

28 September 2016

Mr Chris Pattas
General Manager, Network Pricing, Policy and Compliance Branch
Australian Energy Regulator AER
GPO Box 520
Melbourne Vic 3001

Via email: Ringfencingguideline2016@aer.gov.au

Dear Mr Pattas

RE: AER DRAFT ELECTRICITY RING-FENCING GUIDELINE

Endeavour Energy welcomes the opportunity to provide feedback on the AER's Draft Electricity Ring-Fencing Guideline (Draft Guideline) and Explanatory Statement. We support the implementation of nationally consistent ring-fencing arrangements that enhance confidence in contestable markets by protecting against anti-competitive behaviour to promote the long term interests of customers.

In our response to the AER's preliminary positions paper we raised a number of concerns with the AER's proposed approach. Several of the proposed obligations were considered to be disproportionately burdensome and restrictive compared to the existing NSW jurisdictional guideline. We considered that a more targeted guideline that focusses on addressing the potential for harm would be more beneficial to the development of functional competition in emerging markets. This is particularly pertinent in NSW where an active and vibrant Accredited Service Provider market has demonstrated that network and non-network participants can, and do, operate effectively in the same markets.

The AER's Draft Guideline makes several changes to the approach outlined in the preliminary positions paper. A more prescriptive approach has been adopted requiring legal separation, general non-discrimination obligations, physical separation of staff and restrictions on staff and information sharing. Limited exceptions have been specified, including a materiality threshold with respect to legal separation as opposed to the 'all-in then waiver' approach of the preliminary positions paper.

Overall, we do not consider the Draft Guideline will best promote the National Electricity Objective (NEO). We consider the Draft Guideline lacks clarity in its current form due to several undefined terms, terms used interchangeably and case studies with contradictory positions. These issues mainly relate to the use of the terms "(non-) network" and "(non-) distribution" and the meaning of "directly involved" and "energy-related".

Based on our understanding of the Draft Guideline we consider it is unnecessarily restrictive and onerous. The Draft Guideline is not supported by evidence and experience of the harmful participation of DNSPs in contestable markets. Restrictive obligations such as physically separate buildings, non-sharing of staff (even at contractual arm's-length terms) and no waivers to legal separation will impose costs and are anti-competitive in nature. DNSPs have a demonstrated history of playing an important role in developing immature markets to the long term benefit of customers.

Our concerns with the Draft Guideline are as follows:

- **Clarity:** As noted above the Draft Guideline lacks clarity in its current form meaning it is difficult to understand its scope and application. This is compounded by deferring much of the practical application of the Draft Guideline to the Framework and Approach (F&A) process which occurs several months after the Final Guideline for Endeavour Energy is in place, and only once every five years.
- **Onerous Requirements:** Many of the requirements in the Draft Guideline are significantly greater than those that currently apply under jurisdictional guidelines (including the NSW guideline). There is no established reason as to why more restrictive measures are required or how these will benefit consumers. Locating staff in physically separate buildings, removing the ability to seek waivers and prohibiting the sharing of staff are overly simplistic broad brush anti-competitive measures that do not seek to target specific and demonstrated areas of concern and therefore impose costs

unnecessarily or eliminate scale and scope efficiencies that would otherwise facilitate the development of markets to the long term benefit of customers.

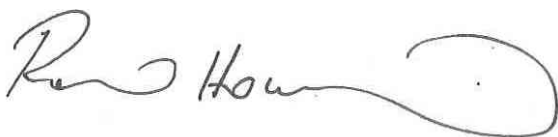
- **Materiality Threshold:** There is no exception to the requirement for legal separation irrespective of whether Endeavour Energy can demonstrate that its Cost Allocation Methodology (CAM) is applied in a manner that protects against cross-subsidisation. Instead, a \$500,000 cost threshold is used to trigger this requirement. This cost threshold is easily exceeded by the costs involved to research and develop new innovations and is inconsistent with the 1% of the Annual Revenue Requirement used for both Pass-Through Events and the Shared Asset Guideline.
- **Transitional Arrangements:** The proposed transition timeframes are unworkable in light of the uncertainty and likely substantial changes required. A 1 July 2018 start date for NSW is in Endeavour Energy's view more appropriate. Utilising this date provides 12 months for Endeavour Energy to complete the required functional and legal separation of services after they have become known with the completion of the F&A process. A financial year start date also reduces compliance and system costs that would otherwise be incurred with a part year start date, and ensures more transparent annual financial reporting to the AER.
- **Compliance requirements:** Endeavour Energy is concerned that the proposed requirement to self-report within five business days is likely to reduce the quality of the reporting provided to the AER, including any proposed remediation actions. Rather Endeavour Energy would favour a reporting requirement more in the order of 20 business days to allow sufficient time to fully review the circumstances and to determine an appropriate course of action to achieve compliance.

