



26th September 2016

Mr Chris Pattas
General Manager, Networks
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

By email to: Ringfencingguideline2016@aer.gov.au

Dear Mr Pattas

RE: AER Draft Electricity Ring-fencing Guideline

ERM Power Limited (ERM Power) welcomes the opportunity to respond to the Australian Energy Regulator's (AER) Draft Ring-Fencing Guideline for Electricity Distribution (the Draft Guideline).

About ERM Power Limited

ERM Power is an Australian energy company that operates electricity generation and electricity sales businesses. Trading as ERM Business Energy and founded in 1980, we have grown to become the fourth largest electricity retailer in Australia, with operations in every state and the Australian Capital Territory. We are also licensed to sell electricity in several markets in the United States. We have equity interests in 497 megawatts of low emission, gas-fired peaking power stations in Western Australia and Queensland, both of which we operate.

ERM Power Limited also has subsidiary businesses in metering services, energy efficiency, behind the meter technologies and data analysis – businesses that we consider may compete with networks or their affiliates.

General Comments

Competitive markets develop where there are fair opportunities for participants to compete to provide services (or goods), and consumers have information and the freedom to take advantage of a wide choice of low cost and efficient service or product offerings. Distortion of competitive markets may occur when single large monopolistic providers, through unrestrained use of their position as a provider of regulated services, are able to operate in contestable markets and gain unfair advantage or restrict access to competitors. As a result there may be lack of service provision aligned to need, imperfect price signals and limited service offerings to consumers who are forced to pay above the efficient levels of provision. Ring-fencing aims to protect and promote competitive markets, to the long term benefits of consumers. It allows companies such as ERM Power to enter markets on a level playing field and offer an innovative and attractive value proposition to customers.

ERM Power welcomes the AER's recognition that Distribution Network Service Providers' (DNSPs) unfettered activities in contestable markets may undermine the development of efficient and effective competition in those markets, to the detriment of consumers. Such distortionary and anti-competitive

actions may transpire through the DNSP using its regulated revenues to cross subsidise its delivery of contestable services and through discrimination, by the DNSP favouring its own contestable services and gaining an unfair advantage over potential competitors.

Further, we support a national approach to ring-fencing regulation, ensuring consistency and simplifying compliance to a single framework. We broadly agree with the aim of ring-fencing identified by the AER and its principled approach of determining ring-fencing requirements. However, we remain concerned that the measures outlined in the Draft Guideline will not sufficiently protect emerging markets nor provide a level playing field whereby multiple players have equal access to provide customers with efficient low cost alternatives to new technologies.

The AER describes Ring fencing as

“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”¹.

It is this definition that should underpin the AER’s scope of where separation is required, ensure ring-fencing captures and enforces the division between regulated monopoly activities and contestable activities. We regard contestable services as those that are or may be provided by any competing company and this includes services that are provided ‘behind the meter’ or down-stream of the metering installation, as well as demand management services, generation and energy storage services. Our view is consistent with that of the Australian Energy Market Commission’s conclusions in their Integration of Energy Storage Final Report, pertaining to the classification of behind the meter services as being contestable services that should not be provided by a network business, except through a ring-fenced business².

ERM Power strongly believes that DNSPs should only be able to provide contestable services through engaging with a contestable provider or via an affiliate, provided that the DNSP’s regulated entity providing monopoly services is ring-fenced from that affiliate. We regard the AER’s distinction of ‘network services’ and ‘non-network services’ to determine when a separate affiliate is warranted, places a weak ring-fencing provision on the DNSP as it still allows DNSPs to exploit its position over competitors and enter contestable markets under the pretext of network service provision.

Despite the provisions on functional separation, we remain concerned that DNSPs will seek to leverage the cost minimisation of the affiliate through exploiting the sharing of services such as corporate services or IT infrastructure. In doing so, the DNSP will gain an unfair advantage over competitors who do not have such opportunities. The AER should not underestimate the harm to competitive markets with the inability of participants to compete against DNSPs that seek to use waivers on staff separation and location to exploit an economies of scale advantage.

ERM Power recognises that ultimately any ring-fencing guideline is only as effective as the compliance and enforcement activities that surround it. We note that the guideline is highly reliant on oversight by the AER through audit. A robust enforcement regime for ring-fencing with substantial penalties, will be fundamental to protecting and promoting competition in the energy market.

¹ AER, *DRAFT Ring-fencing Guideline Explanatory Statement*, August 2016 pg.1

² AEMC, *Integration of Storage: Regulatory Implications, Final report*, 3 December 2015, Sydney pg. iv

The following comments in this submission cover those issues ERM Power believes require further consideration by the AER to ensure that the Draft Guideline meets its objective and supports the development and expansion of competitive markets surrounding energy related services.

