

Fostering competitive markets in the long term interests of consumers

Submission to the AER's development of the
Electricity Ring-Fencing Guideline

7 June 2016

A decorative graphic in the bottom-left corner consisting of a series of overlapping triangles in various shades of blue, creating a geometric, low-poly effect.

Energy
Consumers
Australia



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Introduction

Energy Consumers Australia (ECA) welcomes the opportunity to comment on the Australian Energy Regulator's (AER) Electricity Ring-Fencing Guideline: Preliminary positions paper (Position Paper).

Australian energy consumers may soon face a very different energy market as the drive to decarbonise the economy, falling technology costs and the new digital economy come together to disrupt the current model.

This transition is blurring the hard boundaries that once existed between the various parts of the supply chain, and indeed the separation of the energy market from those for other products and services. This is placing stress on regulatory frameworks as they pre-date distributed generation, household-scale battery storage and 'smart' technology. Policy makers and regulators – in Australia and around the world – are grappling with how to adapt to this new environment. Some jurisdictions, such as New York State, are proposing radical changes to the way the sector is organised to ensure that competition can flourish and the benefits of new technology can be realised for consumers.¹

Although ECA comes to the issue of ring-fencing with these bigger questions about how to regulate a changing market in mind, we are conscious that the AER is working to a specific and confined mandate in this instance. That is, to develop an electricity ring-fencing guideline for the National Electricity Market (NEM) according to the National Electricity Rules (NER). In this submission we focus, therefore, on offering suggestions about the design of the Guideline to maximise its effectiveness.

The objectives of ring-fencing

The separation of the natural monopoly and potentially competitive activities in the energy system is one of the core principles underpinning the Australian Energy Market Agreement (AEMA) and informs the application of the long term interest of consumers (LTIC) framework.² The idea that the long term interests of consumers are

¹ <http://www3.dps.ny.gov/W/PSCWeb.nsf/All/CC4F2EFA3A23551585257DEA007DCFE2?OpenDocument>

² The National Electricity Objective (NEO) of the National Electricity Law (NEL) is 'to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of

best served by separation can be traced back to reports by the Industries Commission and the National Competition Policy Review Committee (The Hilmer Committee) in the early 1990s.³ In its report, the Hilmer Review Committee explained the harm that separation sought to address as follows:

*...[I]rrespective of whether the natural monopoly element is integrated vertically or horizontally with the potentially competitive element, industry structures of this kind present opportunities for cross-subsidisation. Monopoly returns made in the monopoly market may be used to finance otherwise unprofitable prices in the competitive market, potentially driving out or disadvantaging competitors. Indeed, even the prospect of such conduct may deter competitive market entry unless appropriate safeguards are in place.*⁴

The objectives of ring-fencing outlined in the Position Paper at section 2.1 are well-articulated and are consistent with this view of the nature of the harm associated with unrestrained monopoly activity. Accordingly, ECA supports the stated objectives.

ECA's concern is not with the objectives themselves but whether ring-fencing can achieve them. That is, we have doubts whether measures short of full structural separation will provide the level playing field that is needed to allow emergence of a vibrant market in new and innovative energy services. In the telecommunications sector, for example, ring-fencing arrangements did not provide new entrants with an adequate level of protection from the damaging market power of an incumbent with supplementary actions needed to create a level playing field.⁵

consumers with respect to price, quality, reliability, safety and security of supply'. Promoting the long term interests of consumers (LTIC) is also the principle objective of the Australian Energy Markets Agreement (AEMA) and is the objective specified for ECA

See ECA Constitution, Section 4.1(a) "To promote the long term interests of Consumers of Energy with respect to the price, quality, safety, reliability and security of supply of Energy services by providing and enabling strong, coordinated, collegiate evidence based consumer advocacy on National Energy Market matters of strategic importance or material consequence for Energy Consumers, in particular for Residential Customers and Small Business Customers."

