30 May 2016

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

Dear Mr Pattas

RE: AER - Electricity Ring-Fencing Guideline – Preliminary Positions (April 2016)

Endeavour Energy welcomes the opportunity to provide feedback on the AER's preliminary position paper – Electricity Ring-Fencing Guideline (the position paper). Overall, we support the implementation of nationally consistent ring-fencing arrangements that enhance confidence in contestable markets by protecting against anti-competitive behaviour by regulated entities to promote the long term interests of customers.

This position paper follows the Australian Energy Markets Commission (AEMC) Power of Choice program which implemented a number of rule changes designed to promote competition in metering and other emerging energy services. As a consequence of these reforms, the AEMC has imposed a requirement on the AER to develop a national ring-fencing guideline by 1 December 2016. This guideline will be administered and enforced by the AER and replace the various existing jurisdictional based guidelines.

We support the AER's understanding of both the purpose and objective of ring-fencing. Ring-fencing is present in many unregulated sectors such as financial or advisory services where staff and/or information are separate from other activities due to commercial sensitivity or where conflicts of interest, real or perceived, may occur. In this context, ring-fencing refers to the separation of regulated services and contestable activities. 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 Distribution Network Service Provider (DNSP).

We support the AER's emphasis on ensuring the costs and benefits of any proposed ring-fencing arrangements are assessed in order to ensure that a disproportionately burdensome regulatory framework is not established so that DNSPs, and ultimately customers, are not unreasonably incurring additional costs. We therefore understand the value of an approach which aligns with the existing Framework and Approach (F&A) process, whilst providing a waiver mechanism with both fast-track and bulk waiver options.

However, we are concerned that some of the proposed obligations are more restrictive than the current NSW arrangements. It is not obvious that the case for more onerous obligations has been made when more cost-effective alternatives are available and given the strength of existing regulatory measures. We are concerned that some stakeholders have expressed strong but unsubstantiated concerns that overstate the potential for harm and therefore advocate for more extreme obligations to be imposed.

It is important that in developing a ring-fencing guideline, the AER examines the evidence and experience of DNSPs in contestable markets. Rather than respond to the theoretical view that DNSPs' participation in contestable markets (even where ring-fenced) is anti-competitive and detrimental to customers by default. DNSPs play an important role in developing immature markets to the long term benefit of customers. Restricting our ability to do so would reduce competition, distort efficient outcomes and impact the ability of DNSPs, and the market more broadly, to research and efficiently deploy non-network options.

Overall, we consider the National Electricity Objective (NEO) will be better achieved by a ring-fencing guideline which provides for a measured and proportionate approach that protects against the potential for harm at least cost. This will be supported by a guideline which:

- regulates on an individual service basis;
- details a set of proportionate and flexible measures which protect against the potential for anti-competitive behaviour at a net benefit to customers;
- comply with the requirements of clause 6.17 of the NER. Notably, any accounting and/or functional separation of regulated and unregulated activities is to apply to the regulated activities; and not the other way around.
- provides for an efficient and transparent waiver process that allows for the consideration of factors such as safety, cost-benefit evidence, jurisdictional restrictions and other individual circumstances;
- allows customers of contestable services to benefit from DNSP economies of scale and scope and comparative advantages in a competitively neutral manner;
- considers and complements the existing regulatory framework; and
- is supported by a simple, transparent, cost-effective reporting, monitoring and enforcement regime.

In its current form, some of the proposed ring-fencing obligations will unnecessarily restrict the ability for DNSPs to efficiently share corporate resources as it imposes legal, locational and physical separation of unregulated activities whilst also prohibiting the sharing of staff. This form of separation may not comply with NER clause 6.17 as the AER has the ability to ring-fence regulated activities rather than unregulated activities. Further, directly restricting the sharing of corporate resources and staff, or creating artificial barriers to market entry, would eliminate the possibility of cost or revenue sharing opportunities that would otherwise benefit regulated customers in accordance with the Cost Allocation Methodology (CAM) and Shared Asset Guideline (SAG). This would be detrimental to the long term interests of regulated customers and the achievement of the NEO.

An example of the benefits of diversification and corporate cost sharing was Endeavour Energy's participation in the retail market. For Endeavour Energy, the AER found that the loss of synergies associated with exiting the retail market were material and real in approving a $47.6m (nominal) pass-through for Efficient Benefit Sharing Scheme (EBSS) purposes. If Endeavour Energy were to exit all contestable markets (forcibly or otherwise) a similar reallocation of costs, in the same order of magnitude, would occur. The AER should be mindful of these impacts in assessing the potential ring-fencing obligations or alternatively as part of assessing waiver applications.

We therefore consider the AER's ring-fencing guideline could be improved by aligning the proposed obligations with the existing NSW ring-fencing guideline. Endeavour Energy has a proven history of compliance with the existing NSW ring-fencing requirements, and positively contributing to developing effective competition in emerging markets such as the Accredited Service Provider (ASP) scheme, technical training and demand management solutions. We consider the implementation of similar arrangements will preserve our ability to continue engaging in contestable activities in a controlled and beneficial manner for both contestable and non-contestable customers.

We would welcome the opportunity to work collaboratively with the AER and other stakeholders in developing the ring-fencing guideline further. Attachment A contains our more detailed response, including examples of our experience in promoting contestable markets and our response to the AER questions.

If you have any queries or wish to discuss this matter further please contact Jon Hocking, Manager of 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

Attachment A: Detailed Response

1. Overview

This section provides an outline of Endeavour Energy's views on ring-fencing, its purpose and objective, and what a guideline should contain.

1.1 What is ring-fencing?

As stated in the AER's position paper, ring-fencing is a form of regulation that financially, operationally and/or physically separates a portion of a company's assets or services. This can be done for asset protection purposes, to reduce the risks of bankruptcy, to improve confidence an information exchange process, or for regulatory purposes. In this instance, ring-fencing refers to the separation of non-contestable and contestable services provided by a regulated entity.

For economic regulatory purposes this separation can broadly be characterised as follows:

- Behavioural requirements: Measures that are designed to ensure a non-contestable business does not preferentially treat its contestable business. It is to provide a level playing field in the contestable market. Examples include access requirements, activity prioritisation and procurement protocols.
- Cost Allocation requirements: Measures that are designed to ensure a non-contestable business does not subsidise the costs of its contestable business. Examples include accounting separation and cost allocation methodologies.
- Information protection requirements: Measures which prevent a non-contestable business from communicating or sharing information with any person in a way that would favour its contestable business over another contestable business. For example, customer notification requirements or development proposals.
- Functional separation requirements: Measures which separate the operation and management of contestable and non-contestable businesses. This may involve separation of offices, information systems, staff or legal separation.

Historically, jurisdictional regulators in the National Electricity Market (NEM) have utilised ring-fencing to enforce separation between vertically integrated businesses (i.e. separating the production, purchasing and selling of energy from the distribution of it) and connections services in NSW. This followed the recommendations of the Hilmer report[1] which drove National Competition Policy reforms in Australia and, inter alia, called for ring-fencing of generation and retail activities from DNSPs. These jurisdictional regulators have employed various ring-fencing arrangements since the early 2000s to varying degrees of success.

1.2 What is the purpose and objective of ring-fencing?

Whilst these arrangements will be subsumed by a nationally consistent set of guidelines, the purpose and objective remain the same. As noted in the position paper, this is *to limit the ability of the regulated entity to confer an unfair advantage to itself or to an affiliate operating in a competitive market*[2]. Additionally, the AER consider the fundamental purpose of ring-fencing is to *assist in the development of competitive markets where competition is feasible*[3]. These are uncontroversial views that we both appreciate and strongly support.

Although we suggest the purpose is edited to instead focus on "*avoiding constraining the development of competitive markets..."* rather than *"assist"*. "Assist" may imply the AER take an active role in promoting or specifying a certain market design. This is a level of involvement beyond the role of the AER, instead the AER should seek to protect against anti-competitive behaviour and allow the market to self-determine and evolve.

[1] Prof F. Hilmer, M. Rayner and G. Taperell*, National Competition Policy Review*, August 1993

[2] AER, *Electricity Ring-Fencing Guideline – Preliminary Positions*, April 2016, p. 10

[3] Ibid, p. 11

In its position paper the AER then assesses the objective of ring-fencing in more detail. In setting an objective for the ring-fencing guideline the AER is fundamentally attempting to answer the following question[4]:

> *What is the potential harm that ring-fencing is intended to address and do the benefits of ring-fencing outweigh the costs of compliance?*

We support this assessment approach and consider answering this question will best promote the NEO to the benefit of customers.

The AER then turns its mind to the approach adopted by jurisdictional regulators currently[5]. Based on this assessment the AER consider that the more detailed objectives of ring-fencing are to[6]:

1. *avoid the anti-competitive effects of cross-subsidies between the contestable and non-contestable activities offered by an NSP that would adversely affect markets for contestable services or the efficient provision of regulated services;*
2. *avoid discriminatory interactions between the contestable and non-contestable services offered by an NSP that would adversely affect markets for contestable services or the efficient provision of regulated services;*
3. *avoid providing a preferred or related party with an unfair advantage in offering contestable service that stem from information acquired in providing a regulated services; and*
4. *in achieving the first three objectives, promote an even playing field that may encourage market entry.*

The AER also consider that achievement of these objectives should be subject to a consideration of the costs and benefits of compliance and ultimately the NEO. We support these objectives; a regulated monopoly should not be able to harm the development and operation of a competitive market. We have, and continue to, support fair competition to ensure markets operate without distortion to the benefit of customers, as evident in the case studies in section 2.2.2. However, we do caution against the use of the fourth objective to attempt to create a predefined competitive market model or address other matters beyond the scope of ring-fencing. This is discussed further in the following section.

