strong signal that the guideline will likely not achieve the *National Electricity Objective*.
- **Promoting innovation.** Technology and changing customer participation in the energy supply system requires networks be innovative and responsive so that they are able to provide efficient services to meet future needs. The Ring-Fencing Guideline in its current form is likely to constrain efficient network service provision.
- **Applying the 'necessity principle'.** The ENA considers that a comprehensive ring-fencing assessment must evaluate the demonstrated and potential effectiveness of existing mechanisms to address any concerns with the way in which a distribution network could compete in certain markets. Additional regulation, where there is no regulatory need, will discourage efficient participation by networks in emerging markets for contestable services, thereby restricting competition. It will also discourage businesses from pursuing alternative non-rivalrous uses of existing regulated system assets.

The ENA has identified a number of areas which require further consideration and amendment to better meet the policy objective sought by the AER:

- **Requirement for legal separation.** The legal separation requirement is too narrowly defined. The obligation does not give effect to the AER's intent declared in the Explanatory Statement. In particular, the Draft Ring-Fencing Guideline suggests that a Distribution Network Service Provider (DNSP) can only provide *network services*. The ENA is concerned that such a level of legal separation has a potential to prohibit a number of activities undertaken by DNSPs in managing networks and services that the AER appear to otherwise support. For example, the implication is that services such as connections, metering, public lighting, and ancillary network services would need to be performed by a separate legal entity.

Furthermore, some DNSPs have existing arrangements where the current legal entity also conducts other utility activities. A strict requirement for legal separation may result in unnecessary and significant restructuring costs, and in some cases may not be feasible.

The ENA's conclusion is that there is both a need for the guideline to better represent the services that DNSPs do legitimately and efficiently provide, and specifically to ensure that legal separation provisions do not prohibit this.

- **Proportionality.** The guideline should adopt a proportionate approach by crafting ring-fencing obligations that work together to ensure that they address the identified harms in specific market segments, and in circumstances where the harms are evident. The guideline requires greater scope for exceptions and flexibility than the draft provides. As drafted, for example, DNSPs would not be able to share resources with other networks for emergency network restoration, and a DNSP would not be able to attend to a remote customer outage that is found on arrival to be a problem with the metering. The following mechanisms can be used to achieve the principle of proportionality:
  - Pragmatic interpretation of the NER requirements, e.g. using the term 'distribution services' and move away from using 'network services';
  - Consider raising the materiality threshold;
  - Allow for some exemptions from legal separation requirements.
- **Clarity of scope and application of the guideline.** The current drafting of the guideline is not clear as to how the guideline can be meaningfully implemented in practice. The confusion stems from the way definitions are used in the Draft Ring-Fencing Guideline and Explanatory Statement. It is crucial that the AER:
  - Clearly defines all terms that are used in the final guideline;
  - Does not use terms interchangeably; and
  - Aligns with existing NER and NEL definitions to the fullest possible extent.
- **Transitional arrangements.** The ENA recognises the AER's aim for the guideline to apply as soon as possible. However, there are significant challenges in implementing all obligations in the nominated timeframes. The guideline must provide for appropriately phased transition arrangements for any circumstances in which existing compliant network business activities may require restructuring to comply with the AER's final Ring-Fencing Guideline. The step change in regulation will also require DNSPs and related entities to undertake training to operationally

understand how the new obligations must be implemented. The ENA would welcome the opportunity to work with AER on resolving the transition issues and arriving at a schedule that is practical.

## IMPORTANCE OF PROMOTING CUSTOMER BENEFITS AND INNOVATION

The Ring-Fencing Guideline review occurs at a time of significant and fast-moving technology and market change in the energy sector.

It is important that the AER's ring-fencing guideline can be demonstrated to promote the *National Electricity Objective* by serving the long-term interests of electricity consumers.

The focus of the AER's guideline should be on delivering benefits to customers from increased choice, quality of services and innovation.

If network businesses are able to harness economies of scale or scope to deliver lower prices to customers, it is important that customers obtain this benefit. Moreover, the skills and expertise of network businesses may position them to provide innovative solutions and new service offerings to address evolving customer needs.

While we recognise that the AER has sought to adopt a more targeted and proportionate approach to ring-fencing in its Draft Guideline, the ENA is concerned that the AER's position may still be founded on the view that the goal of ring-fencing is to '*eliminate the advantage*' that network businesses may have in providing services. Competition must be fair, but 'fairness' does not imply that regulation should seek to eliminate competitive advantages that may arise from synergies, economies of scale or low transaction costs. In relation to new and emerging energy services, it is likely that retailers and other market participants also have competitive advantages of this nature.