Issues with the division of network to non-network service provision to determine ring-fencing.

The Draft Guideline states that a DNSP must only provide network services through a separate legal entity. Therefore non-network activities must be conducted through an affiliate that is legally separated and maintains separate financial accounts. The AER views that this framework will extend the elements of the Cost Allocation Methodology (CAM) to non-network activities (given the CAM will allow for cost separation of network provision only). The AER intends to suppress the ability of the DNSP to cross-subsidise contestable activities with regulated income through this context of legal separation, separate cost allocation and accounting.

ERM Power strongly views the AER's determinant for legal separation to be based on the distinction of activities arising from network services to non-network services as deficient to satisfactorily protect emerging contestable markets, particularly those that are provided 'behind the meter' or services relating to demand management. With separation at this level cross subsidisation could remain, as the Draft Guideline ignores the provision of services that may fall in the category of 'network services' but have the ability to be provided by contestable players.

Without adequate protection to allow for greater competition in the market for behind the meter or demand response services, customers will be left with the services provided by DNSPs that are incentivised to establish contestable services through the offering of 'network services'. These 'network services' can evolve over time to be no longer for augmentation or support of the network but as a platform for inflating contestable revenues. In doing so, the DNSP has effectively deployed infrastructure and closed out potentially lower cost alternative providers. Exposing and constraining cost allocation alone will not prevent harm ensuing from a DNSP dominated market that has thwarted competitor entry.

ERM Power maintains that for the AER to effectively curtail DNSP's cross-subsidisation of using regulated revenues to promote its delivery of contestable services and crowd out other players, prohibition should be placed on DNSPs from carrying out contestable services, including services that operate behind the meter such as storage and generation. Simply, this can occur by ensuring DNSPs are ring-fenced from the provision these services. Allowing DNSPs to provide these services directly, bypasses the test for efficiency that would have otherwise been exposed through procurement from competitive markets. We believe that Direct Control Services should not include any contestable services that operate behind the meter. In the event that a service is 'not classified', by default, it should not be in the remit of the regulated ring-fenced entity until it can be proven that the service falls under the classification of Direct Control Services.

As a recipient of regulated revenue, DNSPs should focus on the provision of regulated services which should be separated from the provision of any other services via the establishment of a separate affiliate to carry out these activities. DNSPs will then have the option to procure such services from contestable suppliers or an appropriately ring-fenced affiliate.

The AER should consider long-term impacts to customers when limiting functional separation

ERM Power expects that DNSPs will leverage the use of shared services, such as corporate services and information systems to minimise the costs of the affiliate and therefore have substantial competitive advantage over other participants. Though DNSPs will argue that harm is diluted or non-existent as there is lower cost service provision to customers through the leveraging economies of scale, it is our view that this is not the case and customers will be disadvantaged by dampened or distorted competitive markets in the longer term.

We are concerned that under the Draft Guideline, it is not clear that the costs of shared services will be levied on the affiliate and corporate costs not shifted to the regulated cost base whereby all the DNSPs customers are paying for the affiliate's operation. For this to be transparent, we believe that functional separation of shared corporate services, staff and location should be defined up to the board of the regulated entity and waivers be limited to exceptional circumstances, where competitive harm has been thoroughly assessed. Further, we see that restrictions should be placed on information systems, ensuring information protection but also to limit the ability of the DNSP to confer an unfair advantage when establishing the affiliate.

Consultation for the granting of waivers is essential to expose any significant impacts to competitive markets.

While we welcome the limitation of waivers to a narrowed scope covering location and staff sharing, we are concerned that the granting of waivers should be a transparent and consistently applied process, subject to consultation to ensure any potential harm is tested and revealed. The AER has detailed that a formal waiver consultation process will only be undertaken if the AER determines there are significant implications for the provision of competitive services. We argue that any discrimination implications for potential or current market competitors are more likely to be revealed through a consultation process. Specially, information provided by the DNSP under the Draft Guideline's section 5.2.2 relating to the potential for cross subsidisation and discrimination and potential consumer impact, should emanate from a consultation process rather than the AER relying on information that the DNSP provides in its application.

Further, we urge the AER to make certain all waivers are subject to strict conditions whereby any changes to the service provision of the affiliate or regulated entity in a shared location are communicated to the AER for reconsideration of the waiver right. Waivers should not be granted with a hands off approach but should be tested for legitimacy in any compliance audit.

Materiality threshold is problematic and should be removed

ERM Power believes that the \$500,000 materiality threshold should be removed. Currently the Draft Guideline allows for the DNSP to establish contestable services knowingly with forecast costs expected to exceed the threshold. By the time the threshold is exceeded and ring-fencing requirements are triggered, harm to potential contestable markets has already ensued.

