

Draft Decision

Application for Waiver of Ring-Fencing Arrangements by EnergyAustralia

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Commissioners:
Samuel
Sylvan
Martin
McNeill
Willett

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Glossary

ACCC	Australian Competition and Consumer Commission
code	National Electricity Code
Guidelines	Transmission Ring-Fencing Guidelines
EA	EnergyAustralia
IPART	Independent Pricing and Regulatory Tribunal of NSW
kV	Kilovolt
NECA	National Electricity Code Administrator
NEM	National Electricity Market
NEMMCO	National Electricity Market Management Company
SOC Act	<i>State owned Corporations Act (NSW) 1989</i>
TNSP	Transmission Network Service Provider

Executive summary

Introduction

Part G of Chapter 6 of the National Electricity Code (code) requires that the Australian Competition and Consumer Commission (ACCC) develop ring-fencing guidelines.

On 15 August 2002, the ACCC published its Statement of Principles for the Regulation of Transmission Revenues Transmission Ring-Fencing Guidelines (Guidelines).

The Guidelines separate the accounting and functional aspects of prescribed services from those of other services provided by the Transmission Network Service Providers (TNSPs). Under clause 6.20.1 of the code, all TNSPs have to comply with the Guidelines.

Process

EnergyAustralia (EA) submitted a waiver application to the ACCC on 29 October 2002 and a submission supporting its application on 13 December 2002. EA has requested that the ACCC:

- waive EA's obligations under clause 7.1(a)(ii) of the Guidelines
- clarify the application of clauses 7.7 and 7.8 of the Guidelines.

On 4 February 2003, the ACCC invited interested parties to make submissions on EA's waiver application. The ACCC did not receive any submissions.

EnergyAustralia's Ring-Fencing Waiver Application

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. The National Electricity Code Administrator (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. The additional submission was submitted to the ACCC in December 2002 and was subsequently posted on the ACCC's website¹. EA's submission is composed of three main parts relating to i) legal separation, ii) accounting separation and iii) separation of marketing staff. Each of these parts is summarised below.

Legal Separation

According to clause 7.1(a)(ii) of the Guidelines:

¹ <http://www.accc.gov.au>

a TNSP that supplies ring-fenced services: must not carry on a *related business*.

Ring fenced services are defined as transmission services to which a revenue cap applies and related business is defined as the activities of generation, distribution and electricity retail. EA contends that compliance with the aforementioned clause would require the establishment of a new and separate body corporate to which all of its transmission network would have to be transferred. The transmission network would thus be run as a separate business. EA contends that such a requirement is not practicable given its circumstances. EA cites several reasons for this specifically noting the function of its transmission assets, shareholder approval, administrative costs to EA and end-users, and the benefit or lack thereof to the public.

EA notes that if it were not to be granted a permanent waiver from these provisions, then it would at least seek a temporary waiver while appropriate structures were put in place.

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. However, the ACCC stated in the Reporting Guidelines that it did not intend to implement any reporting requirements in addition to those in the Information Requirements Guidelines that already applied to TNSPs from that financial year (i.e. 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 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.

Separation of marketing staff

EA has sought a permanent waiver from the requirements in the Guidelines that enforce separation of marketing staff. The waiver has been sought because EA believes that the definition of marketing staff contained in the Guidelines is ambiguous and may have unintended impacts on its organisation. Furthermore, EA believes that 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. 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.

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. According to EA, Clauses 7.7 and 7.8 which require marketing staff separation will lose meaning, as will other clauses such as clause 7.6.

ACCC staff analysis and position

Having considered this case, the ACCC is of the view that:

- there will be significant costs associated with meeting this particular ring-fencing requirement. The ACCC has reviewed these costs and accepts that they are based on reasonable estimates
- there is no apparent public benefit in enforcing the ring-fencing requirement that EA's transmission services be a separate legal entity
- EA's distribution business is currently regulated by the Independent Pricing and Regulatory Tribunal of New South Wales (IPART). IPART has a comprehensive set of ring fencing guidelines to which EA adheres. These guidelines apply to the separation of contestable and non-contestable services of EA's distribution and retail businesses. Furthermore, IPART regulates EA's distribution business and requires comprehensive financial reporting similar to that required by the ACCC regarding EA's transmission assets. Hence, the opportunity to cross-subsidise between transmission and distribution is extremely limited.

