



27 May 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: Electricity ring-fencing guideline – Preliminary positions

ERM Power Limited (ERM Power) welcomes the opportunity to respond to the Australian Energy Regulator's (AER) preliminary positions paper (the Paper) on establishing a national electricity ring-fencing 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

ERM Power supports the AER's review of the existing jurisdictional ring-fencing regimes, aiming to broaden the scope to address a range of new energy services, while also bringing these together in one consistent national guideline.

Like many businesses in the sector, ERM Power continues to expand its customer offering to include a greater range of energy management solutions. In providing these services, we may be competing with network businesses or their affiliates. We relish the opportunity to differentiate and prove the value of our offerings in a dynamic contestable market, with confidence that we will be competing on a competitively neutral basis. We are hopeful that the guideline resulting from the AER's review, supported by robust compliance and enforcement activities, will provide this confidence.

The AER's preliminary positions are encouraging. We support the proposed ring-fencing objectives and obligations, and welcome the commencement of robust compliance and enforcement activities. The

submission that follows focusses on the areas of the Paper where we consider clarification is required to establish the confidence required in the electricity ring-fencing regime to support a dynamic contestable market in energy management services. In particular, we highlight the Australian Energy Market Commission's (the Commission) recommendations in their *Integration of Energy Storage Final Report* in relation to behind the meter services, and urge the AER to ensure its approach to service classification, and therefore ring-fencing, is consistent with these recommendations.

Which services should be ring-fenced?

Default requirement prior to classification decision

ERM Power strongly supports the AER's preliminary position, to assume ring-fencing is beneficial for consumers. It is appropriate to place the onus of proof on network businesses to demonstrate that the costs of complying with ring-fencing obligations would outweigh the public benefits, as this approach would provide greater confidence to emerging contestable markets.¹

In the Paper, the AER considers options to define or classify those services that would be subject to its ring-fencing guideline. It outlines its preferred approach, which is to review service classifications as part of each jurisdiction's five-yearly determination process. This would lead to decisions being made with respect to particular services in each jurisdiction at different points in time. With the development of cross-jurisdictional contestable businesses likely to be dependent on the AER's classifications, we are concerned about the level of uncertainty for contestable businesses as they await formal decisions on treatment of services between five-yearly determinations. It is possible that, under this approach, a network business may develop a potentially contestable service, and offer this in the market for some years prior to a classification decision that deems ring-fencing required. Under this scenario, the network business may have gained an unfair advantage for the period where the service was not ring-fenced. This advantage may then be passed onto an affiliate, if the service is offered through a ring-fenced entity following classification.

With this in mind, we find that rather than defining or classifying services that should be ring-fenced from regulated network businesses, it would be more constructive to define or classify those services that may be performed by a regulated network business, and expect that all other services should be ring-fenced. Not only does this approach align with the AER's position that ring-fencing is generally in consumers' best interests, but it also provides a much more stable framework for service classification over time. This is because we consider the evolution of potentially contestable services to be far greater over time than regulated services, as a greater number of providers seek to leverage technology to offer value-added services to consumers.

ERM Power therefore recommends the AER clarify that all new services should be assumed to require ring-fencing by default. The five-yearly classification review should then be used to confirm that the existing classifications (including the assumed unregulated classification for new services, and previous waiver decisions) remain appropriate with the changing market conditions.

¹ As an aside, we note it is vital that a public benefits assessment considers scenarios where (i) the network procures a service from a ring-fenced affiliate; (ii) the network procures a service from an unaffiliated contestable provider; and (iii) the service it is offered to a customer independently of the network. It should not be assumed that a service would not exist in the absence of network service provision.

Service purpose and classification

Unclassified services are required to be ring-fenced from direct control services. In the paper, the AER outlines its preliminary position that direct control services must represent investments in devices or services that are undertaken exclusively for network management purposes, and have no component that could be deemed contestable or potentially contestable. Where a proportion of the value from a service or device may be associated with potentially contestable activities, it will be unclassified and must be ring-fenced. While ERM Power concedes that this removes the current ambiguity around mixed-purpose network assets, we remain unconvinced that all services undertaken exclusively for network purposes do not require ring-fencing.

The AER uses the example of an energy storage device that is installed behind the meter exclusively for the purpose of smoothing demand peaks and mitigating the need for network augmentation, stating that no ring-fencing would be required in this scenario. This is contrary to the recommendation of the Commission in its *Integration of Energy Storage Final Report*:

“The AEMC recommends that services provided by DNSPs behind the meter be treated as contestable services that should therefore be unclassified. Network businesses should not provide such services except through a ring-fenced business. Where storage behind the meter would be useful for providing network support, these services must be contracted from a third party or ring-fenced business.”

The Commission explains how network provision of these services, even if intended for network support purposes, could adversely affect the contestable market:

“[The network business] could use the connections process to make it difficult for rivals to install storage behind the meter, if the business or an affiliate were competing in that space. The network business could use information it gains in the course of its regulated activities that is not available to other competitors to provide an advantage to its storage-related activities – for instance, information regarding local network issues and customer demand profiles. The network business could leverage its regulated interactions with customers to also offer non-regulated services, in a manner which results in an advantage for its non-regulated activities and does not make clear to customers that they could choose an alternative supplier for these activities.”

ERM Power shares the Commission’s view that network service provision can have the potential to undermine a competitive market, despite a network’s stated purpose for that service. We therefore recommend the AER takes a broader view of service classification, considering the potential implications to the competitive market holistically. Consistent with the AER’s preliminary position discussed above, the AER should be prepared to reclassify current direct control services as unclassified services unless a network demonstrates the costs of ring-fencing would exceed the public benefits.

Ring-fencing waivers

ERM Power believes that all ring-fencing waiver applications must provide the opportunity for stakeholder consultation. This is important in recognition that the potential for competition to impact a developing services market may vary depending on different geographic areas, customer sectors and applications. Market stakeholders are well placed to identify these differences, and provide insight into business developments; it is unclear how the AER could make an informed decision without such

feedback. It would be inappropriate for an AER approval or rejection of a waiver application to set a firm precedent for future applications without the opportunity to consider these factors.

ERM Power therefore rejects the suggestion of fast-track and bulk waiver approval processes without consultation. While we understand the AER's desire to mitigate costs of unwarranted ring-fencing, we believe that short-circuiting the application assessment process has the potential to lead to greater costs to the development of the competitive market.

Recovering the costs of ring-fencing

It is appropriate for the costs of ring-fencing to be borne by the customers of ring-fenced services. Engaging in ring-fenced services represents a commercial decision made by network businesses that is quite separate from its role as monopoly network service provider. The costs of ring-fencing are equivalent to the costs of a contestable provider establishing their business, and would therefore provide a more even-playing field between competitors.

Reporting, compliance and enforcement

ERM Power welcomes the AER's preliminary views on the need for a robust compliance and enforcement of ring-fencing obligations. Independence and transparency in the AER's compliance and enforcement activities is particularly important to support market confidence that network businesses are operating fairly and in accordance with their obligations.

We support the AER's proposal to place the onus on network businesses to demonstrate compliance with their obligations, and believe the proposed annual reporting requirements will provide an appropriate level of market transparency. However, we recommend that annual audits are undertaken by an independent auditor appointed by the AER, rather than each network business. This will strengthen public perceptions of independence and AER accountability for audit outcomes.

Please contact myself, or my colleague Libby Hawker (03 9214 9324, lhawker@ermpower.com.au) if you would like to discuss this submission further.

Yours sincerely,

[signed]

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