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Dear Mr Pattas

Electricity Ring-Fencing Guideline: Preliminary positions

1. Introduction

EnergyAustralia welcomes the opportunity to comment on the Australian Energy Regulator's (AER) preliminary positions on an electricity ring-fencing guideline. 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.

EnergyAustralia supports regulatory frameworks that encourage efficient investment in new technologies. Services such as advanced metering and storage offer customers greater visibility and control over their energy consumption. They will be able to make fully informed decisions about the timing of their consumption (responding to more cost reflective network tariffs, for example) and consume energy in a way that best reflects their needs and preferences.

We view these technologies as an integral component of retail services offerings so we are pleased that the AER – and also the Australian Energy Market Commission (AEMC) – recognises the potential and commercial incentive for networks to exploit a competitive advantage in these markets. We are already observing a number of networks undertaking trials and behind-the-meter projects with storage technology so development of a nationally consistent guideline that reflects current market circumstances is overdue.

We see little customer benefit from regulatory frameworks that allow regulated monopolies – who have no direct commercial relationship with customers – to take advantage of their regulated status. Rather, we are confident in the ability of competitive markets to develop technologies that truly reflect customers' needs (rather than network-specific or locational) and then deliver them at least cost.

While it falls outside the scope of this process, we believe there is a case for revisiting the National Electricity Rules (NER) as a priority to clarify the distinction between network and contestable services and to consider the merits of structural separation and the imposition of cross-ownership restrictions on networks (as the AEMC recommended).

However, the AER's preliminary position is a good model within the current NER and in our view will promote the integrity of markets by limiting networks' ability to exploit a competitive advantage. The AER's proposed model will of course generate some compliance and administrative costs for networks but we do not expect these incremental costs to be material due to their existing regulatory obligations. More importantly, these costs are outweighed by the benefits to customers over the longer term of more effective competition.

We view monitoring and enforcement as particularly challenging; the exchange of cost and technical information between related parties, for example, is very difficult to detect and can confer considerable advantages to related entities. Therefore, we support the AER's proposed reporting requirements for networks and welcome its statement that the onus will be on networks to satisfy the AER that is has complied with the guideline. We also support strong penalty provisions to act as a disincentive for non-compliance.

The remainder of this submission considers the context for the development of the ring-fencing guideline, including the recognised need to assess the classification of network and contestable services, and how ring-fencing should apply in practice.

2. Context

Related regulatory initiatives

Regulation should seek to promote efficient consumption and investment across the entire energy supply chain, i.e. for network and contestable services. Development of a new ring-fencing guideline to promote competition in emerging technologies is important but one of numerous complementary regulatory initiatives to encourage better outcomes for customers.

Customers require access to cost-effective tools and enabling technologies that facilitate efficient consumption, investment and network utilisation. At the same time, all providers of emerging technologies should have the opportunity to compete to provide services to customers and to other market participants in an environment that does not favour a particular technology, business model, service or industry sector. Effective ring-fencing and competition in markets for emerging technologies can deliver this but further measures are necessary.

The AEMC recognised the linkages between different regulatory initiatives in its *Final Report of the Regulatory Implications of the Integration of Energy Storage*, which included a broad range of recommendations relating to networks' planning and participation in markets.[1] The AEMC recognised that the energy market has fundamentally changed and that numerous elements of the NER need to be revisited to ensure customers benefit from those changes.

Two of the most notable and related reforms are the implementation of more cost reflective network tariffs and the promotion of competition in metering. These measures will combine to provide an opportunity to customers to monetise the benefits of more flexible consumption profiles (by allowing them to shift consumption away from peak periods and face lower

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

charges). Competitive provision of enabling technologies is therefore essential for customers to maximise those benefits.

We also note other AEMC recommendations to promote efficiency of network utilisation and investment, and to encourage the lowest cost solutions to emerging network constraints and asset replacement (rather than favouring any particular technology or form of investment).

Reviews of various aspects of the regulatory framework for networks – such as the Regulatory Investment Test, annual network planning processes, the level of returns to network investment and the operation of incentive regulation – are occurring or will commence during 2016. These reforms are necessary to ensure that customers will benefit from lowest cost network solutions and the greater opportunities offered by the emergence of new technologies.