In addition to the matters raised above, we consider that the NEO will be better achieved by a guideline that:

- details a set of clear, well defined, proportionate and flexible measures that protect against the potential for anti-competitive behaviour with a demonstrable net benefit to customers;
- allows customers of contestable services the choice to benefit from DNSP economies of scale and scope in a competitively neutral manner;
- fosters innovation by incentivising rather than prohibiting DNSPs from utilising their skills and experience to create new energy products/service offerings;
- provides a pragmatic transition period to allow sufficient time for DNSPs to re-structure its operations to ensure compliance; and
- is supported by an assurance and enforcement regime that is simple, transparent, and cost-effective.

Attachment A contains our detailed response and recommendations. If you wish to discuss this matter further please contact Jon Hocking, Manager Network Regulation at Endeavour Energy on (02) 9583 4386 or via email at jon.hocking@endeavourenergy.com.au.

Yours sincerely



Rod Howard
Acting Chief Executive Officer
Endeavour Energy

DETAILED RESPONSE TO THE AER DRAFT ELECTRICITY RING-FENCING GUIDELINE

1. Recommendations

This section provides a list of Endeavour Energy's recommendations to the Draft Guideline and/or Explanatory Statement to facilitate ring-fencing obligations that are clear, proportionate, targeted and promote confidence in markets and regulatory outcomes.

Clarity of the Guideline

1. The AER provide definitions for all terms used in the Draft Guideline and Explanatory Statement, prior to the release of the Final Guideline to ensure it aligns with the intended scope. Key undefined terms include:
 - a. (Non)-network;
 - b. (Non)-distribution;
 - c. Directly involved;
 - d. Energy-related; and
 - e. Other Energy Services.
2. The Final Guideline ceases using the term "(non)-network services. Instead use more direct terms that provide greater clarity. For example, the terms "distribution services" as defined in the National Electricity Rules (NER) and "energy-related service", defined as an electricity service (as defined in the National Electricity Law (NEL)) other than a distribution service.

Ring-Fencing Requirements

3. The AER undertake a robust cost benefit analysis (including a Regulatory Impact Statement) that:
 - a. Quantifies the potential for harm that ring-fencing is trying to address against the cost impacts of the proposed ring-fencing obligations to alleviate it; and
 - b. Assesses the costs and benefits of:
 - i. The proposed ring-fencing obligations compared to the existing jurisdictional guidelines;
 - ii. The current compliance of DNSPs against them; and
 - iii. The success of the existing regulatory framework (such as the CAM, Shared Asset Guideline and the Regulatory Investment Test for Distribution).
4. In the absence of a quantitative analysis of the above factors, do not introduce new and more onerous ring-fencing obligations. Instead, expand the current NSW Guidelines beyond contestable connection works to achieve the stated objectives of discouraging potential cross subsidisation of costs and discriminatory behaviour.
5. Should the requirements for legal and functional separation be maintained, the Final Guideline needs to be cognisant of, and allow for, the various business models that can deliver the required separation in the most efficient manner.

Materiality Threshold

6. The ring-fencing threshold is changed from \$500,000 of costs to 1% of Annual Revenue Requirement to offer a more tailored and consistent approach with existing measures that take account of the size of each potential market a DNSP operates in.
7. Endeavour Energy also requests that the AER provide further guidance on the threshold's practical application.

Transitional Arrangements

8. The Final Guideline to allow for an 18 month transition period to complete the required functional and legal separation of services after they have become known following the completion of the F&A process. A financial year start date also reduces compliance and system costs that would otherwise be incurred with a part year start date. It is acknowledged that accounting and cost allocation requirements can be implemented as at 1 December 2017.

Compliance Requirements

9. The Final Guideline increase the time for DNSP's breach reporting from 5 business days to 20 business days. This allows the DNSP to provide a robust report on what are likely to be complex issues.
10. The AER provide clear criteria and requirements of what constitute a valid complaint and more detail about what the AER's compliance and enforcement policy is. This will assist all stakeholders to have comfort that the process will be balanced and will not be hostage to facetious or spurious complaints.

