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Lodged electronically: ringfencingguideline2016@aer.gov.au

Dear Mr Pattas

Draft Ring-Fencing Guideline: Electricity Distribution

1. Introduction

EnergyAustralia welcomes the opportunity to comment on the Australian Energy Regulator's (AER) Draft Ring-Fencing Guideline for electricity distribution. We are one of Australia's largest energy companies, with over 2.5 million household and business customer accounts in NSW, Victoria, Queensland, South Australia and the Australian Capital Territory. We also own and operate a multi-billion dollar portfolio of energy generation facilities across Australia, including coal, gas and wind assets with control of over 4,500MW of generation in the National Electricity Market.

Competitive markets deliver products and services that reflect customers' needs at least cost. Therefore, we see little customer benefit from a regulatory framework that allows regulated monopolies or their related entities to take advantage of their regulated status.

Electricity networks view many contestable services as integral to their operations. They also offer additional revenue streams at a time when alternative business models are threatening centralised energy. While we agree that behind-the-meter services offer network benefits, we believe competitive markets are better suited to deliver the full range of supply chain benefits to customers.

Networks are already developing capabilities that compete with offerings from other businesses. Notable examples are SA Power Networks' installation of residential batteries and Energex's installation of a solar photovoltaic unit and Battery Energy Storage System at its Eagle Farm Distribution Centre.[1]

[1] More details about the SAPN program are available at http://talkingpower.com.au/battery-trial/. Details of the Energex trial are available at https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/ring-fencing-waivers/energex-ring-fencing-waivers-2016.

Therefore, we are pleased with the AER's approach to ring-fencing and view the Guideline as a necessary first step towards promoting competition in contestable markets. It is an important (and overdue) measure that will go some way towards addressing the ability and incentive for networks to undermine effective competition.

However, we have some concerns about how the AER will monitor and enforce compliance with the Guideline. It will only be effective if the AER can identify and take appropriate action against networks that breach its obligations. For example, we expect it will be very difficult for the AER to identify transfers of important information, such as costs, network performance and load data as well as the precise timing of when that information was made available to an affiliate. We also require further detail about the AER's likely model for monitoring networks' compliance before we can be confident about the Guideline's overall effectiveness. In particular, we are interested in how the AER will direct its monitoring activities, what information it expects networks to provide in their annual compliance reports and on what basis it might undertake more detailed investigations.

Participants in the market for energy products and services require confidence that the regulatory framework does not create or exaggerate a bias in favour of specific market participants. Therefore, we support a regulatory framework where the onus is on networks to demonstrate their ongoing compliance with the intent and details of the Guideline, supported by a transparent approach to monitoring and enforcement.

The Guideline will complement other regulatory initiatives – to improve the transparency of network planning, for example – and will be further enhanced by a forthcoming rule change to clarify the definition of network services. This rule change will overcome current deficiencies in the Rules by removing ambiguity about the boundary between monopoly and contestable services.

2. Observations on the Draft Guideline

The Draft Guideline builds on the AER's Preliminary Positions Paper, proposing obligations that target the main areas of concern:

- Potential for networks to cross subsidise affiliates operating in contestable markets; and
- Potential for networks to discriminate in favour of affiliates operating in contestable markets.

This is a sound approach provided AER can effectively administer the Guideline. We also welcome the AER's decision to reduce opportunities for networks to obtain a waiver from specific obligations. Waivers undermine the policy intent of ring-fencing as they allow networks to develop important capabilities (research or product development, for example). Furthermore, the decision to grant a waiver – for a small scale trial, for example – often reflects a static view of market development, particularly in markets for emerging products and services.

Despite our general support for the Draft Guideline, we do have some specific concerns. The AER should consider more prescription in Provision 4.3.2, which relates to the provision of information on an equal basis to third parties. We view equal access to information as one of the core elements of an effective ring-fencing scheme. Providers of contestable products and services require timely access to information about network performance and load data. This data indicates where they can offer network benefits and it would seem relatively easy for a network to provide this information to a related party on some preferential basis. The current

provision is quite broad and should be extended to include an explicit obligation on networks to release information in a form and timeframe to enable *all* market participants to compete on an equal basis.

We also seek further details about the following:

- How the Guideline will apply to any third parties that a network might employ and how the AER will identify and analyse transactions that could involve multiple entities; and

- AER's decision to exclude senior executives from the restriction on the sharing of staff between networks and related bodies corporate.

We assume the Guideline will apply equally to any third parties and other agents that a network and/or affiliate might employ to assist with the provision of network services. Networks have the freedom to structure contracts and commercial arrangements in a manner that suits their business. This is often a source of operational efficiency, from which customers ultimately benefit. However, it creates significant challenges for regulators to identify the allocation of costs or the transfer of information, particularly if a third party offers services to both network and related business. Moreover, networks could deliberately structure their operations in a way that bypasses regulatory requirements or simply complicates the detection of breaches.