Allowing network businesses to participate in emerging markets ultimately leads to outcomes that benefit consumers. Regulation should not deny customers these better outcomes. Instead, regulation should be designed to facilitate innovation, remove impediments to competition and address competition concerns as they arise.

The ENA understands that it is the AER's intention to develop a nationally-consistent approach to service classifications.

It is very important to ensure that the AER's approach of ring-fencing decisions being linked to the service classifications is workable and sound. In undertaking the review of the service classifications, the AER should conduct high-level analysis to first establish market power as justification for the outcome that would impose ring-fencing obligations that have the effect of restricting the DNSPs participation in competitive markets. Such analysis may include the following elements:

1. The potential for the regulatory obligation to stifle participation, investment and innovation in potentially competitive markets;
2. The extent to which competition would be distorted in the absence of the regulatory obligation being imposed; and
3. The administrative costs of the regulatory obligation on the AER, the network companies and customers.

## EXISTING MECHANISMS AND SAFEGUARDS

The AER's consideration of ring-fencing arrangements in the context of regulated services is reasonable and is clearly a NER requirement.

It is important to consider, however, that there is a range of existing mechanisms in place which impact on the nature and degree of ring-fencing that is likely to be required. That is, a range of existing regulatory and competition law mechanisms already address potential risks set out in the Draft Explanatory Statement.

Ring-fencing approaches and obligations should only be developed to supplement and build on existing protections and only provide such confidence in the market as is required for the promotion of the NEO where the benefits of these additional measures can be shown to exceed the associated costs.

These existing mechanisms include:

- **Competition and Consumer Act 2010 protections** – sections 46 and 50 – which prohibit a variety of anti-competitive conduct that appears to be the target of some of the proposed ring-fencing arrangements, and which are to be further strengthened following the Federal Government's response to the Harper review; and
- **Metering Contestability Rule Change information requirements** – new arrangements under the recent

AEMC rule change on the distribution and use of metering data, which is relevant to the AER's consideration of the potential for unfair informational advantages for customer load profile data.

The existing economic regulatory framework also contains elements directed towards ensuring a level playing field for market participants:

- **Cost allocation rules** - Chapter 6 of the NER provides for cost allocation arrangements aimed at ensuring that costs are allocated appropriately between the various service classifications, to prevent any cross-subsidy of contestable and potentially contestable activities by regulated activities. These requirements are a form of ring-fencing because they separate – in an accounting sense – the monopoly activities from contestable activities.
- **Ex-ante cost reviews** - The AER's regulatory determination process provides assurance that the regulator has the opportunity to fully examine the costs forecast to be incurred by network businesses in delivering regulated services. The AER's RIN requirements and expenditure forecast assessment guidelines provide the AER with very large volumes of detailed information on the costs incurred by network businesses in providing services.
- **Assessments of related party transactions** – The regulatory regime is effective in addressing concerns with regard to related party arrangements. The AER's Expenditure Forecast Assessment Guidelines, amongst other things, set out a rigorous approach to the assessment of related party costs, to ensure that costs arising under a related party transaction reflect arm's length commercial arrangements. These requirements therefore eliminate the potential for a distribution business to favour a related party in the procurement of services.
- **Chapter 5 connection requirements** – recently revised, setting conditions on which networks must accept connections on a non-discriminatory basis.
- **Chapter 5 planning requirements** – including the publishing of distribution annual planning reports providing information on looming network constraints.
- **Benefit sharing rules for shared use of common network** - The NER empower the AER to reduce the annual revenue requirement for a regulated business to reflect the costs of the regulated assets that are used in providing an unregulated service. The AER has

established Shared Asset Guidelines to give effect to the NER requirement.

In reality, current regulatory arrangements already prevent cross subsidies between regulated and non-regulated activities. It is noted, however, that other potential forms of ring-fencing – limitations on the flow of information, and physical, staffing separation – are not addressed through Chapter 6 of the NER.

## EFFICIENT AND PROPORTIONATE RING-FENCING OBLIGATIONS

### Requirement for legal separation

The current drafting of the requirement for legal separation is too narrowly defined and does not give effect to the AER's intent outlined in the Explanatory Statement. In particular, the Draft Ring-Fencing Guideline suggests that a DNSP can only provide *network services*.