Review of National Electricity Rules

The AER's paper also discusses the potential need to structurally separate networks from contestable business activities to completely remove advantages that are not available to unregulated businesses.[2] However, the AER notes that this goes beyond the scope of ring-fencing under the current NER and is ultimately a policy issue for governments to resolve through the COAG Energy Council. EnergyAustralia supports a formal and immediate review of the NER and we note the AEMC's recommendation for the COAG Energy Council to task the AEMC to:

- clarify the boundaries of services that can be provided by a DNSP in its capacity as a regulated entity;
- clarify service classification definitions; and
- if necessary, impose cross-ownership restrictions on network businesses.[3]

These issues require immediate clarification so this review of the NER should occur as a priority regardless of who proposes the rule change. The review of the NER should also focus on the following issues given the increasing scope for effective competition in new technologies and the potential for networks to inhibit competition:

- Cost Allocation Principles in the NER to provide greater clarity and prescription about how networks allocate costs between activities and potentially, to affiliates if they are allowed to continue to offer contestable services.
- Grid connection arrangements, noting the actual and perceived potential for networks to limit connections by non-affiliates. The review should focus on the transparency of networks' assessment frameworks.

On the latter issue, the AEMC recommended that the AER review existing network basic connection services offerings for micro-embedded generation. Prior to the AEMC's review, the Clean Energy Council stated that while they share fundamental obligations with respect to connections, networks imposed varying technical requirements for inverter energy systems due to their business structures, risk profiles and the regulatory environments they operate

[2] We note the Energy Consumers Association's comments in its submission to Ergon Energy's application for a ring-fencing waiver that ring-fencing cannot completely avoid the damage to competitive markets caused by enabling networks to invest in storage.

[3] AEMC (2015), op.cit.

under.[4] This framework has been described as quasi-regulatory and further illustrates the discretion that networks possess and therefore, the potential for favouritism of affiliates in relation to connections.

We also think that any review of the NER should revisit the operation of both the Demand Management Incentive Scheme (DMIS) and Demand Management Incentive Allowance (DMIA). 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. Recent examples of network involvement in contestable services include AusNet Services' mini-grid trial (which involves the installation of solar systems, batteries and associated communication equipment) and SA Power Networks' subsidies for battery storage and potentially solar panels.[5]

We do not accept that networks are any better placed than firms that operate in competitive markets to develop efficient and customer-focussed solutions in contestable (and network-related) services. This point is discussed in more detail in the following section.

In the absence of further clarification through a rule change, we support the AER's proposed approach to the classification of services (Option 3). This will involve the review of services that networks offer on a regular and pre-determined frequency and determination of those services that should be ring-fenced (and consistent with the AER's current Framework and Approach service classification process). We believe this approach strikes the right balance between certainty for market participants and some degree of flexibility for the regulator to respond to technological change.

3. Assessment of ring-fencing models

The theoretical case for ring-fencing is well understood and widely accepted. Networks have an advantage by virtue of their regulated status and position within the market, and both the financial and regulatory incentive to exploit that advantage. This could take the form of a subsidy to an affiliated entity, preferential terms and conditions or access to information for an affiliate, or discriminatory access. The AEMC drew attention to each of these issues in its Storage Paper and recommended various reviews and initiatives to address deficiencies in the current NER.[6]

Actual or perceived biases or deficiencies in the NER hinder the development of competitive markets and the efficient provision of new services, undermining many of the significant regulatory initiatives that are seeking to encourage neutrality between network and non-network solutions.

When developing a regulatory framework, EnergyAustralia supports comparison of the costs and benefits of different forms of ring-fencing once the boundary between networks and contestable services is established. This is consistent with good regulatory practice and ensures that regulation is proportionate to the problem it attempts to address.

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4 Clean Energy Council (2015), Priorities for Inverter Energy System Connection Standards, available at http://fpdi.cleanenergycouncil.org.au/reports/inverter-energy-system-connection-standards.html

5 See http://www.ausnetservices.com.au/CA257D1D007678E1/All/41F5DC5437B4E7C2CA257F3A00205770/$file/160419%20Mooroolbark%20trial%20launch%20%20FINAL.pdf and http://talkingpower.com.au/battery-trial/ for more details.

6 AEMC (2015), op. cit.

The challenge for the AER, however, is to quantify the respective costs and benefits, particularly when networks have an incentive to overstate the negative impact of more onerous obligations. These costs fall into two categories – loss of economic efficiency from the separation of interrelated activities; and direct compliance and administrative costs. Each is considered in turn.

