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30 May 2016

Mr Chris Pattas
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Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001
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Dear Mr Pattas

Submission on the Electricity Ring-Fencing Guideline Preliminary Positions

Ergon Energy Corporation Limited (Ergon Energy) welcomes the opportunity to provide comment to the Australian Energy Regulator (AER) on its *Electricity Ring-Fencing Guideline Preliminary Positions Paper*. This attached submission is provided by Ergon Energy, in its capacity as a Distribution Network Service Provider (DNSP) in Queensland.

Should you require additional information or wish to discuss any aspect of this submission, please do not hesitate to contact either myself on (07) 3851 6416, or Trudy Fraser on (07) 3851 6787.

Yours sincerely

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Submission on the *Electricity Ring-Fencing Guideline Preliminary Positions Paper*

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Australian Energy Regulator

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This submission, which is available for publication, is made by:

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Introduction

Ergon Energy Corporation Limited (Ergon Energy) welcomes the opportunity to provide comment to the Australian Energy Regulator (AER) on its *Electricity Ring-Fencing Guideline Preliminary Positions Paper* (Preliminary Positions Paper). This submission is provided by Ergon Energy, in its capacity as a Distribution Network Service Provider (DNSP) in Queensland.

As a member of the Energy Networks Association (ENA) the peak national body for Australia's energy networks, Ergon Energy has also contributed to and is fully supportive of the issues raised in the ENA's submission.

Ergon Energy welcomes this opportunity and step taken by the AER in commencing these discussions as it has long been argued by Ergon Energy that certain provisions of the current, Queensland Ring-Fencing Guidelines [as developed by the Queensland Competition Authority (QCA)] no longer support a framework that is minimally disruptive to the provision of core distribution services, whilst not inhibiting competition or the achievement of the National Electricity Objective (NEO).

Fundamentally, Ring-Fencing Guidelines should exist only to the extent that they enhance the NEO and are within the realm of best practice regulation. They should not create regulatory uncertainty.

Key Messages

Ergon Energy's key messages are outlined below and should be considered by the AER in drafting a national Ring-Fencing Guideline:

- Ergon Energy supports the development of a national and contemporary approach to ring-fencing. We consider that adopting a suitably structured national approach to ring-fencing will provide certainty to market participants and not deter investment and innovation. Providing a framework that looks to enhance competition and provides minimal disruption to the provision of core distribution services, whilst balancing the NEO is paramount.

- We agree with the AER's preliminary position that services should be ring-fenced and not assets. However, notwithstanding this, Ergon Energy is concerned that changes in the electricity sector, through emerging technologies and associated cost changes mean that by setting these services in for a 5 year period may inadvertently lock out new technologies that DNSPs are utilising to offer Standard Control Services and Alternative Control Services. The Ring-Fencing Guideline should not create any uncertainty, for DNSPs, the market more generally and consumers.

- Ergon Energy is concerned regarding the fluid use of some key terms in this Positions Paper. For example, the Positions Paper discusses an option in that contestable and potentially contestable services are subject to ring-fencing. Ergon Energy understands that ring-fencing obligations are intended to apply to the regulated entity delivering regulated distribution services. It is critical to ensure that there is no ambiguity so as to provide certainty to DNSPs.