1.3 What is outside the scope of ring-fencing?

Whilst we consider the purpose and objective of ring-fencing to be uncontentious there have been several issues and alternative objectives raised by some stakeholders that are neither relevant nor appropriate to consider in developing a ring-fencing guideline. We are concerned that these views will be advanced with considerable weight and force during consultation on this guideline.

It has been suggested that ring-fencing should strictly prohibit regulated businesses from offering contestable services. Some stakeholders suggest that regulated businesses should even be prohibited from providing contestable services even through a separate legal entity or from owning particular types of assets[7]. The AER notes that such objectives would entail structural separation beyond the scope of ring-fencing under the National Electricity Rules (NER) and State Governments would have to enforce this form of separation unless changes were made to the NER by the Council of Australian Government's (COAG) Energy Council.[8]

Setting aside the ability to implement such measures under the NER, we strongly oppose these views as they would detriment the long term interests of customers. In our view, these issues arise from:

- an unproven and ideological fear that the involvement of DNSPs in contestable markets will result in anti-competitive behaviour regardless of any ring-fencing arrangements;

[4] Ibid, p. 14

[5] With the exception of NSW IPART's objectives. Presumably because no objective was specified in IPART's final guideline.

[6] AER, *Electricity Ring-Fencing Guideline – Preliminary Positions*, April 2016, p. 16-17

[7] ECA, *Principles for the Integration of Energy Storage*, November 2015, p 3-4

[8] AER, *Electricity Ring-Fencing Guideline – Preliminary Positions*, April 2016, p. 15

- conflating anti-competitive behaviour with economies of scale and scope and comparative advantages that naturally exist in markets;
- a misapplication of the concept of "crowding out" to suggest that the participation of DNSPs in contestable markets will "*foreclose the market that would otherwise develop*"[9]; and
- opportunistic third parties seeking to reduce competition and establish rent-seeking opportunities.

A ring-fencing guideline should not set out address these concerns as doing so would require the AER to effectively define the competitive market model, indeed there is a long history of the futility of such efforts. Instead, the ring-fencing guideline should seek to enable the market to evolve in response to customer preferences and service model propositions that leverage expertise, whilst avoiding distortionary behaviour such as the use of privileged information obtained through coordinating regulated activities.

The purpose of the regulatory framework is to act as a substitute for the market and create an environment where a regulated entity is subject to the same forces and incentives that it would experience if it were operating in a competitive market. A DNSP should therefore be encouraged and incentivised to explore and take advantage of commercial opportunities as this ultimately benefits customers.

The SAG is an example of this. DNSPs are incentivised to maximise the value of their assets by generating unregulated revenue from the use of regulated assets. This is achieved whilst protecting the interests of regulated customers by providing for a sharing of the revenue generated from the use of the shared assets.

1.3.1 Competitive Advantages

A comparative advantage exists where an entity can produce a good or service at a relatively lower cost (or differentiation) compared to others and therefore produces either a different product, greater volume and/or sets a lower price. Production (and consumption) possibilities are maximised where comparative advantages are realised. One potential source of comparative advantage is economies of scale and scope. Economies of scale are cost advantages created by the increased output of a good (which reduces the average total cost). While economies of scope are associated with producing a complementary variety of goods using a core set of competencies to increase customer choice (also reducing the average total cost).

There are scale and scope economies associated with operating an electricity distribution network that provide DNSPs comparative advantages in other related markets. DNSPs have resources, assets, expertise and knowledge that can increase production in competitive markets if they are fully utilised. For instance, sharing labour that has the skills and capabilities to perform both regulated and unregulated activities drives productivity in each business. It should be noted that such advantages are comparative and not absolute. Other potential competitors have their own distinct advantages. For instance, retailers have advantages in the form of customer information, established customer relationships, sales and marketing capabilities, vertical integration and access to equity investors when compared to DNSPs.

The role of ring-fencing should be to ensure that the leveraging of comparative advantages does not involve an abuse of a DNSPs monopoly position i.e. anti-competitive. This can be achieved without wholly eliminating a DNSPs ability to realise its natural comparative advantages or enter a market. For example, ring-fencing can ensure that any sharing occurs in a transparent, arms-length manner that does not unfairly preclude other providers from participating. There is no reason why DNSPs' field services contractors should not be able to compete for contestable works alongside other contractors provided all bidders have equal access to information and there is no selection bias (i.e. a transparent, robust procurement process exists).

We are therefore concerned by the AER's suggestion that restrictive obligations may be applied and that DNSPs can simply[10]:

[9] ECA, *Principles for the Integration of Energy Storage*, November 2015, p 3
[10] AER, *Electricity Ring-Fencing Guideline – Preliminary Positions*, April 2016, p. 31

> *…reduce the costs it incurs for ring-fencing compliance by not engaging in activities that are subject to ring-fencing obligations. That is, by leaving the provision of the service to other parties.*

This position in many cases may not be in the interests of customers. Excluding DNSPs from realising scale and scope economies by imposing unreasonable ring-fencing obligations would instead be distortionary and detrimental to the market as production capacity and competition would be reduced. Further, regulated customers would also be negatively impacted by such an approach due to the loss of cost or revenue sharing, which is not in accordance with the NEO. This is because more costs would be allocated to a regulated business (thereby increasing prices) if DNSPs are strictly prohibited from contestable markets or effectively restricted through onerous ring-fencing requirements.

This reallocation of costs would be in accordance with the CAM. Corporate service costs and other overheads are largely fixed and would therefore be fully allocated to regulated activities when a DNSP does not participate in contestable markets. An example of this was the introduction of retail contestability in NSW. Exiting the retail market resulted in the reallocation of fixed costs to our distribution activities. The AER approved[11] a pass through amount for EBSS purposes of $47.6m (nominal) for Endeavour Energy recognising the validity of the costs associated (or reallocated) as a result of exiting a contestable market. Restrictive ring-fencing obligations could impose costs of a similar magnitude for each DNSP if DNSPs are required to exit contestable markets.

We consider such an outcome is undesirable for both regulated and contestable customers and unnecessary. A DNSP sharing staff, fleet or corporate services with its contestable business is efficient and practical. It increases capacity and competition in the contestable market whilst reducing the proportion of costs allocated to regulated activities funded by distribution customers. This sharing is only anti-competitive and detrimental where the contestable business has access to sensitive information, the sharing is at subsidised rates or a selection bias exists.

Endeavour Energy is already structured in a manner to enable the efficient deployment of its resources between regulated and contestable activities in a competitively neutral manner. Functions such as asset management and planning are separate to field services contracting and project management. Our field services contracting are already subject to a competitive tender process in awarding work.

Ring-fencing should seek to protect against discriminatory behaviours in a proportionate and effective manner. There is no need to restrict a DNSPs ability to participate or realise competitive advantages which naturally exist within markets to the benefit of customers. Measures such as the CAM, separation of staff and information sharing requirements can adequately protect against anti-competitive behaviour measures by ensuring that costs are appropriately allocated, the flow of information is controlled and any discriminatory behaviour is prohibited.

1.3.2 "Crowding out"

As noted by the AER, several stakeholders have suggested that DNSPs should be prevented from participating in competitive markets, or face stringent ring-fencing obligations which effectively exclude them, to protect against the risk of 'crowding out'.[12]

To prohibit DNSPs from participating in competitive markets, or to significantly reduce their ability to do so through physical separation and non-sharing provisions, is detrimental to the long term interests of customers. If a DNSP is not allowed to compete, or the costs are disproportionately high, then there will be less competition in the unregulated market and therefore higher prices. Further, regulated customers will forego the benefits derived from cost sharing or shared asset revenue opportunities.

The concept of "crowding out" refers to the scenario where government involvement in a market limits the ability of private industry to participate. It typically refers to interest rate adjustments following an increase in government spending (or reduction in revenues) but can also refer to the

[11] AER, Decision: *Endeavour Energy – Application for a retail project event nominated cost pass through*, March 2012

[12] ECA, *Principles for the Integration of Energy Storage*, November 2015, p 3, Origin, Response to Integration of Storage: Regulatory Implications Discussion paper, November 2015, p. 2, PIAC, *PIAC response to AEMC's energy storage discussion paper*, November 2015, p. 3, AER, *Electricity Ring-Fencing Guideline – Preliminary Positions*, April 2016, p. 23

government provision of a service or good that could have otherwise been provided by private industry and therefore subject to the forces of voluntary exchange.

The reference is flawed for a number of reasons. Firstly, several DNSPs are privately owned and no government owned DNSPs are acting on the basis of government policy to acquire assets critical to unregulated markets (such as battery storage technology). Instead, DNSPs are making discretionary planning decisions regarding when, where and how they utilise storage technology subject to the efficiency, innovation and prudency expenditure requirements of the NER and/or Demand Management Innovation Allowance (DMIA) requirements.