2. Clarity of the Guideline

This section provides an outline of Endeavour Energy's views on the purpose of a guideline, an overview of the AER's Draft Guideline and areas where we consider it requires further clarification.

2.1 Purpose of a Guideline

The AEMC's Power of Choice review made several amendments to the NER to promote competition in metering and other emerging energy markets. Noting the impacts this has on the importance and role of ring-fencing, the AEMC require the AER to develop a ring-fencing guideline by 1 December 2016 in accordance with the relevant NER provisions in clause 6.17.¹

The AER's ring-fencing guideline is to replace the existing jurisdictional ring-fencing guidelines which were first published in the early 2000s and not revised since. It will therefore be important for the AER's guideline to cater for the current environment compared to that of the early 2000s where jurisdictional regulators were dealing with a vertically integrated industry.

We consider the key role of a guideline is to provide certainty and clarity as to the AER's intended approach to enable DNSPs and stakeholders to make informed, efficient decisions.

2.2 What the AER has proposed

Given the primary purpose of the ring-fencing guideline is to provide certainty and clarity, Endeavour Energy supports the AER's more focussed approach in the Draft Guideline to deal with two specific potential harms by DNSPs:

- *"prevent DNSPs cross-subsidising between regulated and contestable services; and*
- *prevent DNSPs discriminating against other service providers."*²

The Guideline then seeks to explain how each proposed obligation relates to these potential harms.

Endeavour Energy also supports the AER's consideration of best practice regulation principles to assist in designing the ring-fencing obligations. Specifically, the AER explain they had regard to whether the obligations contained in the Draft 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."*³

Further, the Explanatory Statement also uses diagrams and case studies to try to clarify the services and staff affected by the ring-fencing guideline and its obligations.

However, despite these efforts to be more principled and clear with its intent, the Draft Guideline does not completely achieve this objective. This is primarily due to:

- several undefined terms contained in the Draft Guideline that are crucial to understanding its scope;
- terms used interchangeably causing confusion; and
- case studies with contradictory positions.

¹ AEMC, *National Electricity Amendment (Expanding competition in metering and related services) Rule 2015*, p. xv

² AER, *Draft Ring-Fencing Guideline – Explanatory Statement*, August 2016, p. 3

³ *Ibid*, p. 3

2.2.1 Undefined terms

There are several terms used in the Draft Guideline, which require clarification. A reading of the Draft Guideline based on the ordinary meaning of these terms produces a more onerous and restrictive guideline than what appears to be the AER's intention based on the Explanatory Statement. These definitional issues mainly relate to the use of the following terms:

- **(Non)-network:** used to define the scope of the Draft Guideline;
- **(Non)-distribution:** used interchangeably with Non-network services and also defines the scope of the Draft Guideline;
- **Directly involved:** used to determine what staff must be functionally separated and subject to information sharing provisions;
- **Energy-related:** used to determine what services must be functionally separated and subject to information sharing provisions; and
- **Other Energy Services:** used in the Explanatory Statement at Figure 1 with reference to the Shared Asset Guideline, but nowhere else in the document or Draft Guideline.

In the absence of an explicit definition, terms should be given their ordinary meaning having regard to the context in which the term is used. In the present circumstances, the relevant context is Chapter 6 of the NER, the economic regulation of distribution services and the purpose of the Draft Guideline which is to ring-fence direct control services from other services provided by the DNSP.

As such, with the information available to Endeavour Energy in the Draft Guideline and Explanatory Statement, we consider the following meanings could apply:

- **(Non)-network services:** any service that is not a network service (as defined by reference to Endeavour Energy's classification decision in its 2015-2019 regulatory determination);
- **(Non)-distribution services:** any service that is not a distribution service (as defined in the NER) including a transmission service;
- **Energy-related services:** any service provided by the DNSP that is not a network service and relates to energy including decentralised energy and battery storage; and
- **Other energy services:** meaning any service other than a distribution service provided by Endeavour Energy including transmission services.

The Draft Guideline requires all DNSPs across the NEM to establish a related body corporate for all non-network services provided by the DNSP, where the costs of providing the services exceed \$500,000 in a regulatory year. Arguably, the broad nature of these increases the scope and burden of the Draft Ring-Fencing Guideline obligations by capturing all services provided by a DNSP, except those involved in the point-to-point conveyance of electricity.