The AER should also be mindful of the limitations of the Cost Allocation Principles in the National Electricity Rules (NER). The Draft Guideline states that a '*DNSP must allocate or attribute costs … in a manner that is consistent with cost allocation principles and its approved CAM, as if those cost allocation principles and CAM otherwise applied to the allocation of and attribution of costs between distribution services and non distribution services'*. Our concern with this approach is that the Coast Allocation Principles were not designed to specifically address the ability for networks to allocate costs to affiliated businesses that operate in contestable markets. The NER grant some flexibility and discretion to networks in the allocation of costs; this means there is a range of outcomes that the AER could deem compliant.[2] Therefore, we recommend that the AER review the Cost Allocation Principles (and consider whether a rule change to amend the Principles is necessary) to ensure they prohibit the cross subsidisation of related entities who are operating in contestable markets.

Staff sharing

We support functional separation through restrictions on shared staff. However, the Draft Guideline indicates the AER will allow for common senior management across networks and related bodies corporate. We acknowledge the broad obligations that target favourable treatment of affiliates but reiterate a key point from our previous submission, namely, that networks' senior management will ultimately benefit from the success of an associated entity and therefore, continue to have some incentive (albeit reduced) to operate the businesses in a mutually beneficial way.[3]

Senior managers are responsible for numerous activities across both entities, ranging from contract negotiation to the development of strategies, business plans and performance targets. It is hard to see how they will perform these tasks without access to comprehensive information about both businesses (and their competitive outcomes). Furthermore, they will

[2] See Oakley Greenwood (2016), *Review of the Classification of Services in the National Electricity Rules, prepared for the Australian Energy Council*, for a more detailed discussion.

[3] EnergyAustralia (2016), *Submission to AER Electricity Ring-Fencing Guideline: Preliminary Position Paper*

have directorial responsibilities to pursue outcomes that benefit the network and any other related business. Human nature will prevent senior managers from separating the two entities so the regulatory framework must account for this.

As we have previously argued, the absence of common executives and directors, and shared incentive structures are key elements of effective ring-fencing in a broader group structure. In practice, ring-fencing should limit information flows between executive directors that are drawn from a parent company and these directors should not have a shared role in developing strategies or have shared staff, incentives or key performance indicators.

We also reiterate our suggestion that the AER could investigate whether directors have completed training courses such as those offered by the Australian Institute of Company Directors. This can strengthen personal governance knowledge and reinforce a culture of independence within ring-fenced companies.

Monitoring and enforcement

EnergyAustralia's more fundamental concern with the Draft Guideline is the challenging nature of monitoring and enforcement. The framework will only be effective to the extent that networks perceive a genuine possibility that AER will be able to detect and take appropriate action against non-compliance. This is a function of AER's oversight.

In principle, we support a positive obligation for networks to establish and maintain internal procedures and to prepare compliance reports, with an assessment by a 'suitably qualified independent authority'. However, the effectiveness of this type of oversight depends on how closely AER analyses these reports and any additional measures it might take to assess compliance. The key question for us is what these obligations mean in practice and we would be concerned if they were simply a procedural obligation for networks and the AER.

For example, the Draft Guideline proposes reporting obligations for networks, including a requirement to prepare an annual compliance report. It also indicates that the AER *may:*

- take further action to satisfy itself that a network is compliant;
- require the network to further demonstrate the adequacy of its internal compliance procedures upon reasonable notice;
- make networks' ring-fencing compliance reports publicly available; and
- serve a regulatory information instrument on a DNSP that requires the DNSP to report on transactions with its related bodies corporate.

We agree with the AER's statement that '*public confidence will be enhanced by transparency about DNSP compliance and the ability for customers and service providers in competitive markets to raise concerns about non compliance*'.[4] Therefore, EnergyAustralia would welcome more clarity from the AER about when and on what basis it might take further actions. Triggers could be an inadequate compliance report, a complaint from a competitor, a significant transaction, installation of significant infrastructure, or a specific network's previous compliance record. The AER should be proactive, rather than simply relying on self-reporting or compliance reports from networks that it receives on some defined frequency.

[4] Australian Energy Regulator (2016), *Draft Ring-fencing Guideline: Explanatory Statement*, page 52

We would also welcome more detail about the type of information and level of detail that it would expect from networks in their annual compliance reports. We recognise that the requirement for separate accounting will allow the AER to identify transactions between networks and related parties. However, the AER concedes there is no positive obligation for networks to report on these transactions. We recommend that the AER reconsider this approach and instead require networks to explicitly identify such transactions. Furthermore, publication of networks' annual compliance reports will promote confidence in the Guideline among market participants.

In any event, we recommend that the AER focus its monitoring on areas where the incentive for networks to support an affiliate are strongest and the opportunities are greatest. In our view, AER should pay particular attention to the allocation of costs (in light of the previous discussion of the current Cost Allocation Principles), information exchange and the timing of the release of information to affiliates and the broader market, and non-discriminatory access to services provided by network companies. Much of this relates to enforcement of the Guideline but the overall effectiveness of the Guideline would be further enhanced by complementary rule changes, which are discussed in the following section.

