ACCC Transmission Ring Fencing Guidelines

EnergyAustralia's waiver application
Supporting submission

December 2002

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1. Waiver application

Background

The ACCC released Ring fencing Guidelines (Guidelines) for Transmission Network Service Providers (TNSPs) on 15 August 2002. These Guidelines took effect on 1 November 2002. Prior to their release, EnergyAustralia (EA) made submissions to the ACCC in relation to the draft Guidelines on 16 October 2001 and 31 January 2002 respectively.

Clause 7 of the Guidelines sets out the minimum ring fencing obligations imposed on a TNSP. Clause 11 of the Guidelines provides that the ACCC may waive any of the TNSP's obligations under clause 7, if it is "satisfied that the benefit, or any likely benefit, to the public is outweighed by the administrative cost to the TNSP and its associates of complying with the obligation".

EA applied to the ACCC for a waiver of various sections of the Guidelines on 29 October 2002. The application was for a permanent waiver of the requirement for legal separation of EA's transmission and distribution network businesses, a permanent waiver of the requirement for each of these businesses to retain separate marketing staff, and a temporary waiver of the accounting separation requirements. The ACCC, by letter dated 30 October 2002, agreed that it would not seek to enforce the Guidelines while considering EA's waiver application. NECA also agreed not to enforce the Guidelines until the ACCC had made its decision on EA's application.

EA indicated in its initial application that it would submit further evidence to support the claims made. This submission contains information outlining the issues and costs associated with full compliance with the Guidelines.

EA's submission

EA believes that the costs involved in implementing legal separation between its transmission and distribution businesses are prohibitive, and that the public benefits that will arise from EA undertaking separation of these two regulated monopoly businesses will be negligible.

1. Legal Separation

Clause 7.1(a)(ii) of the Guidelines provides that a TNSP that supplies ring-fenced services (ie transmission services to which the revenue cap applies) must not carry on a related business (which includes distribution activities). This would effectively require EA to establish a new and separate body corporate, transfer all of its transmission network to that entity, and run that network as a wholly separate business.

(a) Function of EA's transmission assets

EA submits that the legal separation requirements of the Guidelines are not appropriate for EA, given the function of EA's transmission assets. This was acknowledged by the ACCC in discussions during the consultation period for the Guidelines. During this process, EA understood the ACCC's position to be that rather than develop separate guidelines for EA, the inappropriateness of some aspects of the Guidelines would be addressed through the waiver provisions. EA accepted this approach and has proceeded on the basis that a waiver would be granted.

EA operates predominantly as a distribution network service provider (DNSP). EA operates transmission lines because its network, which supplies Sydney's CBD, requires the use of these assets to effectively distribute electricity to customers.[1] These transmission assets are physically located within EA's distribution network. They form an integrated and essential part of the distribution network, helping to ensure that EA can meet its distribution service obligations. EA's transmission network does not provide a discrete set of transmission services to other DNSPs or other network users.

These assets are nonetheless defined as transmission assets under the National Electricity Code (Code), due to the fact that they form part of a loop of transmission assets in TransGrid's network, and they provide support services to that network. The Code definition of "transmission network" includes any part of a network operating at nominal voltages between 66 kV and 220 kV that operates in parallel to and provides support to the higher voltage transmission network. 12.4% of EA's assets are captured by this definition.[2]

Due to the location and function of EA's transmission assets, it would, from an operational and functional viewpoint, be very difficult to separate the operation of EA's transmission network from the rest of the distribution network. To do so would undermine the effective operation and functionality of the distribution network, and require a significant duplication of resources and systems at substantial cost. Furthermore, legal separation would not produce any public benefits to outweigh the significant costs involved.

As an aside, we note that EA is the only network business within the NEM that would need to restructure its business operations and legally separate parts of its integrated network in order to comply with the Guidelines. Although there are other DNSPs operating in the NEM who also operate high voltage network assets, either: (a) the DNSP is subject to a jurisdictional derogation that prevents the Code's definition of transmission assets from applying in that jurisdiction; or (b) the assets do not provide support services for the purposes of the definition of "transmission network"; or (c) the proportion of assets that are defined as transmission is too small to be of material concern to regulators. All other TNSPs captured by the Guidelines

[1] EA has a small number of customers that are connected directly to its high voltage network.
[2] As reported on page 3 of EA's 2001-02 ACCC Regulatory Financial Statements.

provide transmission services as their predominant business. Where they have related businesses, they are not likely to meet the materiality trigger of 5% contained in the Guidelines.