Based on the terminology used, the AER's Ring-Fencing Guideline applies to "network services", which can be read as 'standard control services' consistent with the definitions contained in the NER. The implication is that all non-standard control services such as metering, public lighting, connection and ancillary network services will need to be performed by a separate legal entity to the DNSP.

However, such an interpretation is not free from doubt and an alternate interpretation of the Ring-Fencing Guideline is that it is intended to apply less broadly, with a DNSP able to provide standard control, alternate control, negotiated and unregulated distribution services. Therefore, only non-distribution services would need to be provided by a separate legal entity. Whilst this reading is not as well-supported based on the terms used it appears to align more closely with the AER's intent.

Given the onerous nature of the obligations under the Draft Guideline, we consider it a material omission by the AER to leave these terms undefined. We recommend the AER provide definitions for these terms, prior to the release of the Final Guideline to ensure it aligns with the intended scope.

2.2.2 Inconsistent use of terminology

The potential to arrive at two opposing interpretations is due to the use of undefined terms, is further compounded by the inconsistent use of those terms in the Draft Guideline and Explanatory Statement.

A key cause of confusion is the interchangeable use of the terms 'network services' and 'distribution services', which in some cases results in contradictory outcomes. For instance, the intended scope of the Draft Guideline is outlined in section 1.1 and suggests it applies to direct control services (which includes Standard Control Services and Alternate Control Service). Yet the Draft Ring-Fencing obligations throughout the remainder of the Draft Guideline are more narrowly, but variably, targeted as follows:

- **3.1 Legal separation** – legal split between Network Services (Standard Control Services) and non-network services (everything else);
- **3.2 Accounting** – allocate costs between distribution services (Standard Control Services, Alternate Control Services, Negotiated, Unregulated) and non-distribution services;
- **4.1 Non-Discrimination** – not discriminate between distribution service (Standard Control Services, Alternate Control Services, Negotiated, Unregulated) and non-distribution service customers;
- **4.2 Physical separation and staff sharing** – separate office and staff between direct control services (Standard Control Services and Alternate Control Services) and other energy related services; and
- **4.3 Information access** – refers to information sharing by the provider of direct control services (Standard Control Services, Alternate Control Services).

The intended scope of the Draft Guideline is again confused in the Explanatory Statement which states,

***“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).”**⁴* (Emphasis added).

Yet, in the next paragraph,

*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.”⁵* (Emphasis added).

This scope confusion is also found in the Explanatory Statement Case Studies where in some the supporting material considers distribution services (not just network services) will be provided by the DNSP.

For example case study 6 – High Load Escorts:

*“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.”*⁶

However, in other examples the material states that only network services can be provided by the DNSP, such as case study 15 - Contestable connections (noting that currently connection services in NSW are classified as unregulated distribution services),

*“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.”*⁷

Given the above, a conservative, legal interpretation of the Draft Guideline in its current form could lead to a more onerous and unintended application compared to the Draft Guidelines stated intent of allowing DNSPs to offer standard control services, without imposing the Draft Guideline requirements of legal, functional and information separation, and not simply the narrower network services.

Endeavour Energy supports the ring-fencing of regulated services and contestable activities, where these measures are proportionate and targeted as discussed in section 3 below. This is to ensure, where warranted, that a market for contestable services is not adversely affected by discriminatory or preferential interactions between the contestable and non-contestable services offered by a DNSP.

⁴ Ibid, p. 23

⁵ Ibid, p. 23

⁶ Ibid, p. 63

⁷ Ibid, p. 64

A possible mechanism to achieve this, and remove confusion, is to cease using the term “(non)-network services”. Instead, the terms “distribution services” as defined in the NER and, “energy-related service”, defined as an electricity service (as defined in the NEL) other than a distribution service, could be used.

In this context, distribution services refer to the services that a DNSP can supply without the need to apply the Draft Guideline requirements. While energy related services refer to the services that a DNSP cannot provide without the need to apply the Draft Guideline requirements. However, it is noted that other terms could be used that provide the necessary clarity.

2.3 Reliance on the Framework & Approach

It is acknowledged that the Explanatory Statement advises that the Framework and Approach (F&A) stage of a regulatory determination will determine the ring-fencing obligations for a particular service, for a regulatory control period.