³ Energy Consumers Australia, *Interpreting the LTIC* Research Paper No. 1 May 2016 <http://www.energyconsumersaustralia.com.au/research/interpreting-the-long-term-interests-of-consumers>

⁴ See page 219, National Competition Policy Review, 25 August 1993, <http://tinyurl.com/jy7hcd>

⁵ See Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Bill 2010, Explanatory Memorandum, http://www.austlii.edu.au/au/legis/cth/bill_em/tlaacsb2010751/memo_0.html.

We are conscious that the question of structural separation is outside the scope of this process. What is important is that the development of the Guideline is not seen as the end of the conversation about the issue of separation. We therefore look forward to continuing to contribute to the work that the Council of Australian Governments (COAG) Energy Council is undertaking on this issue as part of its emerging technologies workstream.⁶

What services should be ring-fenced?

The Position Paper identifies two main considerations for the selection of services that will attract ring-fencing obligations.

The first relates to the AER's power to regulate 'services', but not (in its view) 'assets' under the NER. According to the Position Paper, ring-fencing obligations could only apply where a Distribution Network Service Provider (DNSP) used a particular technology to deliver a contestable service to customers. That is, ring-fencing cannot be used to restrict DNSPs technology choices. While it may be the case that ring-fencing could not be used to directly prohibit the DNSP from making certain technology choices, the nature of certain technologies might mean that they should automatically fall within the coverage of the ring-fencing guidelines.

The question is whether it is possible to operate the technology in a way that does not affect the market for contestable services, noting that ring-fencing requires that the separated markets (in this case, one regulated, one contestable) operate entirely separately from each other.

In the case of grid-scale storage, our view is that it is not possible to operate this technology in a way that does not affect the contestable market. Even where DNSPs are notionally using storage for network support, the act of charging at times of low demand and discharging at times of high demand means there will an impact on the balance of supply and demand on the wholesale market and price at which electricity is traded. The network has, in effect, acted to supply electricity to the market. It

⁶ Meeting Communique, 4 December 2015, COAG Energy Council, <https://scer.govspace.gov.au/files/2014/05/Energy-Council-Communique-4-Dec-2015-FINAL.pdf>

follows, therefore, that grid-scale storage should automatically attract ring-fencing obligations.

The second consideration the Position Paper explores in relation to the coverage of the Guideline is whether ring-fencing should be applied by default to all contestable services offered by DNSPs, or alternatively, only in those cases where a net benefit can be demonstrated. ECA supports the AER's preliminary view that it should be the former. It would not be reasonable to expect a potential new entrant, or a small player looking to expand their business, to gather the evidence needed to mount a case that they would be or were being unfairly impeded by a DNSP in a contestable market. This approach to the default setting is consistent with the precedent set by Hilmer, that:

[W]here the natural monopoly element is vertically integrated with the potentially competitive activity, the Committee considers there should be a presumption in favour of full structural separation, leaving those who support some lesser reform to establish why this is in the long term public interest.⁷

ECA also agrees with the AER at section 3.3 of the Position Paper that the best way to give effect to this default application of ring-fencing to contestable activity is to periodically review the services offered by each DNSP and determine which activities will be subject to ring-fencing at that time.

Ring-fencing obligations

ECA supports the ring-fencing obligations set out in section 4 of the Position Paper. We also ask you to consider the following further measures.

Access to information from DNSPs

One of the aims of ring-fencing highlighted in the Position Paper is to neutralise the advantage a DNSP receives from the information it gathers as part of its regulated activities. Where DNSPs are competing in contestable markets through ring-fenced business units, potential new entrants into the market may not have complete confidence that a ring-fenced business will not access information from the NSP that

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See page 221, National Competition Policy Review, 25 August 1993, <http://tinyurl.com/jy7hcdU>.

confers a competitive advantage. This could discourage new entry, damaging competition and service innovation.

A potential way to address this risk, is to require that DNSPs, upon request by a potential market entrant, disclose to the potential entrant information that is relevant to their business strategy. It would of course be appropriate that the business receiving the information be required to make appropriate undertakings to maintain the confidentiality of the information.