Secondly, the occurrence of "crowding out" is dependent on the state of the market in question. Specifically, crowding out is theorised to only impact interest-sensitive spending when an economy is operating at full capacity or employment. The battery storage (or Distributed Energy Resources (DER)) market in Australia (and internationally) is an emerging one. It is highly unlikely that the (voluntary) involvement of DNSPs in this market could restrict the ability of others to enter the market. If a DNSP is a first mover in the Australian market (which is highly questionable) it should not be prevented from enjoying the advantages associated with this as it is not anti-competitive to be a first-mover.

It is more likely that the participation of DNSPs in emerging markets will be beneficial to the development of the DER market. DNSPs can often develop procedures and protocols for the safe and efficient operation of emergent markets, develop expertise both internally and externally through training programs and make necessary changes to the non-contestable business to increase the capacity of the contestable market. Rather than crowding out investment we consider these emergent markets have excess capacity that enables our participation to the benefit of the market. This is referred to as "crowding in"; where excess capacity exists, government spending (or DNSPs collectively in this scenario) can expand the market and act as an accelerator for private investment. This is evident in the case studies contained in section 2.2.2 below.

Thirdly, there is no evidence to suggest that the hypothetical collective and coincidental involvement of DNSPs in a market is analogous with the impacts of government fiscal policies. As aforementioned, the supplier side for emerging markets such as battery storage are strongly developing with major international suppliers such as Tesla, Panasonic, Samsung, LG, Bosch, Sunverge etc. and Australian based suppliers such as Ecoult, ZEN Energy, AllGrid Energy, Redflow etc. DNSPs operate individually, are separate legal entities and operate in disparate geographic locations eliminating the capacity to collude on their involvement in such markets. The bargaining buyer power of each DNSP is most likely limited and not significantly different to the bargaining power of other potential entrants given the supply-side involvement of multinational conglomerates and electronics manufacturers.

1.3.3 Asset Ownership

It has also been suggested that DNSPs should be restricted or prevented from acquiring certain assets such as DER devices[13]. The AER notes that a service based approach is currently enshrined in the NER. That is, the service being provided to the customer is the determinant factor in how the AER regulates an activity. The NER also specifies that only direct control services may be ring-fenced from all other services offered by a DNSP (clause 6.17.2(a)).

Despite the clarity and suitability of the existing NER framework, the AER acknowledges that[14]:

> *…some stakeholders may consider more restrictive arrangements should be placed on use or ownership of certain types of assets. In particular, some may view that NSPs should be restricted from acquiring assets that are key to the development of emerging markets, such as energy storage and other types of distributed energy resources.*

In response to these views the AER outlines three options available to DNSPs for utilising a DER device[15]:

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[13] ERAA, *Submission to the AEMC Integration of Energy Storage: Regulatory Implications Discussion Paper*, November 2015, p. 3, PIAC, *PIAC response to AEMC's energy storage discussion paper*, November 2015, p. 3, ECA, *Principles for the Integration of Energy Storage*, November 2015, p 4

[14] AER, *Electricity Ring-Fencing Guideline – Preliminary Positions*, April 2016, p. 19

[15] Ibid, p. 23-24

1. Acquire a DER device to provide direct control services only;
2. Purchase a DER device through a ring-fenced entity and acquire direct control services; or
3. Purchase direct control services from a DER device owned by a third party.

The AER outlines a preference for options two or three but notes it cannot prohibit DNSPs from any particular option[16]. The AER states the ring-fencing guideline should simply contribute to DNSPs making efficient decisions[17]:

> *The ring-fencing guideline and the incentive mechanisms built into the regulatory framework should work together to ensure that NSPs choose the most efficient option.*

We consider the suggestion that DNSPs be prohibited from owning or using a particular type of asset should be strongly discouraged and refuted as it is contrary to the achievement of the NEO and the sound principle of technology neutrality which underpins the economic regulatory framework as endorsed by the COAG Energy Council[18]. It would be unprecedented and inappropriate for the AER to be required under the NER to directly make asset management decisions on behalf of a DNSP.

As aforementioned, the notion that DNSPs acquiring DER devices (on what is a discretionary and individual basis) will adversely impact the market is unsubstantiated and theoretically unsound. As such, we do not consider ring-fencing has any role in guiding which assets a DNSP acquires in providing direct control services. That is purely a matter for the economic regulatory assessment processes to be determined based on the prudence and efficiency principles enshrined in the NER.

The assessment of network and non-network solutions is firmly guided by the incentive mechanisms and framework contained in Chapter 6 of the NER[19]. It is at the time of a regulatory proposal that a DNSP should be required to demonstrate the efficiency and prudency of its capital and operating plans. Chapter 6 provides the AER with the objectives, criteria and factors to be considered in making its assessment. Given this, the ring-fencing guideline should be designed in a way that does not interfere or overlap with this framework.

We are therefore concerned by statements such as[20]:

> *The clear disadvantage of option 1 is that the NSP would not be able to fully utilise the asset—the asset could not be used to engage in contestable activities. Option 1 is therefore unlikely to maximise the efficient use of DER. Nevertheless, option 1 is a choice that NSPs may still elect. We consider that where an NSP selects option 1, it needs to show this is the most efficient option.*

The capital and operating expenditure objectives, criteria and factors make no mention of promoting contestable markets or maximising value across both contestable and non-contestable activities. The AER's assessment of Option 1 (or any regulated expenditure plan) should be strictly confined to whether the proposed expenditure is the most efficient and prudent means of providing the standard control service. Whether a solution has the potential to also provide value in a contestable market is irrelevant to the AER's assessment of regulated capital and operating expenditure plans and outside of its regulatory scope.

1.3.4 Conclusion

There is obviously no definitive evidence as to what the impact of DNSP involvement will be on each emerging market. It is therefore critical that the guideline is not influenced by ideological arguments or positions that are speculative and selective in nature. The assumption that DNSP involvement in emerging markets is inherently and irrevocably negative is not well-grounded in economic theory or market experience. Instead, it may simply be driven by potential entrants or competitors advancing a position of self-interest in limiting competition and rent-seeking.

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[16] Ibid, p. 24
[17] Ibid
[18] COAG Energy Council, *Fourth COAG Energy Council Meeting - Meeting Communique*, December 2015, p. 2
[19] NER clauses 6.5.6, 6.5.7, 6.5.8 and 6.5.8A
[20] AER, *Electricity Ring-Fencing Guideline – Preliminary Positions*, April 2016, p. 24

We therefore urge the AER to maintain their proposed ring-fencing objectives and to uphold them in assessing the requirements and detail of the guideline despite the pressure to address unrelated concerns and objectives outside of the AER's regulatory scope.

1.4 What is the purpose of an AER ring-fencing 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[21].

This 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. We therefore support the AER's assertion that the guideline *"needs clarity of purpose, predictability, reasoned flexibility and the ability to be monitored and enforced."*[22]

More specifically, the AER suggests the guideline will need to include the following[23]:

a) *The guideline should have an objective that identifies the harm we are seeking to avoid though ring-fencing. The objective is important because it will guide our decisions under the guideline (defining the objectives of ring-fencing).*

b) *We should set out which services need to be ring-fenced in prima facie terms at least (identifying ring-fenced services).*

c) *For those services to be ring-fenced, the guideline will need to set out the ring-fencing obligations (ring-fencing obligations).*

d) *We need to provide guidance on ring-fencing waivers to the extent these are seen as appropriate—that is, the circumstances in which an NSP may be exempted from meeting one or more or all ring-fencing obligations.8 In deciding whether or not to grant a waiver, we will examine the nature of the service, the costs of ring-fencing and the ring-fencing objective (waiver processes).*

and may also include[24]:

e) *Transitional arrangements, if any. For example, how quickly do we expect NSPs to become complaint with the new guideline and how will waivers granted under earlier ring-fencing arrangements ('grandfathering') be treated?*

f) *Processes and administration. What are the reporting and compliance requirements? How does an NSP apply for a ring-fencing waiver and will stakeholders be consulted? How will breaches of the ring-fencing guideline be treated?*

We are supportive of these elements (inclusive of (e) and (f)) and consider the guideline will be valuable to stakeholders if it satisfactorily addresses each point. However, item (b) is not technically aligned with the AER's intended F&A based approach. Item (b) may need to be expanded to; set out the services that need to be ring-fenced or, if this decision is deferred to another mechanism, set out the principles, criteria and assessment framework that will be applied in determining which services need to be ring-fenced.

We consider a listing of services subject to ring-fencing as currently envisaged by (b) is preferable as it is simple and certain for stakeholders to understand. The existing jurisdictional guidelines mostly adopt this approach and list the specific services subject to ring-fencing. For instance, in

[21] AEMC, *National Electricity Amendment (Expanding competition in metering and related services) Rule 2015*, p. xv
[22] AER, *Electricity Ring-Fencing Guideline – Preliminary Positions*, April 2016, p. 12
[23] Ibid.
[24] Ibid.

NSW, specified services are ring-fenced from contestable services. Contestable services are connection services as defined Division 4 of Part 3 of the Electricity Supply Act 1995 (NSW) while specified services referred to what were previously known as 'Monopoly services' that are now a subset of 'Ancillary Network Services'. The Electricity Supply (General) Regulation 2001 (NSW) also included *any service comprising work relating to an extension of a service provider's distribution system or an increase in the capacity of a service provider's distribution system;* however this was removed in the amended Electricity Supply (General) Regulation 2014 (NSW).