Unfortunately, these arrangements do not immediately clarify the Draft Guideline scope as the F&A process:

- will be finalised seven months after the Final Guideline comes into force (for NSW network operators and later for other jurisdictions);
- occurs once every five years; and
- occurs at different times for network operators in different jurisdictions.

Instead, this approach will result in the ring-fencing obligations applying differently depending on the home jurisdiction of the DNSP. This is inconsistent with the stated objective in the Explanatory Statement, “[to] establish a national ring-fencing approach to replace State based ring-fencing arrangements that have operated for more than a decade.”⁸

There are currently several services classified as either alternate control, negotiated or unregulated under the existing F&A decisions. For instance, emergency recoverable works, high load escorts, large customer/non-standard connections services, public lighting services, meter testing etc.

The materiality of this issue is dependent on the clarification of the terms discussed above. If the Final Guideline continues to target the obligations in a varied manner at either direct, network and/or distribution services then the split between standard control services and alternate control services, negotiated and unregulated distribution services will become critical.

It is our understanding that the service classifications will continue to be aligned over time (except where genuine jurisdictional differences exist). As the NSW F&A is long-standing and currently in force, we anticipate several changes will be made to bring it into line with more recent AER F&A decisions (at least with respect to the use of terminology).

Given this, and the proximity of the NSW 2019-24 F&A process, we consider the ring-fencing obligations should only apply after the completion of the F&A process (at least for the NSW DNSPs). Further comments on this are in section 4, Transitional Arrangements.

3. Onerous requirements

Endeavour Energy notes the AER's Draft Guideline makes several changes to the approach outlined in the preliminary positions paper. To provide certainty, a more prescriptive approach has been adopted requiring legal separation, general non-discrimination obligations, physical separation of staff and restrictions on staff and information sharing. Limited exceptions have been specified, including the introduction of a materiality threshold with respect to legal separation, as opposed to the ‘all-in then waiver’ approach of the preliminary positions paper.

Endeavour Energy accepts that the AER has a mandated responsibility to ensure contestable markets are free from cross subsidisation of costs and discriminatory behaviour by regulated natural monopolies. However, Endeavour Energy is of the view that the AER has not fully utilised its available regulatory tools to achieve these outcomes, before defaulting to disproportionate and costly alternatives.

For example, introducing robust cost allocation methodology frameworks, coupled with information gathering and cross referencing regulatory accounts with statutory accounts, provides transparency and oversight as to how the DNSP allocates its cost between regulated and contestable services. This removes the ability to cross subsidise contestable service costs with regulated revenue and ultimately negates the need for mandated legal separation.

⁸ Ibid, p. 8

Whilst the AER consider the scope of the Cost Allocation Methodology (CAM) is limited, the majority of DNSPs, including Endeavour Energy, have an AER approved CAM that achieves the desired transparency and specifications to protect against cross-subsidisation. An independent assessment of each DNSP's CAM could have been made and amendments to the Cost Allocation Guideline (and NER if required) are all preferable and more proportionate options available to the AER rather than seeking to address a perceived deficiency through legal separation.

Based on our existing CAM, there would be no change in how we allocate our costs if some of our existing services were moved to a separate legal entity under the Final Guideline. It seems illogical and unnecessary for DNSPs like Endeavour Energy to incur substantive costs, which could in turn reduce the level of competition in contestable markets, where the risk for cross subsidisation is already adequately protected against. We consider the costs of such measures clearly outweigh the benefits given there are less costly, alternate measures available that can provide other participants the confidence and comfort the AER desires.

Similarly, the Draft Guideline seeks to address discriminatory behaviour concerns by requiring staff directly involved in providing contestable services to be located in physically separate buildings. Staff separation is a common ring-fencing measure that does not require physically separate buildings to be used. The risk of discriminatory behaviour can be overcome by separating staff within existing offices, by deploying strategies such as different floors, access restrictions via security passes, and ICT restrictions.

Furthermore, we also consider restricting the sharing of 'directly involved' staff is unnecessary. Staff can book their time to different businesses, with the DNSP required to record these costs in accordance with the CAM and disclose this information as part of a proportionate, risk based compliance regime. Staff could also be required to provide certain written or verbal statements and/or website, quote and price list disclosures to customers where a service can be contestably provided.