- The AER should review existing mechanisms and safeguards in the National Electricity Rules (NER) and the Australian Consumer Law as part of its investigation in developing a Ring-Fencing Guideline. A Ring-Fencing Guideline should not look at duplicating existing safeguards as duplication will result in costs increases which will not benefit the long term interests of consumers and may result in increases in the cost of providing Standard Control Services. Accordingly, a Ring-Fencing Guideline should supplement and enhance existing protections. Some examples of existing safeguards in the economic regulatory framework include the following:
    - The cost allocation arrangements through the Cost Allocation Method. These provide direct attribution of a regulated business's costs or the allocation of shared costs between different categories of distribution services and other non-regulated sections of the business.
    - The regulatory determination process - This process ensures that the regulator examines and approves the costs proposed by the regulated business in delivering network services. It also looks at proposals to offer unregulated services. This process is transparent and looks for economic efficiencies and provides consumers and interested stakeholders visibility of the determination process.
    - The AER's Expenditure Forecast Assessment Guideline – This Guideline sets out related party arrangements and the AER's two staged approach to assessing related party contracts and margins. The AER examines arms' length transactions including the contracts and assesses the efficiency of the costs in supporting these contracts.
    - The Shared Asset Guidelines – The NER provides that, where an asset is used to provide both standard controls services and distribution services that are not classified or services that are neither distribution services or services provided in connection with dual function assets, the AER may reduce a DNSP's annual revenue requirement (ARR) by such amount that it considers reasonable to reflect such part of the costs of that asset that the DNSP is recovering through charging for the provisions of unclassified or non-distribution services.[1] The AER must have regard for the Shared Asset Guidelines when making a decision to reduce a DNSP's ARR. This Guideline ensures that there is no over cost recovery of a shared asset through additional revenues.
    - Regulatory Investment Test for Distribution (RIT-D) – In applying the RIT-D, DNSPs must consider all credible options without, among other things, bias to ownership. This reinforces a positive obligation on DNSPs to consider non-discriminatory behaviour when dealing with all proposed distribution investments (with some exceptions) that look to "promote efficient investment in distribution networks in the National Energy Market by ensuring there is greater consistency, transparency and predictability in distribution investment decision making"[2].

  The AER should have regard for the above mentioned safeguards whilst developing a Ring-Fencing Guideline, on the basis that they already protect consumers and competitive market participants against unfair, anti-competitive and discriminatory behaviour.

- The regulatory framework has been established to encourage DNSPs to provide innovative unregulated solutions for customers. Ergon Energy notes the view presented by the Australian Energy Market Commission (AEMC) in their Draft Rule Determination on the *Economic*

[1] NER, clause 6.4.4(a).
[2] AER, *Better Regulation: Regulatory investment test for distribution Application Guidelines*, 23 August 2013.

Regulation of Network Service Providers, that DNSPs should be encouraged to share assets to promote innovation by NSPs whilst also providing for cost reflectivity to consumers. [3] Ergon Energy supports this view. The AER should balance the promotion of innovation and flexibility with good regulatory practice so as to ensure that the proposed Ring-Fencing Guidelines do not stifle innovation and exclude DNSPs from offering solutions to customers.

- Ergon Energy considers that the AER's proposed approach of "all in, and then obtain an individual waiver" has the potential to be onerous, excessively costly, and may not best serve the long term interests of consumers. In Ergon Energy's experience a good example is having separate Human Resources (HR) staff performing HR functions for a regulated business and unregulated business. In this situation, the overhead costs associated with providing Direct Control Services would increase and Ergon Energy queries whether this is in the long term interests of consumers. Ergon Energy also notes the example of having to send separate field crew in separate vehicles to a single job (i.e. where a regulated and unregulated activity are performed concurrently), all at cost to the consumer. Ergon Energy also queries whether this is in the long term interests of consumers – especially where the unregulated service would be offered to all parties on a non-discriminatory basis. With this in mind, Ergon Energy believes that the AER should also focus on the efficiency benefits of economies of scope when balancing the practical implications of implementing this approach.

- Greater clarity and detail is required from the AER in order to understand operationally how the Ring-Fencing Guidelines will work in practice. Particularly on the classification of services process, the Shared Asset Guideline, bulk waivers, fast track waiver process, grandfathering of existing waivers, and transitional arrangements. Ergon Energy also requests detail on how the Ring-Fencing Guideline will interact with policy intent of other Schemes and mechanisms.

[3] http://www.aemc.gov.au/getattachment/01fab6cf-8f45-4be7-8b2f-b5eee325c51b/Draft-determination.aspx