Role of networks in development of new technologies

A recent paper by Synergies Economic Consulting and George Yarrow for the Energy Networks Association suggested that vertical integration in the energy sector (in this case, between network services and new technologies) would encourage innovation and generate 'vertical externalities'.[7] Conversely, the paper suggests that separation would undermine innovation and impose excessive compliance costs, particularly in emerging markets.

The paper also questioned whether market (rather than internal) processes would enable different market participants to capture the full range of benefits that emerging technologies will deliver. In our view, these benefits are much broader than network benefits and include wholesale and possible environmental benefits. As we noted in our submission to the AEMC's Storage Paper, storage can generate significant value in wholesale markets (in terms of frequency control or load stability) when thermal generation is replaced with less reliable intermittent renewable generation. This suggests retailers are better placed to maximise the benefits from storage and other new technologies.[8]

EnergyAustralia recognises that technologies such as storage, distributed generation, direct load control and smart metering will complement traditional network services. Smart meters facilitate more efficient network utilisation (assuming the right price signals are in place) and storage can overcome the need for network augmentation. Networks should consider all options (including storage and distributed generation) when evaluating the need for asset replacement or when constraints exist on the system.

We disagree, however, that transaction costs are so high that these benefits cannot be realised through market transactions between different parties. Market participants have a compelling commercial incentive to realise value through mutually beneficial transactions and arrangements when they face the cost-reflective prices and when regulation is competitively neutral.

Moreover, we do not agree that networks as regulated monopolies are best placed to realise the full range of benefits through vertical integration.

We agree with the following statement from the AEMC's Storage Paper:

> *Network businesses may argue that it is inefficient having individual consumers buy storage devices when a network solution could provide benefits to all consumers at a lower cost. This, however, assumes that network optimisation is more highly valued by consumers than their individual preferences regarding the alternative uses of storage.*

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7 Synergies Economic Consulting and George Yarrow (2016), *Applying the Hilmer Principles on economic regulation to changing energy markets: A report prepared for the Energy Networks Association*

8 EnergyAustralia (2015), Submission to AEMC Discussion Paper – Integration of Energy Storage Regulatory Implications, available at http://www.aemc.gov.au/Major-Pages/Technology-impacts

> *It is also in conflict with the principles … that underpin the energy market frameworks, particularly the desire for consumer choices to drive energy market development. Moreover, it is important that the investment case of a consumer or retailer is not distorted by the connecting network business imposing onerous connection regimes or requiring control of the device's operation.*[9]

This further highlights the need for greater transparency of network planning arrangements, including emerging network constraints, and more cost reflective network tariffs that allow customers to share network-related benefits where they exist.

In contrast to networks, retailers operate in wholesale markets and already have extensive experience with new technologies. Retailers work with their customers to understand their requirements and develop comprehensive solutions that include these emerging technologies. We offer retail prices that reflect underlying network charges and a range of technology solutions that enable customers to respond to both network and wholesale price peaks in a way that reflects their needs and preferences. Examples include:

- Profit sharing deals where customers reduce load from the NEM upon a dispatch request from the retailer. The savings of avoided high prices are shared between retailer and customers.

- Payment of an availability charge to a customer that then enables the retailer to the customer's load reduction on request. Customers may also agree to a pool pass-through contract with their retailer under which the customer self-dispatches its load curtailment and benefits by avoiding a higher price.

- Retailers help customers to manage their load through substitution, where a customer draws on an alternative source of energy, such as a backup generator or storage unit, to reduce the volume they consume via the wholesale market when prices are high. Customers can also curtail load to avoid punitive network demand tariffs ('peak shaving').

The competitive sector is far better placed to develop technologies that truly reflect a *customer* focus (rather than network-specific or locational) and then deliver them at least cost.

Compliance costs

In terms of compliance costs for networks of ring-fencing obligations, we are sceptical that the *incremental* costs will be significant. As regulated bodies, networks are heavily scrutinised and already comply with cost allocation guidelines (to determine regulated prices for alternative control services, for example), extensive reporting obligations (such as Regulatory Information Notices) and the current jurisdictional existing ring-fencing requirements.