It is recognised that some stakeholders will consider these alternate measures inadequate as they may not eliminate the comparative advantage the DNSP has due to economies of scope and scale. However, it must be reiterated that the promotion of the National Electricity Objective will only be achieved with ring-fencing obligations that are targeted at the potential market failures of cross subsidisation and discrimination in the most proportionate and least cost manner. Otherwise, government failure (or non-market failure) will occur, causing end consumers to pay even higher prices, for less innovation than that which would happen even if the market failures occurred.

It is not the existence of competitive advantage that is the market failure, but instead the use of market distorting mechanisms (cross subsidisation and discrimination) to establish a competitive advantage that is the accepted harm. This is a critical distinction that we consider the Draft Guideline fails to make. Instead, it is seeking to eliminate any advantage a DNSP may possess rather than targeting the potential use of market distorting mechanisms or has inadvertently done so by introducing excessively burdensome obligations.

As it stands the Draft Guideline is not supported by evidence and experience of harmful participation of DNSPs in contestable markets. Instead, it is influenced by unsubstantiated and inaccurate claims of DNSPs distorting the market. For example the Explanatory Statement states,

*"Ring-fencing levels the playing field in competitive markets by eliminating the advantage a DNSP may otherwise have in providing that service."*⁹ We consider DNSPs play an important role in developing immature markets to the long term benefit of customers. Examples of this were explained in Endeavour Energy's response to the Preliminary Positions paper. These included:

- The initiation and development of the ASP/contestable works scheme;
- Technical Training;
- The residential air conditioning cycling program Demand Management Initiative; and
- The standardisation of Battery Storage technical requirements.

Endeavour Energy appreciates that the AER is compelled to balance the varying views of all stakeholders. However, the National Electricity Objective will only be achieved if this balancing is supported by a robust cost benefit analysis that quantifies the potential for harm and against the cost impacts of the measures addressed to alleviate it.

⁹ Ibid, p. 8

To date, this has not occurred, with a Regulatory Impact Statement not being prepared to either assess the costs and benefits of the proposed ring-fencing obligations compared to the existing jurisdictional guidelines, nor the current compliance of DNSPs against them, or even the success of the existing regulatory framework (such as the CAM, Shared Asset Guideline and the Regulatory Investment Test for Distribution).

This is inconsistent with best practise regulation, with the *COAG Best Practise Regulation* Guide stating,

*"If regulatory options are being considered (such as self-regulation where governments expect business to comply, quasi-regulation, co-regulation and 'black letter law') then Ministerial Councils must subject these options to a regulatory impact assessment process through the preparation of a draft and final RIS."*¹⁰

Given the lack of quantitative analysis, Endeavour Energy is of the view that no justifiable case has been put forward to introduce more onerous and costly ring-fencing obligations than the current jurisdictional requirements in place. Instead, we are of the view that the NSW Guidelines can simply be expanded beyond contestable connection works to achieve the stated objectives of discouraging potential cross subsidisation of costs and discriminatory behaviour.

Notwithstanding the above, should the requirements for legal and functional separation be maintained, the Final Guideline needs to be cognisant of, and allow for, the various business models that can deliver the required separation in the most efficient manner.

4. Materiality Threshold

Endeavour Energy notes the AER has moved away from "all in then waiver" approach in its positions paper and instead included a \$500,000 cost threshold to allow DNSPs to undertake some research and investment in contestable services without needing to implement the ring-fencing obligations (specifically legal separation).

Endeavour Energy welcomes the threshold approach, but notes the costs involved to research and develop new innovations easily exceed the \$500,000 cost threshold provided in the Draft Guideline. Furthermore, the threshold itself is an arbitrary figure that does not account for the size of the market. For instance, a competitive market in the Sydney metropolitan area may have far greater capacity and level of competition than a rural area in inland NSW, yet the same threshold applies.

In saying this, we do appreciate the complexity involved in designing a variable threshold on a service and location basis. However, we consider alternatives are available that are more tailored and consistent with existing measures, such as 1% of Annual Revenue Requirement. This measure would be a more appropriate proxy for the size of each potential market a DNSP operates in and is consistent with the threshold used for Pass Throughs and the Shared Asset Guideline on a service by service basis.

We also consider this threshold should apply to the revenue associated with a service rather than the cost. This is because the amount of revenue generated by a service is more reflective of a DNSPs involvement in that market whilst costs are associated with research and development activity that does not necessarily correlate with the level of participation in a market. This would also avoid a threshold that conflicts with other mechanisms in the NER which seek to promote, rather than stifle, innovation.