In noting this, we appreciate the uncertainty associated with emerging markets and the difficulty this creates in future-proofing the guideline. Whilst the jurisdictional guidelines provided certainty they were not periodically reviewed and now require consolidation to better address emerging markets. We therefore support the AER guideline adopting a more flexible approach.

We consider the guideline would benefit from detailed examples and an outline of how the AER will assess the need for, and apply, ring-fencing obligations, in a principled and proportionate manner (and similarly for the waiver process). These issues are discussed in more detail in the following sections.

2. Developing a ring-fencing guideline that best promotes the NEO

The previous section has sought to define ring-fencing and outline the purpose and objective of ring-fencing and a ring-fencing guideline. The following section outlines how a guideline should be developed to ensure that the purpose and objectives outlined by the AER, and reiterated above, can best be achieved in order to promote the achievement of the NEO.

2.1 Understanding the need for ring-fencing in the Australian electricity industry

As noted in section 1 above, we support the fundamental question the AER is attempting to answer in developing this guideline[25]:

> *What is the potential harm that ring-fencing is intended to address and do the benefits of ring-fencing outweigh the costs of compliance?*

Answering this question necessarily requires an assessment of the Australian electricity industry to understand the potential harm and how best to protect against it. Any regulatory measure, including ring-fencing, should be proportionate to the risk that is being addressed. In this context, a proportionate measure is one that eliminates or sufficiently reduces the probabilistic costs of a market failure in a manner that delivers a net benefit to customers in the long term.

A ring-fencing guideline that is poorly specified and targeted will either fail to protect against the potential harm or result in further harm by distorting and disrupting competitive markets. There is a significant risk of this occurring without a proper assessment of what form and level of ring-fencing is required. However, in saying this we accept that perfect information is not available and it would be unreasonable to expect the AER to:

- identify all potential markets and emergent markets that DNSPs may participate in;
- accurately forecast the likelihood that DNSPs may abuse their monopoly power in these contestable markets;
- quantify the impact and costs of any potential abuse; and
- quantify the costs of ring-fencing on both DNSPs (in complying with) and the AER (in monitoring and enforcing) the guideline.

Where this information cannot be reasonably estimated a balanced, detailed and thoughtful qualitative consideration of these issues should instead occur.

2.1.1 Potential markets and costs anti-competitive behaviour

There is an array of contestable markets DNSPs could participate in. These include (this is not an exhaustive listing): generation, retailing, solar plus battery storage installation, maintenance and/or management, metering provision, metering data provision or metering co-ordinator services,

[25] AER, *Electricity Ring-Fencing Guideline – Preliminary Positions*, April 2016, p. 14

embedded network ownership or management, micro-grid or off-grid services, demand aggregation services, connection services, existing and/or emergent ancillary network services that become contestable in the future etc.

Many stakeholders have outlined a strong view that DNSPs will abuse their monopoly power by unfairly leveraging their non-contestable business in a contestable market. While we consider these fears to be unfounded and hypothetical in light of the existing regulatory framework, we accept that a monopoly provider has an incentive to do so in the absence of regulation.

The AEMC have previously noted the types of behaviours that should be ring-fenced against. These are[26]:

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

Whilst it would be naïve to ignore the incentives a monopoly faces it would also be unreasonable to simply assume or postulate that a DNSP is likely to act in an anti-competitive manner without any meaningful evidence or consideration of the broader countervailing commercial implications of acting in such a manner.

As noted above, it is difficult to assess the likelihood of DNSPs both participating and acting inappropriately in each potential contestable market. In light of this, the AER should consider:

- obtaining an independent review of the potential contestable markets DNSPs could adversely impact and the likelihood of this; and/or
- the past behaviour of DNSPs in contestable markets and their compliance with jurisdictional ring-fencing guidelines.

A review may be valuable but could be a largely academic exercise; instead we consider the best indicator available is the past actions of DNSPs in contestable markets. The following section outlines the history of ring-fencing in NSW and Endeavour Energy's pro-competition record.

2.2 Understanding the impact of jurisdictional guidelines

In determining what ring-fencing measures to apply the AER has sought to understand the approach to date of jurisdictional regulators. We support an examination of tried and tested methods to understand where improvements could be made and what measures have been effective.

Whilst we are not in a position to comment on the experience of other DNSPs or jurisdictions we can provide details of the NSW ring-fencing guideline.

2.2.1 IPART Ring-fencing guideline in NSW

In 2003 IPART published distribution ring fencing guidelines as required under clause 6.20 of the National Electricity Code (NEC). Our distribution licence conditions mandate compliance with the IPART guideline, and consequently IPART monitors Endeavour Energy's compliance with this guideline as part of our licence compliance reporting.

In NSW, contestable services are subject to the ring-fencing guideline. Contestable services are defined in the Electricity Supply (General) Regulation 2014 (NSW) as any service provided for the purpose of complying with Division 4 of Part 3 of the Act. Where Division 4 of Part 3 of the Electricity Supply Act 1995 (NSW) refer to customer connection services. The NEC dealt with the separation of retail and distribution functions separately.

[26] AEMC, *National Electricity Amendment (Expanding competition in metering and related services) Rule 2015*, p. 399

The guideline comprises of the following ring fencing requirements:

- Accounting separation: costs must be fully allocated to either regulated distribution services or contestable services on a causation basis
- Access requirements: a DNSP must provide distribution services to an ASP on terms that are no less favourable than to terms on which it provides those services to the part of its business which provides contestable services. Nor must it treat a customer more or less favourably because it has or has not engaged the DNSP to provide the contestable service
- Communication requirements: in providing distribution services a DNSP must not communicate with any person in a way that would favour its contestable business over an independent ASP. A DNSP must also notify customers that they have a choice for the provision of contestable services and ensure staff are properly trained to comply with this requirement.
- Functional separation: A DNSP must ensure offices from which it provides contestable services are separate to offices where specified services (i.e. DNSPs services that facilitate contestable services) area provided, as well as information and staff separation.

Endeavour Energy has obtained a waiver from adhering to these obligations for specific geographic areas within our franchise where a customer is unable to have an ASP provide connection services.

2.2.2 Endeavour Energy's contribution to competitive markets

These measures were designed to promote contestability in connection services through the ASP scheme. We consider a competitive market has been successfully developed in our network area as customers have a choice of approximately 600 ASPs to obtain connection services from.

Endeavour Energy has pioneered and facilitated the development of this contestable market in a number of ways as detailed in Case Study 1 below.

Case Study 1: ASP Scheme

Endeavour Energy played a significant role in the initiation and development of what is currently known as the ASP/contestable works scheme.

The initiation of this scheme came well before the NSW Government's involvement and establishment of the scheme in 2003. In the early 1990's Endeavour Energy (or at that time the Illawarra and Prospect County Council's) undertook connection works. Connection works included individual customer, subdivision, industrial and commercial connections and extensions of the network in rural areas. The distributor undertook this work and the connecting customer reimbursed the distributor through a contribution scheme.

Land developers were looking for an alternative process with greater transparency. Identifying this need, Prospect County Council commenced approving a number of external contractors that could be engaged directly by these developers to undertake the works. This practice grew over the years and eventually management of the scheme was passed over to the State Government progressively over a number of years commencing in the late 1990s.

The progressive handover meant that systems could be developed by the Government to accredit individuals and companies as well as establish an appropriate compliance process. Prior to this, these activities were all undertaken by the distributors.

This handover coincided with a period during which the industry was experiencing a downturn in regulatory funding and investment. Distributers were offering redundancies to many staff, including those who undertook connection works. Many of these staff left distributors and using their skills and training, established ASP companies. Some of the most successful ASP companies started

during this period and used redundancy payments as working capital to establish their businesses.

This transfer of staff essentially, also benefitted distributors and customers by ensuring the quality of workmanship from ASPs was maintained during the transition period. The distributors were the primary source of training for many years before courses became available from external providers to train ASPs.

Until that time, the market was small and developers and customers were reliant on distributors undertaking the majority of the work while the contestable market grew. Whilst the market was small, customers still benefited as the introduction of competition meant that distributors responded to the pressures of competition from both a timeliness and cost perspective.

For several years, until the mid-2000s, the market developed to a state that distributors were able to commence exiting the market. This coincided with an increase in internally funded capital works allowing the distributors to transition staff to these other activities.

Distributors benefited from the fully contestable ASP market and became a customer of it by engaging some companies to also provide contracting services for internally funded capital works.

In summary, the development of what is now a large contestable market in NSW (approx. $100M p.a) required over 10 years of support from the distributors to create, nurture and develop to become a viable stand-alone market.

It is quite evident from Case Study 1 that Endeavour Energy made a significant contribution to establishing a contestable market, developing it and then exiting it once a sufficient level of competition and market capability existed, all to the benefit of customers.

Technical training is another example of where distributors have helped create and establish a market. As above, the ability of distributors to provide both contestable and non-contestable services benefited customers. This is explained in Case Study 2 below.

Case Study 2: Technical Training

Approximately, 10 years ago all annual statutory training for workers (irrespective of whether they were employees, contractors or ASPs) had to be provided by the “host” distributor. Whilst the distributors had an established, monopoly position in provided these services they recognised that this was not the preferred service provider model for customers.

