



28 September 2016

Mr Chris Pattas
General Manager – Network Investment and Pricing
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3000

Email: Ringfencingguideline2016@aer.gov.au

Dear Mr Pattas

RE: SUBMISSION TO AER'S DRAFT RING-FENCING GUIDELINE

Origin Energy (Origin) appreciates the opportunity to provide input to the Australian Energy Regulator's (AER) development of a nationally consistent ring-fencing guideline.

The electricity sector is currently entering an unprecedented phase of technological progress where services once considered monopolies are now better delivered through contestable markets. Therefore, ring-fencing must remove the ability of regulated network monopolies to distort competitive markets, especially new and emerging markets that are driving the development of innovative energy and energy-related products and services.

Origin retains its position that the most effective means of achieving this objective is structural separation. However, we accept that the AER does not currently have the powers to apply this model. Notwithstanding, Origin is strongly supportive of the AER developing a nationally consistent ring-fencing guideline that replaces the existing jurisdictional schemes. Developed, implemented and administered correctly, this will eliminate the inconsistencies that currently exist and will provide stakeholders with greater certainty around the operation of contestable and potentially contestable energy-related markets.

Origin's responses to specific issues in the guideline are set out below.

Definitions

The ring-fencing guideline (the guideline) requires that a distribution network service provider (DNSP) must only provide network services. The guideline also requires that a DNSP must allocate costs between distribution and non distribution services and that it must apply physical separation between direct control services and related bodies corporate providing energy-related services.

We believe the AER's use of different terminology creates confusion and inconsistency in how the guideline is to be applied.

Specifically, there are slight differences between the definition of a network service and a distribution service in National Electricity Rules (the Rules); the former excludes any connection assets.

Furthermore, as part of its classification of services, the AER has specifically defined a network service as:

- planning the network;
- designing the network;
- constructing the network;
- maintaining the network;
- operating the network; and
- administrative support for provision of network services.

This AER definition of network service would provide for a much narrower application than the definition of either distribution or network service set out in the Rules as well as the definition of a Direct Control Service; all of which include different separation obligations in the guideline.

We understand the intent of the guideline is the separation of services as set out in Figure 1 of the explanatory paper. Notwithstanding, to ensure the guideline is internally consistent, workable and able to be audited, it is necessary that unambiguous and consistent definitions are applied through both the guideline and the explanatory statement and that these definitions are consistent with other complementary guidelines and the Rules.

Furthermore, to avoid misinterpretations we believe the guideline needs to provide definitions for all defined terms where these do not exist, for example energy-related services.

Materiality

The guideline includes a provision to allow a DNSP to undertake non-network activities up to a threshold of \$500K per annum. The AER suggest that these services are incidental to, but necessary to support the provision of a DNSP's network services.

In doing so, a DNSP would still be required to apply cost allocation and attribution as well as adhere to the functional separation and information sharing obligations set out in the guideline. The difference between full compliance and the materiality provision is that the latter appears to allow a relaxation of the condition for a DNSP to establish a separate legal entity where the costs of providing the activity fall below \$500K per annum.

However, this is contrary to the guideline that core ring-fencing obligations in relation to legal separation, cost allocation and information protection cannot be waived.

Origin considers that if a service is 'necessary to support the provision of a network services' then it would meet the definition of a network services as set out in the AER's classification of services. In turn, these costs would then be recovered through regulated revenues. On that basis, it is not clear why any network services would need an exemption from ring-fencing compliance.

In the event that there is a regulatory or legislative obligation imposed on a DNSP to undertake certain non-network activities, then we believe the ring-fencing waiver provisions are a more appropriate mechanism to deal with these circumstances.

Where this is not the case, we consider that the AER needs to clearly define the circumstances and services where its proposed materiality threshold would apply and why these circumstances would necessitate a departure from one of the core attributes of the guideline. In our view, introducing materiality thresholds for compliance will diminish the integrity of the ring-fencing regime and should only be applied in extenuating circumstances.

Information Access and Sharing

Non-discrimination seeks to eliminate the ability of a DNSP conferring a competitive advantage to its related businesses that provide contestable energy-related services. The guideline requires that where a DNSP acquires information in providing direct control services and shares that information with a related business, it must provide access to that information on an equal basis to third party competitors of the related business.

Origin considers that this provision must be broadened.