(b) Shareholder approval

It is not within EA's power to transfer its transmission assets to a new entity without the approval of its shareholders. EA is a statutory State owned corporation, constituted under the *Energy Services Corporations Act 1995* (NSW) (ESC Act) and governed by the *State Owned Corporations Act 1989* (NSW) (SOC Act). Sections 20Y and 20X of the SOC Act prevent EA from transferring any of its "main undertakings", or certain assets and investments, without the prior written approval of its voting shareholders. Shareholder approval is also required in order for EA to acquire a subsidiary (section 20W(2)). If the necessary shareholder approvals were not granted, EA would not be able to comply with the legal separation requirements of the Guidelines. Even if such approvals were granted, this process could take time.

(c) Administrative cost to EA and end-users

EA would be required to undertake significant changes to its existing business structure due to the legal separation requirements of the Guidelines. Legal separation will require significant initial set up costs and ongoing compliance costs. Legal separation would also force a significant amount of duplication of staff and systems, at substantial cost. Ultimately, EA's customers would bear the brunt of these costs.

EA staff have compiled a list of necessary tasks that would be required to legally separate the two network businesses, assuming that operational difficulties can be overcome. The following list of tasks and costs is indicative only and not exhaustive. A more accurate list could be determined through a detailed scoping study, but this is likely to be unnecessarily expensive and time-consuming.

Before implementing legal separation a series of decisions must be made regarding the structure of the business, the legal requirements, operational requirements, compliance issues, financial considerations and the new entity's trading identity. The following sections demonstrate the detail involved in some of these considerations.

Business and legal structure –

The legal separation of EA's TNSP business from its other businesses could be undertaken in a variety of ways. Decisions would need to be made up front and in consultation with EA's shareholders about the business model to be implemented and the relative independence of the two businesses from each other. Further resources will need to be spent reviewing EA's current business practices and the effectiveness and efficiencies of various models within the EA context. This process could cost EA in excess of $1m to complete.

In addition, there will be up front costs in developing and delivering the separation proposal to EA's shareholder, setting up the new entity, ensuring that its constitution and governance arrangements comply with any relevant legislation (eg the SOC Act), appointing a separate board and establishing secretariat functions. Legal services and registration fees during the set-up process could cost as much as $50 000 - 60 000.

Stamp duty –

To effect legal separation, EA's transmission network assets would be transferred to the new legal entity. Stamp duty may be payable of up to 5.5% of the value of the transferred assets, to the extent that they are dutiable property. EA does not have a general exemption from paying stamp duty, and a transfer from EA of its transmission assets may not be covered by existing specific exemptions.[3] EA may be able to apply to the Commissioner of State Revenue in NSW, under section 281 of the *Duties Act 1997* (NSW), for an exemption from stamp duty on the basis that the transfer of assets represents an internal restructure. If EA were not granted an exemption and were required to pay stamp duty on the transfer, this would represent a direct cost of legal separation that produces no consumer or public benefit. It is merely a transfer of wealth from consumers to the Office of State Revenue.

Financial considerations –

A transfer of debt would also need to be negotiated with shareholder approval. Issues to be considered include the credit rating status of the relevant entities. The financial arrangements would also need to ensure that the business was sufficiently creditworthy.

IT systems –

EA uses highly complex IT systems that may need to be duplicated if legal separation is required. These systems have annual licence fees that range from $1-10m depending on the system and ongoing maintenance contracts that are a significant percentage of the annual licence fee. These IT systems cover aspects of EA's business including billing, asset management and reporting, and network operation and control.

The current systems for which EA has licences are, in most cases, licensed for a single legal entity only. In order for a second legal entity to use these systems, new licences would need to be negotiated for use of many of the existing systems, or new licences may need to be purchased for the second entity. In either case, IT costs could double if a second legal entity was created. EA believes it unlikely that the costs of any renegotiated licences would be lower than they are currently given the commercial incentive IT companies may have to exploit EA's regulatory obligations to legally separate.

These licence costs do not include additional costs, which would be incurred for mainframe, hardware, and helpdesk facilities as well as IT development, which EA believes would be significant.

A clearer estimate of IT costs cannot be achieved without a full analysis of a specific business model for which quotes can be sought from the relevant IT providers.