The industry therefore developed course material which has now been nationally recognised, and can instead by provided by Registered Training Organisations (RTOs) that are accredited to provide these specific courses.

This process took a number of years, however there are now 10 RTOs accredited to provide these services within the Endeavour Energy network area alone.

Endeavour Energy has also participated in and helped develop the demand management market over a number of years. This market represents an alternative to network-based investment that DNSPs are theorised to favour[27].

Our pro-competitive involvement is detailed in Case Study 3 below, noting it focusses on our voluntary actions rather than those simply required by the NER (such as the DAPR and RIT-D).

[27] The Averch-Johnson effect suggests that regulated companies tend to engage in excessive amounts of capital accumulation to increase profits under a rate-of-return based regulatory regime.

Case Study 3: Demand Management

Endeavour Energy has implemented many demand management (DM) programs since 1998 ranging from fuel substitution, industrial/commercial area programs, aggregated demand response programs, embedded generation, residential air conditioning cycling programs and residential voluntary load curtailment programs. Much experience has been gained which includes an understanding of customer behaviour and acceptance.

In the early days of implementing DM programs there were no established DM services providers, regulatory requirements or market to facilitate DM services. The term 'aggregators' for demand reduction services was unknown, nor was it acknowledged as a service for customers and the electricity distribution industry.

Regardless, Endeavour Energy understood what was required and actively approached the market place and engaged with energy consultants and energy service providers to explain the objectives of the network business to focus on peak demand and the type of service required. This assisted the market development and successive tenders for DM services resulted in an increase in submissions. In this way, and by being involved in the market and the provision of the service, Endeavour Energy assisted market growth.

Endeavour Energy was the first NSP in Australia to develop a residential air conditioning cycling program, even prior to the development of the AS4755-Demand Response Enabling Devise for Air Conditioners. We were also the first to develop a voluntary load curtailment program for the residential sector. At the time, there were no third party service providers to assist in the development of these programs. Endeavour developed the concept and approached the market and customers with an offer and a process to curtail load and trialled the concept. The learnings and information obtained from the trials were shared within the market place to enable other providers to participate and provide services. We consider we have contributed to the current environment of emerging business models where companies offer an aggregated load curtailment service.

This development work in the DM service market has resulted in customers being more willing to accept load curtailment and other DM initiatives as a viable alternative to traditional network infrastructure development. Once the customer understands the concept and the potential benefits gained from reducing demand there is a greater willingness to participate and be involved in this market. From the beginning, companies saw the opportunities in a development market and were willing to participate. Without Endeavour Energy's involvement we consider the market place would not be in the advanced state it is in today.

A more contemporary example of an emergent market is DER devices like battery storage. As aforementioned, some stakeholders have suggested the DER market cannot develop with the involvement of DNSPs.

We consider the opposite is true; that DNSP involvement will play a significant and positive role in developing the market.

Similar to demand management and the other examples above, Endeavour Energy is taking steps to help develop and expand this market in the interests of customers rather than abuse its monopoly position. Case Study 4 provides further detail below.

Case Study 4: Battery Storage

The current market for demand management services with energy storage is in very early stages of development. Studies suggest this market may take several years to fully develop and be widely viable for residential households.[28] Endeavour Energy is already seeking to; understand the impacts and potential uses of energy storage, develop a safe framework for the roll-out and operation of DER technologies and promote growth in the potential market.

Specifically, Endeavour Energy has been involved in Australian Standards development of AS/NZS 4755 – Demand response capabilities and supporting technologies for electrical products Part 3.5 – Interaction of demand response enabling devices and electrical productions – Operational instructions and connections for grid-connected Electrical Energy Storage Systems.

We consider the standardisation of technical requirements will benefit both DNSPs and customers as it: 1) has the potential to result in more streamlined connections of battery storage devices, as DNSPs will have confidence that the integration of the device on its network will not result in adverse safety and reliability impacts; and 2) provides opportunities for customers to more effectively manage their energy usage and reduce their network bill. This means that in addition to the safety and reliability matters the standard now provides standard control functionality that is mostly optional in nature and not limited to use by networks.

In addition to this, Endeavour Energy is currently planning a residential energy storage trial for demand management purposes and to understand how energy storage can be beneficial to the network and to customers.

Under the trial, customers will be incentivised to install energy storage in a future constraint area of the network. This will assist Endeavour Energy to address supply issues and help reduce the costs that would otherwise be incurred to increase capacity in the affected areas to the benefit of all network customers. Endeavour Energy is not seeking to monopolise the ownership, control and use of energy storage devices in this trial. Instead, Endeavour Energy will procure services from:

- a third party external energy storage device supplier;
- a third party external energy storage device installer; and
- a third party external aggregator to deliver the project.

The energy storage system will therefore be owned by the customer. Endeavour Energy will simply subsidise this purchase in recognition of the network support service that will be provided on a few peak demand days of the year managed by the external aggregator. The customer will be able to utilise the battery for their own purposes at all other times.

This trial is not being used as an opportunity to monopolise the DER market. Rather, Endeavour Energy is only procuring network support services (via a contribution to the battery purchase) from the customer by engaging third party service providers whilst seeking to give customers ownership and control of their device. Endeavour Energy is essentially following the principles of the existing ring-fencing guideline on its own volition to develop the capabilities of the market and increase customer ownership of energy storage devices.

The examples above demonstrate Endeavour Energy's responsible and positive contribution to the development of several contestable and emergent markets. The following section discusses that

[28] CSIRO, *Change and Choice: The Future Grid Forum's analysis of Australia's potential electricity pathways to 2050*, December 2013

where ring-fencing obligations have existed (i.e. the ASP scheme for contestable works), Endeavour Energy has complied with these obligations.

2.2.3 Endeavour Energy's compliance

Some stakeholders are uncomfortable with the risk that ring-fencing measures will not be complied with or that they will not be reliably enforced. They consider prohibition would be a simpler and safer alternative. Endeavour Energy's compliance with the IPART ring-fencing guideline (enforced through our licence conditions) provides evidence of the efficacy of ring-fencing.

Endeavour Energy has never breached the guideline since its publication in 2003. This is not through a lax monitoring and enforcement regime. Endeavour Energy is required to monitor and report on its compliance as part of our licence conditions. In addition to this, IPART may also audit or investigate our compliance in response to allegations or as it sees fit.[29]

Endeavour Energy has taken a number of steps to be compliant with the guideline, these include:

- Organisational separation: the group that provides contestable services (noting that we do very little contestable works now that the market has matured) is separated at General Manager (GM) level from the group that facilitates contestable works. That is, Network Connections report to the GM Asset Management where the regionals staff who undertake contestable works answer to the GM Network Services. This is consistent with the traditional asset manager / service provider model.
- Financial separation: by using separate accounting codes to capture all income and costs associated with providing contestable services. These are reported using traditional Profit and Loss accounting. Costs incurred include recovery of overheads and appropriate margin that is akin to profit.
- Information separation: by using an IT data base system to capture all confidential information associated with contestable works. This has highly restricted access and is only available to those that facilitate contestable works. This means that sensitive and/or commercial information is not available to those that may undertake contestable works.
- Equal access to systems and data: by establishing web portals into Endeavour Energy systems such as standards and Geospatial Information System (GIS), that enable ASPs to have equivalent access to systems and data to the internal staff undertaking contestable works

2.3 Understanding the existing regulatory framework

In developing ring-fencing measures an assessment of the existing regulatory framework is also required. This is to ensure any ring-fencing obligations are complementary and not duplicative. There are several relevant aspects of the NER which already protect against anti-competitive behaviour and/or promote competition that should be considered. Specifically:

Connection requirements: Chapter 5 and 5A of the NER set out connection requirements and obligations on both applicants and networks. The AER must approve DNSPs' connection policies, standing offers and agreements. This ensures that DNSPs provide fair and equal access to customers and do not impose discriminatory connection requirements.

Accounting separation: a common ring-fencing obligation is separate accounting to eliminate the risk of cross-subsidisation between contestable and non-contestable activities. The regulatory framework already contains this measure through the CAM (Part F cl 6.15 of the NER). The CAM principles require that costs can only be allocated to direct control services that are directly attributable or on a causal basis or well accepted cost allocation method.

DNSPs proposed and reported direct control service expenditure must be prepared in accordance with the AER approved CAM. This means that DNSPs are already prohibited from allocating contestable business costs to non-contestable activities. DNSPs compliance with the CAM is independently audited each year through the Regulatory Information Notice (RIN) reporting process.

[29] There has been only one investigation since 2003 in response to allegations of breaches in August and September 2015. IPART's investigation found no breach of the guideline.

Additionally, as discussed in section 1.3.1 the costs allocated to regulated activities would increase where a DNSP ceases its unregulated activities. This is an important cost and consideration when assessing the impacts of potential ring-fencing obligations or waiver applications. Regulated customers currently benefit from the sharing of corporate services and other costs between activities in accordance with the CAM.

Profit sharing: The SAG provides an additional layer of protection to the CAM. The CAM is concerned with the initial allocation of costs; however the use of assets can change over time. If a regulated asset is funded by distribution service customers, where that asset is subsequently used to also generate a material amount of unregulated revenue the SAG compensates distribution service customers for this use.

It is essentially a rental payment by a DNSP that provides an incentive to explore commercial opportunities where it is efficient to do so. The SAG, like the CAM, protects against a DNSP subsidising its contestable activities with its non-contestable business.