The AER is seeking further information on these compliance costs and we agree on the need to consider relative costs and benefits when developing regulations. However, networks have a clear incentive to overstate these compliance costs and we believe the AER is well placed to assess the networks' cost estimates. Furthermore, these costs represent the cost of doing business in a competitive market and can be avoided completely if a network does not compete to provide a contestable service through an affiliate, either because of regulatory restriction or by choice. Any such costs clearly do not represent the efficient cost of providing

[9] AEMC (2015), op. cit.

network services so there are no circumstances under which networks should be able to recover those costs through regulated revenues.

We expect the incremental impact on effective competition and innovation if a network chose not to offer a contestable service would be minimal but this can be examined further in the context of a rule change proposal.

4. Models for ring-fencing

EnergyAustralia supports robust and consistent ring-fencing arrangements to overcome the commercial incentive for networks to exploit a comparative advantage in markets for contestable services. As such, we support the AER's proposed obligations, particularly those prohibiting networks from providing ring-fenced services unless through a legally separate ring-fenced entity and the requirement to ensure that information provided to ring-fenced entity is also available to third parties on an equal basis.

Elements of the current NER grant networks considerable discretion in terms of cost allocation and grid connections, for example. Therefore, we are pleased that the AER proposes to include a requirement (and positive obligation for a network to demonstrate compliance) that there is no cross subsidy between a network and a ring-fenced entity; and a requirement that information that a network provides to a ring-fenced entity is also available to third parties on an equal basis.

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. The AER could investigate whether directors have completed training courses such as those offered by the Australian Institute of Company Directors, which can strengthen personal governance knowledge and reinforce a culture of independence within ring-fenced companies. This could be one of a number of mechanisms by which a network could demonstrate compliance or satisfy market participants that it has implemented effective ring-fencing.

The proposed obligations could be further augmented in the following ways:

- Requirement for networks to implement access controls between their information systems for regulated activities and for non-regulated activities (as suggested by the AEMC).

- Statement by a network that it will grant connections to its grid on a consistent and non-discriminatory terms.

- Strict disclosure obligations for any research and development or trials of contestable services, particularly when they are funded via DMIA / DMIS or when a network has obtained a waiver from ring-fencing requirements.

The AER should focus its monitoring on areas where the incentive and ability of networks to support an affiliate are strongest. In our view, this will relate to the allocation of costs, 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.

Therefore, we support the AER's proposed compliance and reporting obligations for networks and its statement that the onus of proof should be on networks to demonstrate compliance. Publication of networks' compliance activities information and the requirement for an independent audit will give confidence to current and prospective market participants about the integrity of the market and effectiveness of market practices.

Even so, information exchange and non-discriminatory access to information are challenging to monitor so the AER should consider this as it develops a penalty regime. Penalties should typically be proportionate to the harm caused by any regulatory breach but there may be merit in considering relatively onerous penalties to act as a deterrent when detection of some breaches is difficult. The AER is seeking views on whether pecuniary penalties apply, which we support, but it should also consider tailoring the size of penalties to each networks' allowable revenue to offer a fair and genuine disincentive.

Differentiated ring-fencing models

The AEMC suggested that ring-fencing obligations could differ according to the potential for harm in the market for a contestable service. More specifically, the AEMC recommended that the AER consider the following when developing a ring-fencing framework:

- The ability of a network business to obtain access to the contestable services efficiently through alternative means, such as contracting the provision of services from third parties.

- The extent to which an activity might generally be expected to be used to provide regulated network services compared with its use to provide contestable services.

- The degree to which it is expected that a network business would have the ability to impact competition in the contestable market through leveraging an advantage from its regulated activities. The perceived advantages which a regulated network business may seek to leverage in providing contestable services should be clearly articulated and evaluated.

- The extent and nature of other benefits that the network business may have in operating in the contestable market, separate from those arising from its regulated status.

- The ability of other elements of the regulatory framework to adequately address concerns about the interaction between regulated and non-regulated activities.[10]

This model for regulation is also similar to Synergies' suggestion of a 'calibrated' or 'differentiated rule book'.[11] These suggestions reflect a concern about the relative costs and benefits applying regulation in the market for various emerging technologies.