The ACCC notes that EA's transmission service activities will remain subject to all other aspects of the Guidelines and that being subject to a separate regulatory regime, assets, costs and accounting records will need to be separately identifiable.

In regards to the issue of 'staff separation' the ACCC believes that the issue will be redundant if it waives clause 7.1(a)(ii) as requested by EA. If this happens it can be assumed that the staff in question will continue to be employed by EA, the same legal entity which supplies transmission services. Even if their activities are such that the staff can be characterised as 'marketing staff', there would be no breach of clauses 7.7 or 7.8 because they would not be employees of an 'associate that takes part in a related business' (per 7.7(a)(i)). Nor would the staff be 'marketing staff of an associate that takes part in a related business' (per 7.7(b)(i)).

Draft Decision

The ACCC's draft decision is to issue a notice under section 11 of the Transmission Ring Fencing Guidelines to waive EA's requirement to comply with ring-fencing obligations under clauses 7.1(a)(ii) and 7.7(a)(i).

1. Introduction

Part G of Chapter 6 of the National Electricity Code (code) requires that the Australian Competition and Consumer Commission (ACCC) develop ring-fencing guidelines.

On 15 August 2002, the ACCC published its Statement of Principles for the Regulation of Transmission Revenues Transmission Ring-Fencing Guidelines (Guidelines).

The Guidelines separate the accounting and functional aspects of prescribed services from those of other services provided by the Transmission Network Service Providers (TNSPs). Under clause 6.20.1 of the code, all TNSPs have to comply with the Guidelines.

The Guidelines require a TNSP to establish arrangements to segregate (i.e. ring-fence) its business of providing regulated transmission network services from other services. The aim is to separate as far as possible the monopoly powers of TNSPs from the contestable activities of generation and retail supply. Under the Guidelines, a TNSP must be a legal entity and, in general, not engage in electricity generation, distribution or retail. In practice, legal separation can be thought of as structural separation in that the TNSP is prohibited from competing with the other firms using its network.

Legal separation between a TNSP's prescribed and other services is required as accounting separation alone does not effectively prevent discrimination against a competing network user. Furthermore, accounting separation cannot effectively be used to promote entry into the contestable network user segment of the electricity market.

According to the Guidelines, a TNSP must not preferentially deal with itself and any related utility in such a way as to discriminate against other access seekers. The prices that the TNSP charges access seekers should not disadvantage them when competing with the TNSP or an associate of the TNSP in another market. The preamble to the Guidelines states, as one of the objectives of the Guidelines, the necessity to stem the flow of information between the TNSP's regulated activities and competitive activities. For this reason, the Guidelines state that marketing staff of a TNSP should not also work for an associate in a related business and vice versa. One of the aims of the Guidelines is to ensure that decisions and actions in competitive activities (such as retail) are based on access prices that are published and verifiable.

EnergyAustralia (EA) submitted a waiver application to the ACCC on 29 October 2002 and a submission supporting its application on 13 December 2002. EA has requested that the ACCC:

- waive EA's obligations under clause 7.1(a)(ii) of the Guidelines
- clarify the application of clauses 7.7 and 7.8 of the Guidelines.

On 4 February 2003, the ACCC invited interested parties to make submissions on EA's waiver application. The ACCC did not receive any submissions.

2. Ring-fencing determination requirements

2.1 Procedures for waiving ring-fencing obligations

Section 7 of the Guidelines details the minimum ring-fencing obligations imposed on TNSPs operating within the National Electricity Market (NEM). A TNSP also has the right to seek a waiver from any of its obligations under section 7. The right is provided under section 11 of the Guidelines. Specifically, section 11, states:

The ACCC may, by notice to the *TNSP*, waive any of the *TNSP*'s obligations under clause 7 provided that the ACCC 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.