When businesses are considering entering new markets, the perception of competitive neutrality can be as important as the true state of the market. An information obligation of this kind would contribute to both the appearance and fact of competitive neutrality.

DNSP compliance process

The Guideline must require that DNSPs implement a compliance program to ensure the ongoing operation of any ring-fencing arrangement. This compliance program should meet the relevant Australian Standard AS 3806-2006.

DNSP complaints handling process

The Guideline should require DNSPs to develop rigorous and transparent processes for handling complaints from suppliers with concerns about the effectiveness of ring-fencing. These processes should be compliant with the relevant Australian standard AS-ISO-1002-2006.

That is, there must be a clear process that a competing service provider can follow in order to raise a complaint with the DNSP in the first instance, and where the issue is not resolved in a satisfactory way, escalate it to the AER. The Guideline should require DNSPs to report the number and nature of the complaints they have received to the AER.

Reporting on the health of downstream markets

ECA submits that DNSPs be required to report on the effectiveness of competition in the downstream markets covered by the Guideline. This would promote competition in two ways.

First, because DNSPs have an important role to play in working with suppliers in such markets, the reporting requirement places an incentive on networks to render effective assistance to market participants. Second such reports will provide important information about potential business opportunities to firms considering offering a service in a new area.

AER Reporting

ECA requests that the AER commit, in the Guideline, to publishing an annual report on the DNSPs' compliance with the ring-fencing obligations and the health of the downstream markets.⁸

Restrictions on asset sharing

Question 7 in the Position Paper asks whether 'asset sharing [should] be restricted between regulated services and contestable service provision?'. ECA favours ring-fencing arrangements that deliver strong functional separation. Whether this should extend into a prohibition on asset sharing will depend on the nature of the particular service. Where, for example, the sole use of an asset is to deliver a contestable service (e.g. grid-scale storage), it follows that the DNSP should be prevented from transferring any of the costs into the regulated part of the business.

ECA notes, however, that it may be appropriate to reconsider the current approach to asset sharing, in light of the development of this Guideline and the evolution occurring in the energy market.

Reducing the administrative costs of ring-fencing

Question 9 of the Position Paper asks under what circumstances 'customers of ring-fenced services and not customers of the DNSP's service in general [should] pay the additional cost of complying with ring-fencing obligations?'.⁹ ECA's position is that

⁸ We note that the ACCC publishes an annual report on Telstra's compliance with its Structural Separation Undertaking <https://www.accc.gov.au/media-release/accc-reports-on-telstras-compliance-with-its-structural-separation-undertaking>.

⁹ *Electricity Ring-Fencing Guideline: Preliminary Positions*, April 2016, Australian Energy Regulator, p 31 <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/electricity-ring-fencing-guideline-2016>

because customers of general DNSP services will not receive any benefits from effective ring-fencing, they should not have to bear any of the costs associated with delivering those services. If a DNSP is considering creating a ring-fenced entity to participate in contestable markets, part of this decision must include whether the costs of ring-fencing are outweighed by the benefits of offering the service.

Concerns about DNSP conduct

ECA has received reports from energy consumers of instances where a proposal to connect a storage or generation project to a distribution network has been rejected by a DNSP only for the proponent to be subsequently contacted by a sister company of the DNSP.

It is ECA's understanding that where a monopoly business provides information to a sister company that advantages it in a downstream market, this would not only breach existing ring-fencing rules but also give rise to questions about whether an abuse of market power under the *Competition and Consumer Act 2010* may have occurred. ECA encourages anyone who has evidence of this kind of activity to document it and provide it to the Australian Competition and Consumer Commission (ACCC).

Conclusion

ECA thanks the AER for the opportunity to provide comment on the Positions Paper. We look forward to further exploring these issues in the stakeholder workshops you have planned as the next phase in the development of the Guideline.




If you would like any further information, please do not hesitate to contact Oliver Derum, Associate Director of Advocacy and Communications, on 02 9220 5514 or oliver.derum@energyconsumersaustralia.com.au.



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