The AER should also closely monitor outcomes in the market for contestable services that offer significant network benefits (e.g. storage) and where networks and their subsidiaries have been operating.

3. Related regulatory initiatives

Ring-fencing is one of numerous elements of the broader regulatory framework that influence the market for contestable services. The AER will not be able to achieve the objectives of its Ring-fencing Guideline without complementary initiatives to remove distortions and other problematic aspects of network regulation. These include:

- Imprecise definitions of network services in the NER.
- Inadequate obligations on networks to provide important information to the market about emerging network constraints, i.e. the content of distribution annual planning reports.
- Inadequate measures to ensure networks consider all feasible solutions to network constraints and ageing assets, i.e. limited scope of the Regulatory Investment Test for Distribution (RIT-D).

The previous section discussed particular elements of the Draft Guideline. However, there remains some confusion about its precise coverage. This stems from the classification of network services in the NER, which does not adequately deal with contestable services that can also be used to provide core network services.

This is an important issue that will be addressed through a forthcoming rule change proposal. The objective of this proposal is to retain the incentive for networks to procure the lowest cost solution to network issues (such as constraints or asset replacement) while more precisely defining the boundary between network and contestable services. This will clarify which services a network can deliver directly and which services must be delivered by competitive markets (including through ring-fenced entities). By implication, this determines the point at which ring-fencing obligations commence.

We view this change as a high priority and it is consistent with the AEMC's recommendations to the COAG Energy Council.[5] We also support the AER's rule change proposal that relates to Replacement Expenditure Planning Arrangements, i.e. network planning and the scope of the RIT-D.

Finally, we continue to hold the view that the AER and AEMC should revisit both the Demand Management Incentive Scheme and Demand Management Incentive Allowance. By funding and compensating networks to research and trial demand management, these schemes confer an unfair advantage to networks and their subsidiaries. They allow networks to develop capabilities in contestable services and crowd out what might have occurred through a competitive process. An example is SA Power Networks' trial of combined solar and energy storage, which it notes is funded by 'savings for network deferment and Demand Management Incentive Scheme funds.'[6]

We cannot see how these schemes are consistent with the AER's ring-fencing objectives and they seem redundant in light of other developments in network regulation. At the very least, they should be redesigned to ensure they do not contradict or allow networks to bypass the Guideline.

4. Conclusion

EnergyAustralia believes a national ring-fencing guideline is a high priority. This is due to the widely acknowledged deficiencies in the NER and the actions that many networks are now taking to develop capabilities in contestable services. Customers benefit from effective competition in the market for emerging technologies such as advanced metering and storage. However, these benefits won't be realised in an environment where networks have the ability and commercial incentive to exploit their competitive advantage.

We support many elements of the Draft Guideline, particularly the following:

- Requirement for legal separation if a network intends to offer a contestable service;
- Requirement to establish and maintain separate accounts;
- Prohibition on cross subsidies between networks and ring-fenced entities; and
- Requirement that information is made available to all parties on an equal basis.

However, we also see some areas for improvement, namely, greater clarity about the treatment of related and third party transactions, and extension of restrictions on the sharing of staff to include senior executives. More fundamentally, we see significant challenges for the AER in monitoring and enforcement. As noted, we require more detail about the AER's likely model for monitoring networks' compliance before we can be confident about the Guideline's overall effectiveness. Our concerns reflect the immaturity of these markets.

Customers are the ultimate beneficiary of improved network regulation so we look forward to the commencement of the AER's Final Guideline on 1 December. At the same time, we encourage the AER and others to implement complementary reforms of network regulation as

[5] Australian Energy Market Commission (2015), Integration of Storage: Regulatory Implications, Final report

[6] See SA Power Networks' 19 May Media Release for more information, http://www.sapowernetworks.com.au/public/download.jsp?id=54883

soon as possible. In particular, the pending rule changes to provide greater transparency of network operations and neutral network decisions for asset replacement and augmentation is essential and will enable providers of contestable services to identify important sources of value.

Finally, we recommend the AER consider a framework for assessing the effectiveness of the Guideline. This could potentially be the AEMC's recently announced annual monitoring report to 'assess the state of economic regulation for electricity networks in the face of energy market transformation'. Whatever the mechanism, the AER should publish regular reports on its administration of the Guideline that note developments in the market for contestable services, trends in network compliance, areas of focus and perceived deficiencies in the overarching legislative framework. The latter would provide an evidence base for legislative amendment, including cross ownership restrictions or more severe penalties for non compliance with the Guideline, if the existing framework is found to be deficient.

Should you require further information regarding this submission please call Geoff Hargreaves on (03) 8628 1479.

Yours sincerely

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