Electricity Ring-Fencing Guideline Preliminary Positions

Question(s)	Ergon Energy Response
1. What aspects of the current jurisdictional ring-fencing arrangements have or have not worked well?	Ergon Energy considers that the current Ring-Fencing Guidelines that apply in Queensland work well in the following regard: • The waiver process and the certainty provided in terms of precedents being set and conditions imposed; • The requirement to submit a high level Annual Ring-Fencing Report demonstrating compliance when aligned with demonstration of appropriate costs allocation and adjustments for sharing assets via Regulatory Information Notice (RIN) reporting; • The ability to report exceptions, for example staff movements, rather than adopting a Ring-Fencing Protocol; • The certainty provided for by allowing DNSPs to implement a Ring-Fencing Protocol for shared staff; and • Assumption by the Regulator that compliance is implicit, that is, the onus is on the DNSP to demonstrate compliance. Current aspects of the Ring-Fencing Guidelines that apply in Queensland that have not worked well, include the following: • The difficulty faced by the AER in being able to apply a consistent approach because of different jurisdictional requirements and applications by previous jurisdictional regulators; • The Ring-Fencing Guidelines in Queensland and more generally other jurisdictional Guidelines have not been updated to align with current regulatory arrangements nor do they take consideration of current market conditions and developments. In essence they are antiquarian and outdated. This leaves DNSPs and ultimately customers with high costs to test new and innovative markets. Due to this inflexibility, DNSPs and customers do not receive benefits; and • The Ring-Fencing Guidelines do not allow for a fast track waiver process.

2. Do you consider these objectives discussed in section 2.1 adequately reflect the harm ring-fencing is seeking to avoid and the benefits of an even playing field?	In principle, Ergon Energy agrees with the AER's proposed objectives in that the Ring-Fencing Guidelines should operate to prevent anti-competitive outcomes. However, we recommend that the Ring-Fencing Guidelines should adopt a light-handed approach to regulation. Ring-fencing arrangements should, as far as possible, streamline and simplify the requirements and obligations on distribution businesses. They should not involve additional complexity and regulatory burden, or be overly prescriptive. They should seek to balance these objectives against the long-term interests of consumers and not assume that ring-fencing is 'beneficial to consumers' especially in emerging markets. Furthermore, ring-fencing should not preclude or diminish the possible role of DNSPs in the provision of other competitive services such as advanced metering services and demand management services when efficiency benefits are demonstrated.
3. Which services should be ring-fenced? Do you agree with the service classification approach to ring-fencing which is discussed in section 3.3 (outlined below)? Is there a better alternative?	Ergon Energy supports in principle the proposed service classification approach to ring-fencing. However, the Ring-Fencing Guideline needs to provide detail regarding circumstances in which a service classification may change during the Final Determination process. Further, there is a risk that the proposed approach may capture more services than necessary. Without full clarity and detail around the proposed approach to the service classification process, DNSPs may for example be prevented from engaging in demand side participation activities to alleviate network constraints. There needs to be certainty when developing this process to ensure that there is no increase to compliance costs, which is counter-intuitive to the long term interests of consumers. Ergon Energy recommends the Ring-Fencing Guidelines should adopt a light-handed approach to regulation in conjunction with other regulatory mechanisms. Please refer to the upfront discussion under the Key Messages for more information on this matter.
4. Does the proposed approach to ring-fencing adequately deal with the prospects for development of the	Ergon Energy's notes that more often than not, it's the DNSPs that promote and initiate the use of innovative technologies in the DER market. As such we are concerned that the AER's approach to ring-fencing may inhibit a DNSP's ability

contestable market for DER?	to use DER devices for the provision of unregulated services where that use is efficient. Additionally this may inadvertently act as a barrier to allowing DNSPs use of regulated infrastructure and thus be detrimental to the long term benefits of consumers. As noted earlier, the AEMC during their discussion in the Draft Rule Determination on the *Economic Regulation of Network Service Providers* supported the use of regulated assets to provide innovative services on an unregulated basis. Please refer to upfront section under Key Message for more information on this matter.
5. Are there other ring-fencing obligations we should impose on NSPs that provide services into contestable markets?	Ergon Energy considers that less intrusive obligations or even complete removal of some obligations should be considered as alternatives to the ones proposed. For example, proposed obligation (b), *not locate a ring-fenced service at the same physical location as the DNSP*, should not be included. From Ergon Energy's perspective, our related retailer, Ergon Energy Queensland Pty Ltd, which is prevented from competing for customers in the competitive market, would be required to be housed in a separate building to Ergon Energy. This would be extremely costly and onerous with no demonstrative benefit. In addition it seems to be counter-intuitive to the AER's rationale that the services are ring-fenced. Further, Ergon Energy considers that other regulatory mechanisms, such as the Shared Asset Guideline and the information restrictions between regulated and unregulated related businesses would adequately deal with this. Obligation (h), *ensure information obtained by the DNSP is not disclosed to any party without the informed approval of the customer or prospective customer to whom it pertains*, should only apply in exceptions. For example under the NER, there are many provisions where information is required to be provided to certain parties.
6. What costs would be incurred in meeting these obligations?	Ergon Energy considers that the following costs will be incurred in meeting the ring-fencing obligations: • The costs of setting up a separate legal entity; • Appointment of an external auditor to undertake compliance assessment annually; • Physical location establishment costs; • Duplication of IT infrastructure costs; • Duplication of staff costs (in event that Ring-Fencing protocol is not