The ENA is concerned that such a level of legal separation has a potential to prohibit a number of activities undertaken by DNSPs in managing the networks and services that the AER appear to otherwise support. For example, the implication is that services such as connections, metering, public lighting, and ancillary network services would need to be performed by a separate legal entity.

The ENA's conclusion is that there is both a need for the guideline to better represent the services that DNSPs do legitimately and efficiently provide, and specifically to ensure that legal separation provisions do not prohibit these.

The ENA considers that careful analysis in terms of the use of the definitions is required in order to achieve the following objectives:

- Remove any doubt that a DNSP can provide services such as connections, metering, public lighting, and ancillary network services.

One option to achieve this is to use the term 'distribution services' and move away from using 'network services'.

- Allow a DNSP to not be denied economies of scale or scope which are available because it is a member of a corporate group, such as joint procurements.

It is important to note operation of the incentive-based regulation means that consumers will benefit from such

arrangements due to lower operating and capital costs in future regulatory periods.

- Ensure that the Ring-Fencing Guideline works in harmony with the Shared Asset Guideline.

It is important that the regulatory arrangements continue to incentivise electricity networks to pursue alternative non-rivalrous uses of their existing regulated system assets. In relation to the NEO, customers' long terms interests are best served where the net revenues associated with alternative uses are maximised and are used to provide reductions in network prices over time.

Furthermore, some DNSPs have legacy arrangements where the entity also conducts other utility activities (such as reticulation of water or gas supplies). A strict requirement for legal separation may result in unnecessary and significant restructuring costs, and in some cases may not be feasible. The final Ring-Fencing Guideline needs to accommodate such circumstances.

The ENA further notes that, the NEO is intended to promote efficiency and the long-term interests of electricity consumers. The NEO does not extend to promoting efficiency or the interests of consumers outside of the electricity sector. Therefore, the AER's guideline should not capture services supplied outside of the electricity sector (e.g. NBN-related services) as it is difficult to see how this could promote the NEO.

### Proportionality

In clause 6.17.2 of the NER, the Ring-Fencing Guideline is required to specify the need for, and the extent to which, the ring-fencing obligations should apply. The Rules, therefore, do not mandate the imposition of ring-fencing obligations, but rather suggest a proportionate approach having regard to the circumstances.

The guideline should adopt a proportionate approach by ensuring ring-fencing obligations work together to ensure that they address the identified harms in specific market segments. The guideline requires greater scope for exceptions and flexibility than the draft provides. As drafted, for example, DNSPs would not be able to share resources for emergency network restoration, and a DNSP would not be able to attend to a remote customer outage that is found on arrival to be a problem with the metering.

The following mechanisms can be used to achieve better outcomes:

- **Pragmatic interpretation of the NER requirements**

It is important that the AER adopts a pragmatic approach to the interpretation of the NER. For example, clause 6.17.2 (b) (1) (i) of the rules provide that the AER may define the need for and the extent of

*legal separation of the entity through which a Distribution Network Service Provider provides network services from any other entity through which it conducts business* (emphasis added)

Recent consultation with ENA members demonstrated that the use of the term 'network services' is not practical. As discussed in the previous section, it unintentionally captures services such as such as connections, metering, public lighting, and ancillary network services. The ENA encourages the AER to adopt the term 'distribution services' (or any other credible options) and move away from using 'network services'.

The ENA notes that there is very little material available to guide the interpretation of the ring-fencing provisions of the NER. They appear to have originated in the National Electricity Code. Very similar language was used in the Code providing for guidelines to be developed by the ACCC (for transmission) and jurisdictional regulators (for distribution). They were brought across to the NER with very little explanation of their purpose or intent.

- **Consider raising the materiality threshold**

The ENA welcomes the cost threshold approach adopted by the AER. However, the \$500,000 threshold appears to be an arbitrary figure. The ENA encourages that AER to consider a threshold that is proportionate to a DNSPs annual revenue requirement. The ENA considers that a threshold which aligns with cost-pass through arrangements may be an appropriate starting point.

The ENA is of the view that the materiality threshold needs further clarification to ensure its interpretation is unambiguous.

- **Allow for exemptions from legal separation requirements**

Some DNSPs have legacy arrangements where the entity also conducts other utility activities. A strict requirement for legal separation may result in unnecessary and significant restructuring costs, and in some cases may not be feasible.