It is therefore unclear why the ring-fencing guideline would need to restrict asset sharing when the CAM and the SAG appropriately address the allocation of costs and sharing of profits in such a scenario. The AER states[30]:

> *The AER's Shared Asset Guideline, which applies when unregulated revenues are earned from use of regulated assets, could also be restricted. Functional separation could restrict this type of sharing. It might be desirable to contemplate more restrictive ring-fencing obligations that would prevent asset sharing. This might appeal to stakeholders that are concerned about the enforceability and effectiveness of ring-fencing obligations.*

Such an approach would be inconsistent with the existing NER provisions. In particular, shared asset principle clause 6.4.4(c)(1) which states:

> *the Distribution Network Service Provider should be encouraged to use assets that provide standard control services for the provision of other kinds of services where that use is efficient and does not materially prejudice the provision of those services;*

It seems unnecessary to restrict this sharing and remove incentives for a DNSP to investigate commercial opportunities where regulatory measures are in place to ensure customers benefit from this form of sharing. As discussed in section 2.2 above, Endeavour Energy's contribution to competitive markets in NSW has been positive and we have complied with our obligations.

A more restrictive approach would be unnecessarily harsh and eliminate a DNSPs scale and scope economies to the detriment of competition in non-regulated markets (and therefore customers). This includes regulated customers as additional costs would be allocated to the distribution business (increasing prices) in accordance with the CAM and there would be no potential sharing of revenue under the SAG.

We reiterate our position that the regulatory framework should be technologically neutral and incentive based. Any ring-fencing guideline should support this framework rather than restrict DNSPs and seek to eliminate the variability in comparative advantages between participants that naturally exist within markets.

Information requirements: the Distribution Annual Planning Report, zone substation information publication and customer access to metering data requirements are measures which require DNSPs to provide information about network load profiles, constraints and opportunities for non-network solutions. This seeks to ensure that third parties have equal access to information and to promote the development of the market for demand management technologies.

The RIT-D complements these measures by requiring that DNSPs publish proposed network solutions and provide third parties with an opportunity to propose alternative solutions. This is a transparent process that involves screening for non-network options, publishing a non-network options report, a draft project assessment report and a final project assessment report whilst also providing a dispute resolution mechanism.

[30] AER, *Electricity Ring-Fencing Guideline – Preliminary Positions*, April 2016, p. 28

We consider these mechanisms provide information and access that facilitates the development of emerging markets thereby addressing the "information sharing" issue raised in section 6.2 of the AER's paper.

Demand management: in addition to the above information requirements, there are other measures which promote technological innovation and in turn the capacity of emergent markets. The Demand Management Incentive Scheme (DMIS) and DMIA incentivise DNSPs to implement and investigate non-network solutions. DNSPs are also required to demonstrate to the AER that demand management and non-network options have been duly considered as part of their proposed capital and operating plans.

Metering competition: Changes to Chapter 7 of the NER to facilitate a competitive roll-out of enabling technology which will promote growth in competitive markets. Under these changes, all forms of metering (excluding unmetered Type 7) are open to competition. DNSPs will be designated as interim metering co-ordinators (MC) and provide regulated metering services during the transition process (from Types 5 and 6 metering to Type 1-4). DNSPs are prevented from acting as a metering provider, metering data provider or MC unless this is via a separate legal entity. Further, the updated Chapter 7 provides for a clearer delineation between a customer's metering and a DNSP's connection point.

In addition to the regulatory framework, DNSPs are also required to comply with the several pieces of legislation including the Competition and Consumer Act and Electricity Supply Act that protect against anti-competitive behaviours.

It is clear that there are already a number of regulatory and legislative requirements that protect consumers against anti-competitive practices. As there are several layers of safeguards it is unnecessary for the ring-fencing guideline to impose stringent obligations. Instead, it should impose measures which are in-line with the existing suite of protections and simply seek to reinforce and complement them.

3. Assessing the AER's preliminary position

The previous sections we have defined ring-fencing and outlined the purpose and objective of ring-fencing and a guideline. We have also sought to understand the scale of the potential harm to be addressed, the effectiveness of the NSW ring-fencing guideline and the protection provided by the existing regulatory framework.

This section seeks to assess the AER's preliminary proposed approach to ring-fencing. Overall, we support several aspects of the AER's preliminary position paper which seeks to implement a straightforward approach to ring-fencing. However, we also consider there are aspects of the position paper which could be improved to ensure that any ring-fencing is both targeted and proportionate to the potential harm being protected against.

3.1 Endeavour Energy's views on AER's proposed approach

The AER's ring-fencing objectives and guideline purpose have been discussed in previous sections. We broadly support the AER's understanding of ring-fencing and their objective and intent in administering a ring-fencing guideline. The following sections examine the AER's intended approach to ring-fencing, which is broadly as follows:

- **Service based:** The decision to ring-fence services will be based on the service provided (rather than the assets used to provide the service);
- **F&A process:** This decision will be made as part of the F&A process;
- **'All in'**: The default position is that ring-fencing is beneficial to consumers and the development of contestable markets. The onus is on DNSPs to demonstrate where the costs exceed these assumed benefits;
- **Queensland Competition Authority (QCA) obligations:** The ring-fencing obligations will be based on the existing QCA ring-fencing obligations;

- **Waiver process:** Waivers will be granted based on a number of factors. A 'fast-track' and 'bulk' waiver application and decision processes will also be established to reduce the administrative burden.
- **Transition:** The guideline will provide for a transition from the existing jurisdictional guidelines and accommodate any existing waivers and exemptions (with limitation potentially).
- **Reporting, compliance and enforcement:** DNSPs will be obliged to report on their compliance and obtain an independent audit of their compliance.

Our views on these matters are provided below along with suggested improvements or points of clarification.

3.1.1 Service based and F&A Approach

The AER is clear that the existing regulatory framework requires the AER to classify and regulate on a service basis rather than asset basis. We support a technologically neutral approach to regulation as it allows DNSPs to assess and utilise the most efficient options available without limitation.

As noted by the AER, the decision on whether to ring-fence a service can be made in a number of ways:

1. Defining a precise list of service (most likely within the guideline);
2. Providing a general definition of services to be ring-fenced; or
3. Periodically reviewing the services offered by each DNSP and making a ring-fencing decision at that time (as part of the F&A process).

Whilst a guideline would ideally provide certainty (through a full listing) we appreciate that this may not cater for rapidly emerging markets and industry developments. The waning relevance of the existing jurisdictional guidelines supports the view that a more flexible approach is required which involves a periodic review of services.

Therefore, the AER considers the third option is the most appropriate. This is because the decision to ring-fence is related to the decision of which services to regulate and the form of regulation. We agree with the AER and consider the F&A process is a natural fit that does not require any new regulatory decision making process (which would be costly).

We do note that a rule change made be required to give effect to this approach, specifically to clause 6.8.1 of the NER. The guideline (or the F&A) may also need amendment to cater for services which emerge during a regulatory control period. Currently, such a service is by default unclassified, and therefore unregulated, until the AER has an opportunity to classify the service. Default ring-fencing arrangements may need to be specified in the guideline or the F&A for such services (although we consider the risks and likelihood of this are low). Alternatively, a re-opener trigger may need to be included to deal with material changes as noted by the AER in section 6.2 of the preliminary positions paper.

3.1.2 'All-in' Assumption

The AER identified that a key consideration in developing the guideline would be whether the benefits of ring-fencing outweigh the costs of compliance. This would typically involve a detailed cost-benefit assessment of ring-fencing on a service by service basis. Instead, the AER has adopted a more straight-forward position that ring-fencing is by default beneficial to customers and the development of markets. Further, DNSPs are the best placed party to provide evidence to the contrary should they seek to obtain a waiver.

We understand the pragmatism and simplicity of such an approach. It would be a difficult and costly exercise to quantify the costs and benefits of ring-fencing. However, this approach is not proportionate resulting in an increased risk of inefficient outcomes where circumstances warrant a more nuanced approach.

More importantly, this approach may not be in accordance with clause 6.17.2 of the NER. As aforementioned, this clause specifies that it is the *regulated services* of the business that can be

separated from the provision of other unregulated activities. Under clause 6.17.2 the AER has the ability to ring-fence regulated activities from all other activities that a business may wish to undertake, or adopt other measures such as voluntary undertakings, commitments to equivalence or non-discrimination. The proposed guideline appears to reverse this and seeks to ring-fence out each individual contestable service a DNSP may provide. The AER may wish to review this approach to ensure that the obligations comply with the measures available to the AER under the NER.

Overall, our support of this approach is dependent on the ring-fencing obligations and the waiver process. Our preferred model would be to rely on the existing measures in the NER, such as the CAM, for all services and then apply additional obligations on a case by case basis where a real market risk or potential for harm has been identified. However, an 'all-in' approach can suffice where the ring-fencing obligations are measured and restrained. Further, the risks of an 'all-in' approach could also be well-managed by the availability of an efficient waiver process. At this stage, we do not support the 'all-in' approach as we consider the proposed QCA-based ring-fencing obligations are excessive. We would otherwise accept this assumption.