The Draft Guideline has allowed for the DNSP to undertake non-network services, free of ring-fencing requirements until costs of that provision exceed \$500,000 in a year. We disagree with the AER's contention that the DNSP'S service provision up to this threshold is unlikely to have a materially adverse effect on the markets for contestable services. By endorsing an avenue for the DNSP to establish a non-network service, albeit until costs reach a threshold, the foundations for discrimination

may have been formed as functional separation is only in place against a related body corporate. Competition may immediately be compromised as information may already be shared with staff prior to the formation of the affiliate, marketing may already be established, and an unfair advantage already materialised. We maintain that the materiality threshold should be removed to ensure the foundations of distorting the competitive market are not realised prior to the threshold being met.

Staff separation requirements should uphold independence and clear accountability of decision making

We note that staff separation provisions under functional separation do not apply to senior executives of both a DNSP and a related body corporate. Further the Draft Guideline allows DNSPs to give incentives to senior executive of both the DNSPs and a related body corporate, based on the performance of a related body corporate. We question a senior executive's ability to remain independent in strategical decision-making when a conflict of interest may exist. It may be difficult for senior executives who may have incentives, not to favour the affiliate over the regulated entity, resulting in an increased cost to the monopoly provider. This outcome will be to the detriment of consumers who pay higher Distribution Use of System charges.

Importantly, contractual arrangements are unlikely to be formalised or negotiated with efficient outcomes when senior executives span across the parties to a negotiation. It would be very difficult to quarantine sensitive information obtained through contractual negotiations from being shared and used to the advantage of the affiliate when reporting lines lead to the same senior executives who are usually parties to the negotiation. Formal contractual arrangements under a separate governance model are required, as compliance issues will not be transparent to a regulator.

We are concerned that executives shared between the regulated entity and affiliate may be involved in commercial dealings and contractual negotiations with a competitor of the affiliate. Through this, it would be difficult to avoid prejudiced decision making or the provision of sensitive information to the affiliate that the executive has obtained. In our view such risks would only be minimised if senior executives were to operate independently and separation of duties span up to board level. Further we consider that governance would be compromised unless independent oversight occurs, whereby senior executives involved in internal audit are not shared between the regulated DNSP and the affiliate.

Separate branding

DNSPs must have independent and separate branding of their distribution services from an affiliate including advertising and promotion. We regard the requirement for separate branding to be important so that the DNSP and its affiliate are seen to be distinct, stand-alone entities to customers. This restriction will ensure customers do not confuse the services that each delivers and the affiliate is not provided with the advantage of leveraging from the known branding of the network.

ERM Power believes that as currently worded, the restrictions on advertising and use of brand are relatively easy to circumvent and we urge the AER to consider whether further measures can be place on ensuring the affiliate is not able to refer to the DNSP in promoting its brand or advertising.

Compliance and enforcement is paramount to the effectiveness of ring-fencing

ERM Power sees enforcement of the Draft Guideline to be critical to its effectiveness. Without providing a consequence for non-compliance, the guideline will be relegated to be treated as a best practice guidance document. From the high level clauses of the Draft Guideline, we are uncertain as to

how the DNSPs will be held accountable for non-compliance or indeed how compliance will be measured and tested.

We suggest the final guideline will need a strong supporting compliance framework including a penalty regime formed with clear compliance criteria to be tested under independent audit. We believe that the penalties for non-compliance should be substantial, commensurate with similar penalties for competition breaches available to the Australian Competition and Consumer Commission (ACCC). We believe such enforcement action is warranted to reflect the potential consumer detriment from the actions of the DNSP in frustrating competition in services, and the likelihood that breaches of the guideline by the DNSP may influence the behaviour of other market participants.

ERM Power supports the AER's intention of placing independent audit obligations on DNSPs to ensure they operate in a compliant manner in accordance with any ring-fencing guideline. However, we see that the effectiveness and robustness of an audit would be strengthened with a limited tenure (a limit on the consecutive use of the same auditor), and auditors be subject to approved selection criteria established by the AER. Finally, audit outcomes should have transparency and be made publically available.

Closing comments

Where DNSPs are active in the competitive space, ERM Power sees the ring-fencing as essential to protecting emerging competitive markets and allowing consumers to benefit from effective competition. In its current form, ERM Power sees that the Draft Guideline has placed considerable weight on the transparency of non-network services cost allocation to control the DNSP's ability to cross-subsidise contestable services with regulated revenue. We believe there is still potential for DNSPs to materially adversely affect markets for contestable services by conferring an unfair advantage in the provision of services behind the meter. We urge the AER to take a more holistic approach to determining potential harm to the markets for all contestable services including those that may be delivered under the umbrella of 'network services'.

Please contact me if you would like to discuss this submission further.

Yours sincerely,

[signed]

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