Operational issues –

EA operates its network as a single network and it is not clear how the integrated, highly meshed network could be operated separately. One option may be for the network to be

[3] The transfer would not be covered by the exemption under section 20V of the SOC Act, as it is not a transfer from the State, an authority of the State or a subsidiary of an authority of the State. It would also not be covered by the exemption under clause 6 of Schedule 3 to the ESC Act (unless the transfer were made under clause 16 of Schedule 5 to that Act, which is unlikely).

operated by one business or the other, although this may be difficult to structure given the current ring fencing requirements which impact on the ability for EA to distribute information to its related businesses. Another potential option may be to outsource the operation of the network as a whole to a third entity, separate from both the distribution and transmission businesses. While this may work in an operational sense, it is difficult to see how a third entity (either private or a SOC) could bear the substantial financial and safety risks inherent in operating an electrical network, especially one that services Sydney's CBD. In the current climate of increased attention on public liability issues and the recent insurance industry crisis, it is difficult for such a business to operate without the backing of significant assets or other mechanisms to mitigate the substantial risks it would face as system operator.

Staffing issues –

Staffing issues may also be a difficult area of negotiation and could be time consuming. Any change to staffing arrangements, particularly where field staff are involved is likely to require extensive consultation and negotiation with union representatives.

Other duplication and general cost increases –

EA believes that the creation of legally ring-fenced transmission and distribution businesses is likely to require the re-creation of internal generic business services such as HRM and call centre services, which in the past have been the source of significant efficiency gains.

In addition, new contracts would need to be negotiated between the two EA business entities and with external suppliers, registration as a Code participant would need to be arranged, and intellectual property issues such as business names and trading identity would also need to be reviewed and developed, and relevant registrations attended to.

Duplication of staff, skills and assets will simply increase the costs (and therefore the inefficiencies) within the supply chain for no apparent benefit.

(d) Benefit to the public

EA cannot identify any public benefits that would result from undertaking the tasks outlined above. The costs involved in separation are significant and could be in the order of $10-15m with such costs clearly unjustified given that there are potentially no incremental public benefits.

Ring fencing is sought by regulators to meet two objectives. The first is a competition objective – to prevent favourable treatment or favourable trading terms being offered by a monopoly business to a competitive associated business which could inhibit fair competition from occurring between competitive businesses, either upstream or downstream. The second objective of ring fencing is a regulatory objective – to prevent cost shifting between businesses. These two objectives are related where cost shifting occurs between a monopoly business and an associated competitive business. In such circumstances cost shifting to the monopoly business may be used to favour the associated competitive business to give it an unfair advantage and therefore inhibit competition or to provide customers of a monopoly business with prices that are unnecessarily high.

At a basic level, ring fencing is required to ensure that competition is fair.

EA's transmission and distribution network businesses are both monopoly businesses. There are no competition benefits to be achieved by requiring legal separation of the two.

Competition concerns relating to cross-subsidisation are relevant where competitive and monopoly businesses operate within the same organisation. However, IPART's distribution ring fencing guidelines already cover the separation of competitive and monopoly distribution network businesses. Any overlap (and potential inconsistencies and duplication) between the distribution and transmission ring fencing guidelines should be avoided. Furthermore, cost shifting concerns are addressed through the ACCC's Information Reporting Requirement Guidelines, with which EA complies.

EA also notes that legal separation has been canvassed by several regulators in recent years. The ORG, the predecessor of the ESC in Victoria, when considering ring fencing requirements to be introduced in Victoria was sceptical about the success of legal separation in guaranteeing the removal of cost shifting. The ORG acknowledged that the proposed benefit of increased transparency may not eventuate even where legal separation has been required. In practice, wherever there are whole of business costs, costs will be apportioned to each legal entity. In such cases, a level of subjectivity will always exist when determining how the costs of such services are apportioned despite the entities' legal separation. The level of comfort that can be generated by legal separation is therefore no greater than that generated by implementation of effective accounting based ring fencing requirements. Unless ownership separation were to occur, which the ACCC has not signalled, concerns over the allocation of whole of business costs will not be alleviated by a move to legal separation.

(e) Temporary waiver

If EA is not granted a permanent waiver from these provisions, then it would at least seek a temporary waiver while appropriate structures were put in place.

2. Accounting separation

The ACCC released Reporting Guidelines on 23 Oct 2002 that give guidance to TNSPs seeking to comply with the accounting separation requirements (clauses 7.3, 7.4 and 7.5) in the Guidelines, which were released on 15 August 2002.

The Reporting Guidelines specify that certified annual financial statements are to be submitted to the ACCC which may be used by it to, amongst other things, monitor compliance with the revenue cap, assess the allocation of costs, and determine future revenues caps. The Reporting Guidelines also provide for the ACCC to seek other information from TNSPs and undertake an audit if necessary. However, the ACCC stated in the Reporting Guidelines that it does not intend to implement any reporting requirements in addition to the Information Requirements that already apply to TNSPs from this financial year (ie 2002-03). The ACCC specified in the Reporting Guidelines that "the obligations imposed on TNSPs under clauses 7.3, 7.4 7.5 and 13 of the Transmission Ring Fencing Guidelines are consistent with the obligation under the Information Requirements Guidelines."