The draft guideline introduces a new and unnecessary obligation that a DNSP must be a legal entity. This would preclude organisations such as SA Power Networks which are partnerships (not legal entities) from providing any network services (or, preferably, distribution services).

The ENA considers that the Ring-Fencing Guideline needs to accommodate such circumstances by:

- deleting the requirement that the DNSP must be legal entity; or
- allowing exemptions from legal separation requirements.

## Clarity of scope and application of the guideline

The current drafting of the guideline provides insufficient clarity as to how the guideline can be meaningfully implemented in practice. The confusion comes from the way definitions are used in the Draft Guideline and Explanatory Statement.

It is crucial that the AER:

- Clearly defines all terms that are used in the final guideline.  
For example, the term "energy-related services" is not defined in the draft guideline. The ENA suggests that "energy-related service" should be defined as an electricity service (as defined in the *National Electricity Law*) other than a distribution service.
- Does not use terms interchangeably.  
For example, in a number of instances the AER appear to have used the terms "network services" and "distributions services" interchangeably.<sup>1</sup> These results in significant confusion as "network services" are clearly a subset of "distributions services".
- Aligns with existing NER definitions to the fullest possible extent.  
Ideally, the guideline should use the NER definitions or the definitions available under the NEL, noting that careful analysis is necessary as the definitions will determine the scope and application of the guideline.

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<sup>1</sup> See Figure 1, AER *Draft Ring-fencing Guideline – Explanatory Statement*

## Transitional arrangements

The ENA recognises the AER's aim for the guideline to apply as soon as possible. However, there are significant challenges in implementing all obligations in the nominated timeframes. The guideline must provide for appropriately phased transition arrangements for any circumstances in which existing compliant network business activities may require restructuring to comply with the AER's final Ring-Fencing Guideline. The step change in regulation will also require DNSPs and related entities to undertake training to operationally understand how the new obligations must be implemented.

In addition, network businesses must be provided with appropriate time to be able to comply with any change to its ring-fencing obligations. This includes:

- The situation where the AER varies or revokes a waiver;
- The situation where there is a change to classification of service which materially impacts the DNSP's obligations under the guideline.

The ENA would welcome the opportunity to work with the AER on resolving the transition issues and arriving at a schedule that is practical.

## Suggested next steps

The ENA encourages the AER to consider a further dedicated workshop with networks and other interested parties to focus on the correction of any unintended effects of the revised draft guideline, or other purely drafting issues. Such a workshop should take place prior to the final decision.

## IMPLICATIONS FOR TRANSMISSION NETWORKS

ENA notes that the focus of this current consultation is on electricity distribution, and recognises that references to transmission in the draft guideline do not bind TNSPs, but are included for guidance of the DNSP in the situation of a DNSP also providing transmission services (ref cl 3.1(c)).

However, the AER should provide a 'for the avoidance of doubt' clarification to this effect in the guideline. In this context, the ENA provides initial feedback here on a number of high-level matters relating to electricity transmission, given the AER's explanatory statement references possible applicability of the elements of the electricity distribution

ring-fencing guideline to transmission. The ENA notes that a national ring-fencing guideline already applies to transmission networks.

ENA's view is that transmission issues should be considered thoroughly and holistically in an independent review process. Any review of the existing ring-fencing obligations on transmission businesses must carefully consider the regulatory framework as it applies to transmission networks and should not simply apply the same framework that the AER seeks to apply to DNSPs. In this regard, the ENA makes the following observations

- Transmission services are materially different to distribution as defined in the *National Electricity Rules*. For this reason and, in contrast to distribution, transmission services are not classified by the AER in the lead up to a regulatory determination process.
- Customers directly connected to transmission networks include generators, mines, smelters and DNSPs. Typically, these customers are sophisticated and have established highly commercial connection and access agreements with relevant TNSPs, given the size of their demands.
- The existing controls on transmission networks, such as the Cost Allocation Method and Shared Asset Guideline have proven to be robust in preventing cross-subsidisation and ensuring that the benefits of a network business providing unregulated services is shared with consumers. In particular, since the AER's approval of existing TNSP Cost Allocation Methodologies in 2007/08, the AER has not identified any cost allocation issues that would result in a need for change.

Given that the AEMC is currently considering a Rule change in relation to the electricity transmission connections and planning framework which also seeks to extend contestability in the provision of transmission services, the ENA suggests that it would be most practical to postpone any review of the transmission ring-fencing arrangements until that matter has concluded. The ENA would welcome further discussions with the AER on this issue.