It is essential that the DNSP provide exactly the same level of information, connection standards, turnaround times etc to all parties at the same time to ensure a level playing field; not just on an as requested basis. Making the information available to the market would act as a mechanism to stimulate competitive outcomes for behind the meter network support services. It would enable a range of service providers to offer different solutions while building a greater understanding of emerging network issues; this in turn can facilitate greater competition going forward. Failure to ensure all relevant information is provided on equal terms will create a bias towards a DNSP's related business and limit the effectiveness of the market.

An example of how a DNSP would make this information available is through a portal such as the system limitation template envisaged by the AEMC's draft rule determination on local generation network credits. A DNSP could signal to the market through the portal the types of services it requires in specific geographic locations and over what time period. Not only would this meet the obligation of equal access to information, but it would act as a mechanism to stimulate competitive outcomes for behind the meter network support services and contribute to the NEO.

Relationship with Other Regulatory Instruments

The guideline operates in tandem with other key regulatory guidelines and instruments namely: the cost allocation guideline; cost allocation methods; shared asset guideline and the regulatory information instruments.

The shared asset guideline sets out the arrangements when regulated assets are used to generate unregulated revenues. A key feature of the shared asset principle is to ensure that the DNSP does not recover the costs of network assets twice; once from regulated revenues and again from unregulated revenues.

Origin understands that when a DNSP establishes an asset it determines the proportion of the asset use for regulated purposes and the portion for unregulated using a DNSP's cost allocation method. A shared asset arises when the use of the regulated asset changes after its initial cost allocation.

The AER will make a cost reduction if the unregulated use of the shared assets is expected to be greater than one per cent of the DNSP's total smoothed annual revenue for that regulatory year. For larger networks such as Energex and Ausgrid this trigger amount is of the order of \$17M per annum, with the cost reduction being 10 per cent of shared asset unregulated revenues. We understand from the regulatory information notices submitted by both Energex and Ausgrid as part of their most recent regulatory proposals that neither DNSP forecast triggering this threshold.

Origin has a number of concerns with respect to the arrangements governing the use and payment of shared assets in the context of creating a level playing field for contestable services: 1) how does the AER determine how much each third party has paid for the use of the regulated asset; and 2) if the one per cent threshold is not triggered then how are cross-subsidies for shared asset use monitored.

We recognise that the ring-fencing guideline requires a DNSP to deal with competitors of its related businesses on substantially the "same terms". However, we believe the shared asset principles fall

outside of “same terms”. Because a regulated asset has already been fully allocated, how does the AER know to whom and for what price that asset has been subsequently provided. In the case of a vehicle, what incentive is there for a DNSP to charge a related business a market rate for the use of that vehicle when it may already be fully recovered in the asset base. Under such a scenario, the DNSP is financially indifferent, yet its related business is able to obtain a cost advantage by virtue of its relationship with the DNSP which in turn places it at a distinct competitive advantage over other market participants.

For these reasons, we believe the arrangements governing the use and payment for shared assets must be re-assessed in the context of the ring-fencing guideline. In particular, we believe that where a related business operating in energy-related services uses a shared asset, the rate paid for the use of that shared asset must be commensurate with a market rate. Furthermore, shared asset transactions between the DNSP and related businesses must be reported to the AER as part of the DNSPs’ annual compliance reporting.

Establish and Maintain Accounts

The current cost allocation guidelines were approved in 2008, and in the case of the Victorian DNSPs their cost allocation guidelines are still based on the Essential Services Commission cost allocation guidelines developed in 2003.

One of the principal reasons for establishing a national ring-fencing guideline was that the jurisdictional guidelines are no longer fit for purpose. This reasoning must also extend to key supporting guidelines such as cost allocation. On the basis that existing guidelines have remained in place since 2008, it is essential that they are reviewed as a matter of priority to ensure they are fit for purpose and support the integrity of the revised national ring-fencing guideline. This review must be undertaken consistent with the distribution consultation procedures set out in the Rules.

Staff-sharing

The guideline requires that staff directly involved in the provision of direct control service cannot be involved in the provision or marketing of a competitive or contestable energy related service by a related party.

While we believe there a number of definitional matters to resolve in the guideline, we note that the staff sharing provisions do not apply to staff involved in both negotiated and unregulated services.