	considered appropriate); and • Inability to use regulated assets for unregulated services resulting in the need to duplicate assets.
7. Should asset sharing be restricted between regulated services and contestable service provision?	Ergon Energy considers that regulation should encourage network businesses to pursue innovative provision of network services, including the provision of unregulated services. Asset use should not be confined but rather be allowed to develop and mature with the market. As such, DNSPs should be encouraged to use regulated assets for the provision of unregulated services where that use is efficient. This view was presented early by the AEMC during their discussion in the Draft Rule Determination on the *Economic Regulation of Network Service Providers*. Please refer to upfront section under Key Message for more information on this matter.
8. Do the factors set out above reflect the issues we should consider in deciding whether to grant a ring-fencing waiver?	Ergon Energy considers that in addition to the factors outlined by the AER in the Preliminary Positions Paper, the AER should also consider including a cost-benefit analysis of ring-fencing when considering granting a ring-fencing waiver. Similarly to the QCA's approach to granting Ring-Fencing waivers, a DNSP should be entitled to seek and receive a waiver, if they can demonstrate that the administrative costs of complying outweighs the benefit to consumers.
9. In which circumstances should the customers of ring-fenced services and not customers of the DNSP's services in general pay the additional costs of complying with ring-fencing obligations?	Ergon Energy's view is that the regulated DNSP should be responsible for the costs associated with complying with the Ring-Fencing Guidelines not the customers of the unregulated business. This view is premised on the fact that it's the DNSP's obligation to comply with the Ring-Fencing Guidelines. It should also be noted that everyone who pays Standard Control Services and Alternative Control Services charges will pay increased costs if separate legal entities and other obligations are enforced than otherwise allow economies of scope to prevail.
10. How else could the AER minimise the administrative cost of ring-fencing while maintaining the integrity of its approach?	The AER should consider reliance on existing safeguards and mechanisms to reduce the administrative cost of ring-fencing. For example, the current annual reporting requirements associated with the RIN, Schedule 1, Clause 2.4 requires Ergon Energy to describe the process we have in place to monitor compliance with the Queensland Competition Authority, Final Determination - Electricity

	Distribution: Ring Fencing Guidelines, September 2000 (or any Ring-Fencing Guideline the AER may develop under clause 6.17.2 of the NER). In addition, we must list all instances of non-compliance, including the date of the non-compliance event, reason for the non-compliance, impact on customers, impact on competitors, and any remedial action taken by Ergon Energy. For more information on other existing safeguards and mechanisms please refer to the discussion under the Key Messages section.
11. Is it reasonable for the AER to consider these transitional arrangements to the new ring-fencing guideline?	Yes. It is paramount that certainty is provided for DNSPs that already have existing waivers in place and how long DNSPs will have to address current practices that become non-compliant with the new national Ring-Fencing Guideline. Ergon Energy does not agree with the AER's proposal that one year is reasonable for DNSPs to be able to comply with the new Ring-Fencing Guideline. At this stage we do not have an indication of what detail will be provided in the Guideline, especially as it relates to the waiver process – fast track, bulk waiver and ordinary waiver process – and we have no knowledge yet as to how the classification of services will operate in terms of the new ring-fencing requirements. Without this detail it is difficult to advise how long the transition period should be. However, the more significant the change, the longer the transition period that will be required. The AER should give consideration as to whether to align full implementation of the Ring-Fencing Guideline with the next Distribution Determination for each business such that the Guideline can be considered as part of the development of the classification of services and the implications fully consulted with customers as part of the stakeholder engagement associated with that process.
12. How can we ensure ring-fencing compliance is robust and effective without imposing excessive costs that may ultimately be borne by consumers?	To ensure that ring-fencing compliance is robust and effective, and doesn't result in excessive costs to consumers, the AER should have regard to the long term interests of consumers as defined by the NEO. The current enforcement mechanisms are appropriate and as such no additional measures are required.