Note: In deciding whether to waive any of the *TNSP*'s obligations under clause 7, the ACCC may consider any additional obligations that can be imposed under clause 9.

2.2 EnergyAustralia's submission

Section 7 of the Guidelines prescribes the minimum ring-fencing requirements that TNSP's within the NEM must comply with. The obligations that EA seeks a waiver from is clause 7.1(a)(ii) which states that a TNSP that supplies ring-fenced services:

subject to clause 7.1(b), must not carry on a related business. To avoid doubt, if the *TNSP* is a member of a partnership, joint venture or other unincorporated association, the *TNSP* is carrying on the activities of the partnership, joint venture or unincorporated association.

EA is also seeking clarification of the application of clauses 7.7 and 7.8 of the Guidelines. Sections 7.7 and 7.8 detail the minimum requirements in relation to marketing staff. Specifically, 7.7 and 7.8 state the following:

- 7.7 A *TNSP* that provides ring-fenced services must:
- (a) (i) ensure that its *marketing staff* are not also servants, consultants, independent contractors or agents of an associate that takes part in a *related business*; and
 - (ii) in the event that its *marketing staff* become or are found to be servants, consultants, independent contractors or agents of such an *associate* contrary to clause 7.7(a)(i), procure their immediate removal from its *marketing staff*; and
 - (b) (i) ensure that none of its servants, consultants, independent contractors or agents are *marketing staff* of an *associate* that takes part in a *related business*; and
 - (ii) in the event that any of its servants, consultants, independent contractors or agents are found to be the *marketing staff* of such an *associate* contrary to clause 7.7(b)(i), procure their immediate removal from their position with the *TNSP*.
- 7.8 A *TNSP* that provides ring-fenced services must notify the ACCC if:
- (a) any of its servants, consultants, independent contractors or agents are, or will be, servants, consultants, independent contractors or agents of an *associate* that takes part in a *related business*; or
 - (b) any servants, consultants, independent contractors or agents of an *associate* that takes part in a *related business* will be servants, consultants, independent contractors or agents of the *TNSP*.

The Guidelines define related business as the activities of generation, distribution and retail.

3. The ACCC's analysis and position

As stated in the introduction, on 29 October 2002, EA submitted a waiver application to the ACCC and a submission supporting its application on 13 December 2002. The waiver would allow the transmission network services of EA to continue to operate as a related business within the legal entity of EA.

For the purposes of this draft decision, transmission network includes any part of a network operating at nominal voltages between 66kV and 220kV that operates in parallel to and provides support to the higher voltage transmission network. According to EA, 12.4% of its assets are captured by this definition.

On 4 February 2003, the ACCC placed EA's waiver application on its website², calling for submissions on the application by no later than 3 March 2003. The application together with calls for submissions were mailed to all Jurisdictional Regulators and interested parties as is required by the code.

The ACCC did not receive any submissions on EA's application.

EA's submission is composed of three main parts relating to i) legal separation, ii) accounting separation and iii) separation of marketing staff. Each of these parts is summarised below.

Legal Separation

EA contends that compliance with the aforementioned clause 7.1(a)(ii) would require the establishment of a new and separate body corporate to which all of its transmission network would have to be transferred. The transmission network would thus be run as a separate business. According to EA such a requirement is not practicable given its circumstances. EA cites several reasons for this specifically noting the function of its transmission assets, shareholder approval, administrative costs to EA and end-users, and the benefit or lack thereof to the public.

In regards to the function of transmission assets, EA operates transmission lines because its network, which supplies Sydney's CBD, requires the use of these assets to effectively distribute electricity to customers. These transmission assets are physically located within EA's distribution network. They form an integrated and essential part of the distribution network. Fundamentally, EA's transmission network does not provide a discrete set of transmission services to other Distribution Network Service Providers or other network users.