That being the case, and after receiving confirmation by ACCC staff in a meeting on 21 November 2002 that a transaction based system is not required in order to comply with the Information Requirement Guidelines, EA believes it now complies with the accounting separation requirements of the Transmission Ring Fencing Guidelines.

On this basis, EA believes it no longer needs a temporary waiver from the accounting separation requirements of the Guidelines at this time. EA wishes to withdraw the request for a temporary waiver of the accounting separation requirements. However, EA may reinstate this application should it believe that it will not be in a position to comply with these requirements for the 2002-03 financial year.

The following section demonstrates the methodology used by EA to comply with the ACCC's Information Requirements. It also provides further explanation of EA's intentions to generate schedules that up to this point have not been submitted, but which will be submitted in 2003-03 to ensure EA's full compliance.

EA's current practice: TNSP regulatory accounts

The Regulatory Financial Statements that EA has submitted to the ACCC to date have been derived from regulatory accounts maintained by EA as part of its compliance with IPART's reporting requirements for prescribed distribution services. The Regulatory Financial Statements for 2001-02 were audited by PriceWaterhouse Coopers and were submitted to the ACCC on 28 October 2002.

The Regulatory Financial Statements submitted to the ACCC are derived using an allocation methodology. EA allocates costs between its distribution and transmission businesses because it does not utilise a reporting system that assigns costs to individual assets. EA's systems assign costs to asset classes such as substation, underground cable or classes of lines based on line voltage (ie 11kV or 132kV lines).[4]

[4] 66kV and above are a clearly identifiable class (or classes) of assets. If the definition of transmission assets in the Code aligned with 66kV and above, allocation would be very straightforward.

An allocation methodology is consistent with the ACCC's Information Requirement guidelines, which specifically allow for allocation to be used where costs cannot be directly attributed to specific assets and where the use of an allocation can be justified on the basis of compliance costs (section 3.3.9 of the Information Requirements).

EA attributes direct costs to the transmission business where such costs occur, for example, property, plant and equipment that are identified as being transmission assets. Where costs are incurred on a non-causal basis they are allocated to the transmission business based predominantly on the proportion of EA's total network assets defined to be transmission assets.[5]

The definition of transmission assets included in the Code is not based on financial criteria or based on specific asset classes but is related to whether the assets are operated in 'parallel' to other transmission assets. Thus assets that have the same physical characteristics and maintenance requirements can be considered as transmission or distribution assets dependent on whether they operate as parallel or radial assets.[6]

EA's accounting and IT systems assign costs to asset classes which crosses over the transmission and distribution definition. EA therefore makes an allocation of costs using a robust and audited methodology. EA's directors, in their responsibility statement that accompanies the Regulatory Financial Statements, considered that the non-causal allocations would approximate actual costs for the prescribed transmission network services over the longer term.

Further information regarding EA's allocation methodology is included in EA's Regulatory Financial Statements.

EA submitted its 2001-02 Regulatory Financial Statements to the ACCC for the 'prescribed services segment' of its network (ie its transmission business) in October 2002. As mentioned above, there were five schedules with which EA would need to produce to comply with the Information Requirement guidelines for 2002-03. EA notified the ACCC of this in a letter dated 20 September 2002 and again when the Regulatory Financial Statements were submitted on 28 October 2002. The following schedules were not provided:

- Cash flow schedule
- Asset aging schedules
- Causal allocation schedule
- Price Reduction/Recovery schedule
- Tax schedule
- Tax was excluded from the P&L

Cash flow statement – The cash flow statement required by the ACCC's Information Requirement guidelines is a reconciliation of EBIT to operating cash flow. EA does not operate a separate bank account or ledger for its transmission business. To derive a cash flow

[5] While the underlying allocation methodologies remain consistent, allocation percentages vary slightly between years depending on the actual costs. For example, opex costs are allocated based on the proportion of transmission assets to total network assets excluding easements because easements are not a driver of opex costs. See Appendix A for more details.

[6] EA operates 132kV lines that operate in parallel to Transgrid's transmission assets and other 132kV lines that are radial.

statement for the transmission business alone, the statement would be generated based on the profit and loss and the movement in balance sheet items. EA believes that it will be possible to submit a derived cash flow statement with its regulatory accounts next financial year.