Endeavour Energy also requests that the AER provide further guidance on the threshold's practical application. For example Endeavour Energy has the following questions:

- Does it apply on a service by service basis?

We consider it should. In its current form, i.e. \$500,000, it would be wholly inadequate and practically serve no purpose. If the threshold was amended to 1% of the Annual Revenue Requirement it may be reasonable to apply it on a collective basis.

- Does it reset to zero every time the service(s) are shifted over?

As above, if the \$500,000 threshold was to apply collectively and on a 'once-only' basis it would serve no practical purpose and dis-incentivise innovation in a more permanent way.

- How does this interact with the Shared Asset Guideline?

¹⁰ COAG, *Best Practice Regulation: A guide for Ministerial Councils and National Standards Setting Bodies*, October 2007, p 7

The AER notes in Figure 1 of the Explanatory Statement that the Shared Asset Guideline will identify and separate distribution and non-distribution revenues earned from the use of regulated assets. However, the Shared Asset Guideline 'box' runs over both distribution and non-distribution services. It is unclear how a service associated with a regulated asset could provide a non-distribution service when it involves the use of a distribution asset.

If this is the case, we would like to understand if it is possible for the potential non-distribution use of a shared asset to exceed the threshold and require the transfer or re-allocation of assets to the separate legal entity that would have to be established and if this is possible within the NER.

We consider this is not the intent of the Draft Guideline and this issue will be resolved once the matters which require clarification (as outlined in section 2 above) are addressed. In our view, the Shared Asset Guideline box in Figure 1 can only wholly sit within the distribution service box by definition.

5. Transitional Arrangements

Endeavour Energy understands that the Final Ring-Fencing Guideline, which will apply to all electricity DNSPs across the National Electricity Market (NEM), will come into effect on 1 December 2016. Accounting, compliance, information sharing and cost allocation obligations must be implemented by this time. However, a transition period of up to one year will be put into place for DNSPs to comply with legal separation obligations and six months to comply with obligations for functional separation.

The proposed transition timeframes are inadequate, especially given the scope of the guideline will not actually be determined until the completion of the F&A process in June 2017 (later for DNSPs in other jurisdictions). This means that Endeavour Energy must implement accounting, compliance, information sharing, cost allocation obligations and functional separation prior to knowing exactly what services need to be ring-fenced (or when significant changes to our existing F&A may be imminent).

To overcome this shortfall, Endeavour Energy recommends that the Final Guideline allow for an 18 month transition period for legal and functional separation requirements. This will mean DNSPs will have until 1 July 2018 to comply with these aspects of the guideline, with compliance enforced from this date.

A 1 July 2018 start date provides 12 months for Endeavour Energy to complete the required functional and legal separation of services after they have become known following the completion of the F&A process. A financial year start date also reduces compliance and system costs that would otherwise be incurred with a part year start date. It is acknowledged that accounting and cost allocation requirements can be implemented as at 1 December 2017.

6. Compliance requirements

It is important that the compliance and reporting requirements are transparent, cost effective and proportionate. The requirements for a DNSP to notify the AER in writing within five business days of becoming aware of a material Guideline breach and requiring a DNSP to provide a formal response to particular complaints or concerns about compliance with the Guideline are not cost effective, nor proportionate. Endeavour Energy accepts the practice of self-reporting, but requests 20 business days is provided for breach reporting. This allows the DNSP to provide a robust report on what are likely to be complex issues.

Finally, Endeavour Energy notes that section 6.4 of the Draft Guideline, Complaints and investigations, mandates that,

"At any time, the AER may require a DNSP to provide a formal response to particular complaints or concerns about compliance with this Guideline."¹¹

This is in addition to the annual compliance reporting DNSPs must adhere to. Arguably, this additional reporting requirement infers the burden of proof rests with the DNSP for all complaints and concerns, even if they are unsubstantiated. Endeavour Energy requests the AER provide clear criteria and requirements of what constitute a valid complaint and more detail about what the AER's compliance and enforcement policy is. This will assist all stakeholders to have comfort that the process will be fair and will not be hostage to facetious or spurious complaints.

¹¹ AER, *Draft Ring-Fencing Guideline – Electricity Distribution*, August 2016, p. 11