These assets are nonetheless defined as transmission assets under the 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. EA points to the code definition of "transmission network" which 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 <http://www.accc.gov.au>

With respect to shareholder approval, according to EA, it is not within their 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) 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. EA notes that even if such approvals were granted, this process could take time.

If the waiver were not granted, 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. EA notes that ultimately the end-user would bear the brunt of these costs.

According to EA, the legal separation of its 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.

To affect 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. Furthermore, 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.

In regards to IT and general operational issues, EA uses highly complex IT systems that may need to be duplicated if legal separation is required. These systems, according to EA, 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.

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

owned corporation) 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.

According to EA, 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.

Public Benefits

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

According to EA, 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 apply to the separation of contestable and non-contestable services. 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 Requirements Guidelines, with which EA complies.

EA notes that if it were not to be granted a permanent waiver from these provisions, then it would at least seek a temporary waiver while appropriate structures were put in place.

Accounting separation

EA notes that the ACCC's Reporting Guidelines released on 23 Oct 2002 give guidance to TNSPs seeking to comply with the accounting separation requirements (clauses 7.3, 7.4 and 7.5) in the 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 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 has effectively withdrawn the request for a temporary waiver of the accounting separation requirements. However, EA notes that it 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.

Separation of marketing staff

EA has sought a permanent waiver from the requirements in the 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, EA contends that 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. 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.

According to EA, 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.

ACCC analysis and position

Having considered this case, the ACCC is of the view that:

- there will be significant costs associated with meeting this particular ring-fencing requirement. The ACCC has reviewed these costs and accepts that they are based on reasonable estimates
- there is no apparent public benefit in enforcing the ring-fencing requirement that EA's transmission services be a separate legal entity
- EA's distribution business is currently regulated by the Independent Pricing and Regulatory Tribunal of New South Wales (IPART). IPART has a comprehensive set of ring fencing guidelines which EA adheres to. These guidelines apply to the separation of the contestable and non-contestable services of EA's distribution and retail businesses. Furthermore, IPART regulates EA's distribution business and requires comprehensive financial reporting similar to that required by the ACCC regarding EA's transmission assets. Hence, the opportunity to cross-subsidise between transmission and distribution is extremely limited.

The ACCC generally considers the requirement of legal separation a necessary aspect of transmission businesses, particularly in effectively separating any upstream or downstream business activities from the monopoly business. This reinforces the ACCC's commitment to eliminate cross-subsidies, enforce stringent accounting separation and to eliminate perverse incentives to undertake anti-competitive

behaviour. However, the ACCC considers that each case should be judged on its merits.

It is important to note that EA's transmission service activities will remain subject to all other aspects of the Guidelines and that being subject to a separate regulatory regime assets, costs and accounting records will need to be separately identifiable.

In regards to the issue of the separation of marketing staff, EA argues that the term 'marketing staff' may capture a certain number of EA's staff who EA considers should not be caught. EA notes that certain staff of its network business contribute to public campaigns about network operations and safety issues unrelated to sales and promotions. EA is concerned that, on one view, these staff are within the definition of 'marketing staff' under the Guidelines.

The ACCC believes that the issue will be redundant if it waives clause 7.1(a)(ii) as requested by EA. If this happens it can be assumed that the staff in question will continue to be employed by EA, the same legal entity which supplies transmission services. Even if their activities are such that the staff can be characterised as 'marketing staff', there would be no breach of clauses 7.7 or 7.8 because they would not be employees of an 'associate that takes part in a related business' (per 7.7(a)(i)). Nor would the staff be 'marketing staff of an associate that takes part in a related business' (per 7.7(b)(i)).

4. The ACCC's draft decision

The ACCC's draft decision is to issue a notice under section 11 of the Transmission Ring Fencing Guidelines to waive EA's requirement to comply with ring-fencing obligations under clauses 7.1(a)(ii) and 7.7(a)(i).