3.1.3 Proposed QCA Obligations

Whilst initially referred to as an example, it appears the AER intend to adopt the QCA ring-fencing obligations. The proposed obligations are[31]:

> *A DNSP providing direct control services must:*
>
> > *(a) not carry on a ring-fenced service unless it is within a separate legal entity to the DNSP,*
> >
> > *(b) not locate a ring-fenced service at the same physical location as the DNSP*
> >
> > *(c) not share staff between the ring-fenced entity and the DNSP*
> >
> > *(d) establish and maintain separate accounts that clearly identify the extent and nature of transactions between the NSP and ring-fenced entity(s)*
> >
> > *(e) ensure there is no cross subsidy between the ring-fenced entity and the DNSP*
> >
> > *(f) protect information provided by a customer or prospective customer and ensure its use is only for the purpose for which that information was provided*
> >
> > *(g) ensure that information provided to a ring-fenced entity is also available to third parties an equal basis*
> >
> > *(h) ensure information obtained by the DNSP is not disclosed to any party without the informed approval of the customer or prospective customer to whom it pertains*
>
> *Exemptions to these obligations could be offered in certain in circumstances. For example, if:*
>
> > *(a) the DNSP shares an employee, consultant, independent contractor or agent with an Associate that takes part in a related business; or*
> >
> > *(b) confidential or commercially-sensitive information obtained by the DNSP is disclosed to its employees, consultants, independent contractors or agents or to any employee, consultant, independent contractor or agent of an Associate;*
>
> *is consistent with protocols prepared by the DNSP and approved by the AER.*

We fully support obligations (d) through (h) and consider they are consistent with the ring-fencing objective.

We do not support the universal application of obligations (a) through (c), which are more onerous measures.

Obligation (a) requires that all unregulated activities be provided through a separate legal entity. As noted by the AER, *many of the services currently offered without waivers will need to be relocated*

[31] AER, *Electricity Ring-Fencing Guideline – Preliminary Positions*, April 2016, p. 26-27

under a separate legal entity[32]. This demonstrates that this obligation would go beyond what the majority of jurisdictional guidelines currently impose. It is not clear why such a move is necessary or justified.

We accept that in certain circumstances legal separation will be the most cost-effective form of ring-fencing. However, it is unnecessary in many instances and it would result in additional costs. The costs to initially restructure a DNSPs' activities would be passed through to direct control customers as it involves complying with a regulatory change. The costs of ring-fencing on an ongoing basis would also be borne by regulated customers as ring-fencing applies to direct control services.

Ring-fencing may also have cost impacts on contestable activities as these businesses may no longer have access to economies of scale and scope that they currently (and justifiably) do. If these costs (or ring-fencing restrictions) result in DNSPs' exiting contestable markets then both contestable and non-contestable customers would be negatively impacted. Contestable customers would have access to fewer suppliers and therefore face increased prices. Non-contestable customers would also face increased prices (all else being equal) as additional fixed costs would be wholly allocated to the non-contestable business in accordance with the CAM.

This obligation is intended to address a few specific markets of concern. However, its universal application would have unintended an inefficient outcomes. Endeavour Energy would have to establish a separate legal entity to provide the following services, which in our opinion would serve no purpose or benefit customers:

- Undertake customer funded service connections.
- Undertake customer funded design works.
- Undertake customer funded asset construction works including asset relocation.
- Provide security lighting using street light infrastructure (i.e. Nightwatch).
- Undertake modification works to our assets to enable third parties to utilise our assets (such as NBN).
- Install telecommunications cables for third parties on our assets.
- Undertake specialist consulting services for customers who own private electricity networks (e.g. assist with system protection studies with major industrial customers).

Obligation (b) requires that any unregulated business be located at a different physical location. We would not support this obligation in any circumstance. Under the NSW ring-fencing guideline we must separate staff that provide contestable services and those that provide specified services (i.e. we must keep region staff who provide contestable services separate from network connections who facilitate contestable works). This can quite easily and effectively be achieved at the same location. This kind of separation is commonplace in many industries and offices. Much more important is that demonstrated protections are put in place to ensure privileged information required by the regulated business is not shared with the unregulated business through influence or unauthorised access.

It is entirely unreasonable and unnecessary to mandate that the separation be in the form of establishing offices in new and different locations. There are simpler and more cost-effective ways of achieving what is a reasonable objective. For instance, the NSW ring-fencing guideline outline a number of ways the requirement of "physical separation" could be satisfied[33]:

> *For the purpose of clause 5.2.1 the first offices and second offices will be regarded as separate only if:*
>
> > *(a) the first offices and the second offices are in different buildings; or*
> >
> > *(b) the first offices and the second offices are on different floors of the same building; or*

[32] Ibid, p. 32

[33] IPART of NSW, Distribution Ring Fencing Guidelines, February 2003, p. iii

(c) the first offices and the second offices are protected by a security system that prohibits occupants of the first offices from accessing the second offices and vice versa; or

(d) the Tribunal under Part 6 of these Guidelines has approved other measures to separate the first offices from the second offices.

As such, we ask that the AER clarify that (b) can be complied with as per the existing NSW arrangements. If this is not the case, we ask that (b) be amended to reflect the above.

Obligation (c) prevents the sharing of staff between the ring-fenced entity and the DNSP. We do not support this obligation because it is disproportionate to the underlying issue. It is important to ensure that DNSPs do not cross-subsidise their contestable activities by providing under-costed labour. This is already protected against by obligation (e). If a specific obligation is required it should simply seek to ensure that any sharing is fully costed and negotiated and transacted at arm's length with equal access provided to external parties.

As discussed in section 1.3.1 labour should be fully utilised and productive where the opportunity exists. A DNSPs staff has expertise and knowledge that can be used to provide both competitive and non-competitive services. This is a comparative advantage DNSPs enjoy which should not be negated by a ring-fencing guideline. It is not anti-competitive to make use of available scale economies provided it is not done in a subsidised manner or the shared staff have accessed to privileged information. The ring-fencing guideline should not prohibit this sharing when it can quite easily be done in a competitively neutral manner. Section 1.3.1 outlines the adverse impacts of restricting any sharing on both contestable and non-contestable customers.

Our understanding is that exemptions (a) and (b) may be designed to readily bypass this obligation, which may resolve the issue. However, it may be more efficient to simply publish the protocols that should be followed in sharing staff in the guideline rather than prohibit it unnecessarily and require DNSPs to seek an exemption. For instance, a protocol could be established to exclude the sharing of staff that have a role in facilitating competitive activities due to the information advantage they would possess whereas the participation of field staff in performing work is adequately addressed by the CAM.

Overall, the key is to implement proportionate and effective measures. Where a more generalised, simplified approach is adopted it is critical that the measures are more restrained. If "once-size-fits-all" measures are tailored to address worse case scenarios then they will be distortionary and costly in all other scenarios. Instead of providing exemptions to obligations (a) through (c), as it appears the AER proposes, it might be more appropriate to rely on the existing regulatory measures for all services and then identify the markets where a real risk for harm exist, to which obligations (a) and (c) would ***apply***.

3.1.4 Waiver Process

We are supportive of a waiver mechanism being available to DNSPs and the factors the AER intends to consider in granting waivers. Although, a 'provider of last resort' style factor may also be appropriate to include. The AEMC considerations are also useful but may be difficult to assess in some circumstances.

The AER also states that[34]:

Fast track waiver applications would be acceptable where use of a service was not material and/or the prospects for competition were minimal. In these cases, a waiver may be granted by the AER based on an exchange of letters that would be published.

And[35]

Second, we would undertake a bulk waiver application and decision process as part of the guideline development process. NSPs would identify each non-standard control service they consider should be exempt from ring-fencing. The AER would determine whether or not to provide waivers for all NSPs simultaneously.

[34] Ibid, p.31
[35] Ibid

We fully support both of these options and consider they will help reduce the administrative burden of ring-fencing and protect against the risks of the 'all-in' approach. Whilst the AER has outlined the factors it will consider, it would be beneficial for the guideline to include additional detail about how the respective waiver processes will operate.

We would prefer that the guideline itself provide a list of excluded services, but we accept that a bulk waiver process provides additional flexibility and ultimately achieves the same purpose.

We support a precedent style system to reduce costs by avoiding the need to process waivers for the same service (or highly similar services) on multiple occasions. It is also important that the process is not abused by third parties to frustrate DNSPs' unregulated activities. Objections (particularly to a fast track process) should strictly be confined to providing an evidentiary counterpoint in reference to the AER's assessment factors.

We also consider that R&D activities should be automatically granted waivers. A clear set of criteria and requirements exist under the DMIA for allowable research trials and projects. If a DNSP can satisfy the DMIA requirements there is no need to impose an additional regulatory hurdle that may not be aligned to the DMIA. It is important that DNSPs investigate and understand the impacts of emergent activities and are incentivised to adopt innovative solutions rather than restricted.

3.1.5 Transition

The AER recognise that DNSPs should be provided time to transition to the new guideline for several reasons[36]. We support the AER's rationale and consider it good practice to provide a transition.

It is concerning however that the AER consider many services currently offered by DNSPs will need to be relocated under a separate legal entity. As aforementioned, whilst we support a nationally consistent guideline we do not see any reason for that guideline to be any more restrictive or onerous than existing guidelines.

If more proportionate ring-fencing obligations are developed, particularly addressing our concerns outlined above regarding (a) through (c), we consider less transition time will be required. Based on the proposed obligations a 12 month period, following any bulk waiver assessment process, seems reasonable. This could be shortened if the obligations are more reflective of the current jurisdictional guidelines.