These are worthy considerations but we do not agree that this is a practical or effective approach for ring-fencing. Rather, we prefer a simple and consistent approach for ring-fencing that promotes competitive neutrality across all contestable services. Under the current NER, this would involve the AER classifying services through the Framework and Approach process and then applying a consistent approach, rather than a differentiated and highly complex framework that is tailored to individual services. We view alternatives such as the Synergies'

[10] AEMC (2015), op. cit.
[11] Synergies Economic Consulting (2016), op. cit.

or the AEMC's suggestion of a differentiated model as overly complex, difficult to interpret and administer, and reflective of a static view of markets and regulation.

The factors the AEMC refers to as a basis for differentiating ring-fencing arrangements are not only very difficult (if not impossible) to quantify with any certainty but will also change over time as technology evolves, the market matures or customer needs change. The potential harm to customers over the longer term in different markets will differ but the scale and how it might change can't be known with certainty.

Waivers

We see limited scope for the AER to issue waivers from the guidelines. We believe the possibility of a waiver undermines the policy intent of ring-fencing, particularly when there is regulatory discretion. Waivers also introduce complexity and uncertainty for all market participants.

The AER suggests that a waiver might be justified if a service is not potentially contestable or where there are no adverse effects on a contestable market. As with the 'calibrated' approach to ring-fencing (discussed above), it is difficult to quantify the precise harm to the development of any particular market when effective competition is undermined.

Therefore, our preference is to only use waivers in exceptional circumstances. The onus should be on networks to demonstrate that a waiver will not undermine competition. The AER should only grant a waiver following a rigorous and transparent assessment that includes stakeholder engagement and takes account of the full range of costs and benefits, including the detrimental impact on competition over the longer term.

We note that the AER was constrained in its assessment of Energex's waiver application in March 2016, stating that the QCA Guidelines did not 'contemplate competitive neutrality and broader market contestability issues'.[12] This further highlights the deficiency of current arrangements and the compelling need for a national guideline that seeks to promote effective competition across all contestable services.

Waivers should only be granted for a defined period, based on the expectation that market conditions will evolve. If a waiver is granted for the purposes of a trial, details of that trial should be made public. Even small scale projects and trials, such as Energex's Battery Energy Storage System trial and Ergon's Grid Utility Support System trial for which the AER granted ring-fencing waivers this year,[13] will generate important learnings and information that networks can apply in other contests and on a larger scale.

We also recommend that the AER should reassess current waivers once the new ring-fencing guideline is in place. We expect the AER may not have issued these waivers if a new national guideline that was better suited to the current state of the market for new technologies had been in place.

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12 Australian Energy Regulator (2016), *Final Decision: Energex application for waiver from Queensland Ring Fencing Guidelines.*

13 Details of Energex and Ergon's waiver applications are available at https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/ring-fencing-waivers

5. Conclusion

In summary, EnergyAustralia believes a national ring-fencing guideline is a high priority in light of the widely acknowledged deficiencies in the NER and the actions that many networks are now taking to develop capabilities in contestable services that will have an adverse effect on competition if allowed to proceed. Customers are the ultimate beneficiaries of effective competition in the market for emerging technologies such as advanced metering and storage. However, benefits won't be realised in an environment where networks have the ability and commercial incentive to exploit a competitive advantage.

We support many elements of the AER's preliminary position, 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 any 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, a requirement for networks to implement access controls between their regulated activities and for non-regulated activities, and strict disclosure obligations when they offer contestable services. At the same time, we see little benefit in undermining ring-fencing by allowing waivers from the guidelines (unless in exceptional circumstances and under strict conditions) or by differentiating obligations across different services.

The AER acknowledges it is constrained in the restrictions it can impose on networks, noting that structural separation of regulated from contestable business activities goes beyond the scope of ring fencing under the NER. The AEMC made numerous recommendations to improve the NER to improve outcomes for customers over the longer term. These included recommendations for the AER to review incentives structures for networks and current arrangements for connections. We recommend that all the AEMC's recommendations are implemented as a priority and look to the AER to comment on the adequacy of relevant aspects of the broader regulatory framework as it finalises its ring-fencing guideline. In particular, we welcome the AER's perspective on whether the NER's Cost Allocation Principles are fit for purpose when networks have an incentive to subsidise their affiliates who compete in markets for contestable services.

Should you require further information regarding this submission please call me on (03) 8628 1242 or Geoff Hargreaves on (03) 8628 1479.

Yours sincerely

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