Asset aging schedules – EA is able to submit asset aging schedules for its transmission assets. However, it is not possible to generate an aging profile for non-system assets because these assets are allocated across all of EA's businesses.

Causal allocation schedules – EA assigns costs to asset classes rather than individual assets. EA therefore does not allocate costs on a causal basis for its transmission business. EA believes there is little point in submitting this schedule as it would be blank.

Price Reduction/Recovery schedule – This schedule is an additional schedule contained in the final Information Requirement Guidelines released on 5 June 2002 and will be required for the 2002-03 financial accounts. EA believes it can provide this schedule.

Tax schedules – EA is a taxpaying entity. EA does not separate its tax affairs into its business units because it pays tax on a consolidated basis. In order to submit the tax schedule required by the ACCC, EA would need to generate a schedule based on balance sheet items and consolidated tax figures. EA believes that it will be possible to generate this schedule at the end of this financial year and thereby fulfil the ACCC Information Requirements. However, EA staff believe that further clarification is needed to determine the exact information that the ACCC requires in this schedule. The current explanation is somewhat ambiguous and needs to be clarified prior to the 2002-03 accounts being finalised.

EA notes that developing a tax schedule for its transmission business would have no value for tax purposes but would be generated simply to meet ACCC's accounting separation and reporting requirements.

P&L (income tax charges net of deferred tax has not been shown) – EA has included an allocation of income tax in the Regulatory Financial Statements to date. As mentioned above, EA now believes it can derive a tax schedule for its transmission business and insert this figure into P&L in future statements.

EA believes it can generate the schedules listed above for the Financial Statements for 2002-03 and thereby fully comply with the ACCC Information Requirements and the accounting separation requirements in the Transmission Ring Fencing Guidelines.

4. Separation of marketing staff

EA has sought a permanent waiver from the requirements in the Transmission Ring Fencing Guidelines that enforce separation of marketing staff. The waiver has been sought because the definition of marketing staff contained in the Guidelines is ambiguous and may have unintended impacts on EA. Furthermore, some terms contained in the definition lose meaning in the context of a single legal entity.

EA's network business undertakes marketing campaigns but the network business does not contain specific marketing staff. These campaigns are paid for by the network business but are effectively outsourced to another business division within EA.[7] The campaigns instigated by the network business are limited to public education about network operations and to safety related issues such as tree trimming. There are also campaigns relating to general safety around electricity both in the home and in the neighbourhood which are run to coincide during school holidays to educate young Australians and families about the dangers of electricity. The campaigns are undertaken to fulfil regulatory requirements for education and safety and do not relate to sales or sale promotions.

EA's safety and educational campaigns do not involve the transfer or use of commercially sensitive information. In fact, the campaigns benefit all users within EA's distribution area regardless of whether they are customers that belong to EA or customers that have switched to another retailer.[8]

The problem arises because the definition of marketing staff contained in the Guidelines does not specifically exclude network operational staff that may advise on the content of public education campaigns. The definition excludes staff that perform technical, administrative, accounting or service functions. However, EA believes there is sufficient ambiguity within the definition and its exclusions to apply for a waiver from this clause.

Should the advisory functions of network staff be captured by the marketing staff definition, EA strongly believes that the requirement for staff separation is impractical for its business. Where common ownership exists, it is efficient to streamline staff where possible, provided that competition and cost shifting concerns are addressed. In the case of EA's network marketing campaigns, there are no commercially sensitive information flows between the division that undertakes the publishing/marketing function and the division that instigates the campaign and pays for it. Similarly, there are no cost shifting issues. The Information Requirement Guidelines require EA to directly attribute costs (including marketing costs) to specific business divisions where possible. Corporate marketing costs like other corporate costs (including company branding) are allocated to the network businesses in a way consistent with the Information Requirement Guidelines. Therefore, clauses 7.7 and 7.8 in the Guidelines are simply not relevant to effective ring fencing of EA's distribution and transmission businesses.

A further and more general point relates to the way the term 'associate' is defined throughout the Guidelines. 'Associate' is defined in relation to the Corporations Act, which assumes legal separation. If EA is successful in its application to be exempt from legal separation, it will remain a single entity and will have no associates. Clauses 7.7 and 7.8 which require marketing staff separation will lose meaning, as will other clauses such as clause 7.6. This issue should be considered by the ACCC when making its decision as to whether it should

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[7] EA already has functional separation of its marketing function.

[8] EA is happy to report in more detail on Network related "marketing" activities related to safety.

grant the waivers requested. This will ensure that the remainder of the Guidelines continue to apply to EA.