We also support grandfathering existing waivers rather than conducting a re-assessment, this will avoid unnecessary costs. We consider existing waivers should be grandfathered and re-assessed at the time of the next F&A for each DNSP.

3.1.6 Reporting, compliance and enforcement

The AER's proposed compliance regime places the onus on DNSPs to demonstrate their compliance. This mirrors the self-reporting approach of existing jurisdictional regulators to monitoring compliance. We support this approach.

The AER outlines a number of potential reporting items which are to be independently audited. We support these items and consider they be added to existing reporting mechanisms such as the Annual RIN, to avoid creating new reporting obligations and processes.

We also support the AER's ability to seek court enforceable compliance with the guideline to deal with guideline breaches. In addition to self-reporting, the AER may also need to conduct ad-hoc investigations and should perhaps specify a mechanism by which third parties may report potential breaches. Such a mechanism must require evidence and seek to ensure that facetious claims are not made or investigated.

We also believe that transparency of compliance would be aided by maintaining a register of any formal investigations into breaches and the outcomes of that investigation. This would serve as a reputational deterrent to engage in prohibited activities and would also provide information to stakeholders regarding those matters that have been investigated but no issue found to focus concerns to new issues or new information and help best allocate the AER's investigation resources.

[36] Ibid, p. 32

4. Response to AER Questions

In the sections above we have largely responded to the questions contained in the AER's preliminary position paper. The questions are re-produced below with references to our response and/or additional views as required.

Question 1: What aspects of current jurisdictional ring-fencing arrangements have or have not worked well?

See section 2.2 above for our detailed response. In particular the examples provided in section 2.2.2

Whilst we cannot comment on the experience of other DNSPs, we consider the NSW ring-fencing arrangements have been successful. The measures were not unnecessarily restrictive and sought to target a specific market. The reporting and monitoring arrangements were also effective.

Endeavour Energy had a strong history of compliance with this guideline and took all the necessary measures to comply. In addition to this, our actions helped promote and develop contestable markets in NSW successfully. We consider the nationally consistent guideline should closely align with the NSW obligations and reporting regime.

Question 2: Do you consider these objectives discussed in section 2.1 adequately reflect the harm ring-fencing is seeking to avoid and the benefits of an even playing field?

See section 1.2 and 1.3 above for our detailed response.

We support the objectives outlined by the AER and consider their fulfilment will best achieve the purpose of the guideline. As noted by the AER, the guideline should seek to answer the following[37]:

> *What is the potential harm that ring-fencing is intended to address and do the benefits of ring-fencing outweigh the costs of compliance?*

We are concerned however that the fourth objectives may be used to address matters beyond the scope of ring-fencing. The ring-fencing guideline should be strictly limited to protecting against anti-competitive behaviour and promoting competitive neutrality at least cost.

Whilst the AER recognises this, there will be significant pressure from stakeholders to implement more extreme measures in response to ideological concerns. Ring-fencing should not seek to eliminate the variability that naturally exists within markets to the benefits of customers. Each participant will have unique capabilities and competitive advantages. Ring-fencing should not seek to harmonise the market, it should only seek to provide a level playing field.

Question 3: Do you agree with the service classification approach to ring-fencing which is discussed in section 3.3? Is there a better alternative?

Yes, we support the AER's service classification approach to ring-fencing (in accordance with the regulatory framework). See section 3.1.1 for our detailed response.

See sections 1.3.1 through 1.3.3 for our concerns with any alternative approach.

Question 4: Does the proposed approach to ring-fencing adequately deal with the prospects for development of the contestable market for DER?

We consider the proposed obligations are unnecessarily restrictive and may distort competition in certain markets (inclusive of DER). See section 3.1.3 for further detail.

More specifically, see section 1.3.2 and 1.3.3 for our views on the development of the DER market. We do not consider DNSP involvement in DER will be detrimental to the development of the contestable market (provided the involvement is not anti-competitive). On the contrary, we consider

[37] Ibid, p. 14

DNSP is crucial to the development of this market. The case studies in section 2.2.2 support this view.

We acknowledge there is concern amongst stakeholders that DNSP participation in DER will hamper its development. However, the market is developing strongly with a number of large, multi-national conglomerates entering the supply-side of the DER market. As outlined in sections 1.3.2 and 1.3.3, the view that the independent, discretionary actions of Australian DNSPs will somehow stop this market from developing is not grounded in any meaningful evidence or economic theory.

It is a spurious claim and the ring-fencing guideline has no role to play in alleviating such concerns.

The ring-fencing guideline should simply ensure that a DNSPs participation in DER, or any contestable market, is done in a competitively neutral manner. The ring-fencing guideline has no role in guiding the AER's assessment of non-contestable asset management decisions. The existing regulatory framework, specifically clauses 6.5.6 and 6.5.7, outline the approach for assessing capital and operating expenditure plans. It is this process that will determine the efficient use of DER (i.e. leasing or ownership models) on a case by case basis.

Question 5: Are there other ring-fencing obligations we should impose on NSPs that provide services into contestable markets?

No, instead we consider the proposed ring-fencing obligations require further review. The proposed obligations are based on the existing QCA guideline and are more onerous than most other jurisdictional arrangements.

We provide our views on each obligation in section 3.1.3 above.

Question 6: What costs would be incurred in meeting these obligations?

As noted in section 2.1 above, it is difficult to accurately quantify the costs of ring-fencing obligations (or lack thereof).

As discussed in sections 1.3.1 and 3.1.3, the cost of overly restrictive ring-fencing obligations could be substantial. Proposed obligations (a) through (c) would impose significant costs on DNSPs.

These obligations, especially (b) (based on our understanding of it), would unnecessarily require all economies of scale and scope to be unwound and removed. A DNSPs contestable business would have to establish its own exclusive labour force, office-space, fleet, corporate services (such as payroll, finance, HR) etc. This could cost would apply for each contestable activity a DNSP wishes to participate in.

If that cost is prohibitive a DNSP may elect to not participate in the contestable market, as suggested by the AER. However, this is not an ideal outcome for both contestable and non-contestable customers as there are costs associated with DNSPs exiting contestable markets as well. All overheads, staff and other shared costs would be fully allocated to the non-contestable business. Many of these resources may be fixed in nature and cannot be exited resulting in a permanent increase in standard control service operating expenditure. Whilst the contestable market will have lower production, less competition and innovation and higher prices; these costs are immeasurable.

Question 7: Should assets sharing be restricted between regulated services and contestable service provision?

See section 2.3 for our detailed response and section 1.3.3 to a lesser extent.

Restricting the sharing of assets is both unnecessary and inconsistent with the existing regulatory framework. Such measures go beyond the AER's stated objective of ring-fencing.

Ring-fencing should simply ensure that any sharing that does occur is done in a transparent, arm's length and competitively neutral manner. There should be no cross-subsidisation or discriminatory treatment between a DNSPs contestable and non-contestable services. The CAM and SAG seek to ensure that costs are appropriately allocated between services and a reasonable sharing of profits occurs. The ring-fencing guideline should simply support these measures and ensure that no anti-competitive sharing occurs. The sharing of assets does not need to be prohibited to achieve this.

Question 8: Do the factors set out above reflect the issues we should consider in deciding whether to grant a ring-fencing waiver?

Yes, see section 3.1.4 for our detailed response.

Question 9: In which circumstances should the customers of ring-fenced services and not customers of the DNSP's services in general pay the additional costs of complying with ring-fencing obligations?

See section 3.1.3

Regulated customers should pay for any costs a DNSP incurs complying with the ring-fencing guideline as ring-fencing applies to direct control services.

Ring-fencing may also impose costs on contestable customers. This is because the ring-fencing obligations may (unnecessarily) remove the ability to access economies of scale and scope resulting in higher costs than what would have otherwise been required to operate the contestable business. Contestable customers also bear the costs of ring-fencing obligations which reduce competition or lower production in the respective market.

Question 10: How else could the AER minimise the administrative cost of ring-fencing while maintaining the integrity of its approach?

The costs could be reduced by revising the proposed ring-fencing obligations in accordance with the comments set out in section 3.1.3

A more proportionate set of measures would reduce compliance and administration costs. The QCA measures are relatively more onerous than the majority of existing jurisdictional arrangements and are less adaptable to changing circumstances with higher transaction costs for undertaking waivers. It is not entirely clear why more stringent and restrictive measures are required. Endeavour Energy has complied with the NSW guidelines and helped develop effective competition in customer connection works and other markets such as demand management as detailed in section 2.2.2.

A relaxation of the 'all-in' approach may also help reduce costs. An 'all-in' approach may result in a burdensome waiver application and assessment process. This could be resolved by the bulk-waiver process (although more detail and examples are required of how this will operate in the guideline) or by other measures such as enforceable undertakings, protocols or applying more onerous obligations in specific circumstances only.

Question 11: Is it reasonable for the AER to consider these transitional arrangements to the new ring-fencing guideline?

Yes, see section 3.1.5 for our detailed response.

Question 12: How can we ensure ring-fencing compliance is robust and effective without imposing excessive costs that may ultimately be borne by consumers?

See section 3.1.6 for our detailed response. The existing regulatory framework provides for reporting and enforcement mechanisms for obligations under the NER are effective.