We understand a less prescriptive regulatory approach is applied to negotiated services because all relevant parties have sufficient market power to negotiate the provision of those services. However, these are nevertheless network services. On that basis, staff directly involved in negotiated services must be ring-fenced from the provision or marketing of a competitive or contestable energy-related service of a related business.

Furthermore, the guideline allows a senior executive of both a DNSP and a related party to be shared staff. As a result, these staff are in the unique position of making decisions to optimise the performance of both the DNSP *and* its ring-fenced related businesses. While these staff must nevertheless adhere to the ring-guideline, a higher standard of compliance must apply in these circumstances; including access to board minutes and personal penalties for breaches.

Furthermore, to ensure that staff movements are able to be monitored and audited, there must be an explicit obligation on the DNSP to maintain and submit at regular intervals, or when certain conditions are triggered, a shared staff register. This register must include staff shared across the DNSP and its related business, whether these staff had previously held positions directly involved in network services, when they held these positions and how often they have switched.

Furthermore, Origin seeks clarification on what the AER deems an acceptable level and frequency of staff movements and what prohibition would apply if the AER's acceptability levels are breached.

Waivers

The guideline allows a network to apply in writing to the AER for a waiver from the functional separation provisions.

The AER must assess any application taking into account: 1) the National Electricity Objective; 2) the potential for cross-subsidisation and discrimination; and 3) whether the benefit or likely benefit to consumers would be outweighed by the costs of the network complying with that obligation.

The guideline also allows the AER the discretion on whether to publicly consult on any application.

We believe that irrespective of the nature of a waiver application, to ensure the integrity and transparency of the ring-fencing regime the AER must consult publicly on all waiver applications. We accept that in some instances it may be practicable to adopt a simpler process, however, engagement with stakeholders must be retained.

Also, to provide greater certainty regarding how the AER will assess an application, we consider that the AER should develop an assessment framework that clearly sets out how costs and benefits will be defined and used in a cost/benefit assessment. Furthermore, we believe the AER also needs to establish stringent pre-defined criteria regarding how claims for commercial in confidence will be assessed. While we recognise that waiver applications to date have been assessed under jurisdictional guidelines, we have been disappointed with the level of detail presented in those applications and the ease with which commercial in confidence has been obtained.

With respect to existing waivers, the AER has indicated that it will review each of the existing waivers before the guideline takes effect. Origin strongly supports the position taken in the AER's assessment of recent waiver applications to require a DNSP to comply with the national ring fencing guideline within 12 months of them being established. We believe that previous waivers should lapse at the end of this 12 month moratorium with full compliance then required. To the extent that a DNSP considers that a waiver is still applicable, the onus must be on the DNSP to apply for a continuation under the new guideline. We believe retaining waivers under a previous regime creates unnecessary inconsistencies and distortions in how ring-fencing is applied.

Compliance and Enforcement

The guideline requires the DNSP to prepare an annual compliance report which includes an assessment of compliance by a suitably qualified independent authority. The guideline allows the AER to publish from time to time a report regarding the DNSPs' compliance.

Origin considers that the AER must undertake its own assessment of compliance and not rely solely on the assessment of a proponent engaged by the DNSP. In addition, we believe the AER must publish its assessment annually by a specified date to provide the market confidence that ring-fencing is operating as intended. Consistent with our views on waiver applications, we believe the AER needs to establish stringent pre-defined criteria regarding how claims for commercial in confidence will be assessed with respect to what is disclosed in a DNSP's annual compliance report.

In terms of a breach, the guideline does not include a civil penalties regime. Origin is concerned that a compliance framework with only enforcement powers and no mandated penalties will not act as a credible threat. For this reason, we encourage the AER to apply a more severe penalties regime.

Closing

The availability of emerging technologies to residential customers and small business on a commercial basis is relatively recent. The market is immature but is emerging through increased numbers of entrants and an expansion of products and services.

It is essential that the AER ring-fencing guideline provides the market governance to promote competition. This in turn will promote choice and innovation which will complement other key reforms such as competition in metering and network tariffs.

We believe the ring-fencing guideline provides an appropriate structure. However, there remains a number of attributes, as we have defined, and supporting guidelines that require either strengthening or review.

We would welcome the opportunity to discuss our view further with the AER. If you have any questions regarding this submission please contact Sean Greenup in the first instance on (07) 3867 0620.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'R. Keith Robertson'.

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