



# Power and Water Corporation – Response to Consultation on AER Ring- Fencing Guideline (version 3)

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D2021/288057

**PowerWater**

# Overview

Power and Water Corporation (Power and Water) is pleased to provide detailed feedback and comment in response to consultation on version 3 of the Australian Energy Regulator's (AER) Ring-Fencing Guideline (the Guideline).

Ring-fencing plays an important role in the development and efficient operation of competitive markets. Over time there may be the need for obligations to evolve to reflect market and technology changes, and changes in customer expectations and preferences in how they use and consume electricity.

Our submission is focused on the need for further amendments to the Guideline to better accommodate Power and Water's unique operating circumstances, and reflect differences in market conditions and competitive pressures in the Northern Territory (NT) relative to other jurisdictions. We are concerned that without further amendments, the Guideline will result in adverse outcomes for Territorians, as measures are too broad and impose restrictions which are onerous and disproportionate to the potential risk of market harm.

Power and Water has proposed minor amendments to the Guideline aimed at addressing concerns and issues we have identified with the Guideline's current operation in the NT. We believe these amendments will allow the Guideline to better achieve its policy objectives and will promote outcomes for Territorians that are more consistent with the achievement of the National Electricity Objective (NEO), as they result in clearer and more targeted obligations.

Our submission is structured around three main themes:

1. **Current issues with the Guideline** – this section is aimed at providing further context on why aspects of the Guideline are considered problematic and difficult to achieve compliance with in practice.
2. **Promoting greater transparency and clarity of ring-fencing obligations** – this section seeks to demonstrate the benefits from having a separate NT version of the Guideline.
3. **Improving the Guideline's effectiveness and workability in the NT** – this section outlines minor amendments to the Guideline (which would be specific to the NT) aimed at ensuring that ring-fencing measures are clearer, targeted, and proportionate to the potential risk of market harm.

Each of these themes are discussed in further detail below.

## 1. Current issues with the Guideline

Power and Water is finding current arrangements under the Guideline to be overly prescriptive, rigid, and complex. We have found it difficult and costly to meet our obligations under the Guideline due to:

- the breadth of services Power and Water provides and the geographically dispersed nature of our operations (refer to Appendix 1 for further details)
- the adoption of our new Operating Model which centralises and groups services by 'like' function rather than by line of business to capture cost savings and efficiencies
- limitations with existing Information Communication Technology (ICT) systems, which do not allow for classification of data and information flows at a granular level
- the need for Power and Water to maintain compliance levels for a host of services and activities as though they are contestable, even though they are subject to jurisdictional regulatory oversight, and are not contestable in the true sense (i.e. other service providers are not willing or able to provide the same services).

Power and Water also has the added complexity of being subject to jurisdictional ring-fencing requirements under the Utilities Commission (UC) Ring-Fencing Code. We have found it challenging and difficult to try and design controls that allow us to meet obligations under the Guideline and UC Ring-Fencing Code without the need to create separate (and potentially duplicative) processes and procedures.

## 1.1 Why a one-size fits all approach does not work in the NT

The AER's Ring-Fencing Guideline is developed on the premise that:

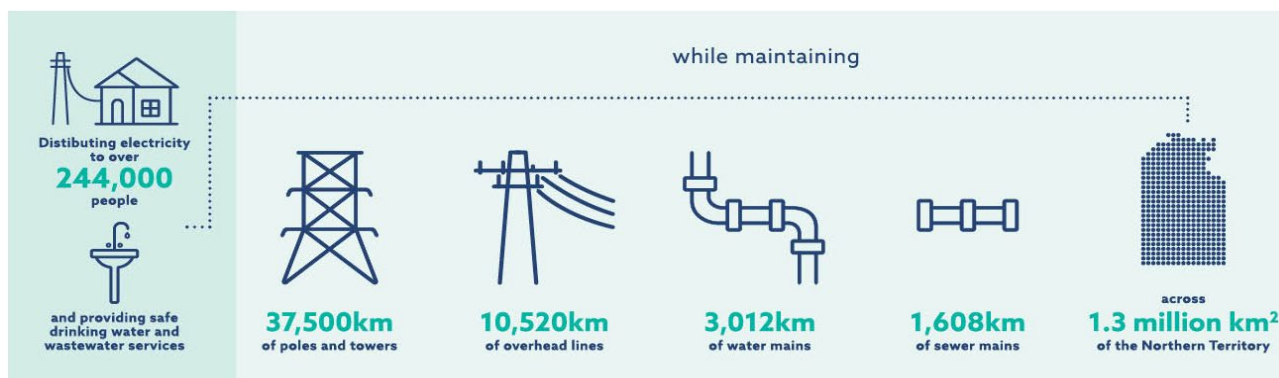
- the core nature of the distribution network service provider's business (DNSP) is the supply and conveyance of electricity to end-users
- anything not classified as a direct control service is contestable, and that competitive markets exist for the provision of these services
- service providers are willing and able to provide services
- no other mechanism exists to safeguard against anti-competitive behaviour.

While these assumptions generally hold true and are appropriate in National Electricity Market (NEM) jurisdictions they do not reflect operating circumstances or market conditions in the NT.

### **Electricity supply is just one of many services that Power and Water provides**

Power and Water is a multi-utility that provides a broad range of essential services (including gas, electricity, water, and sewerage) to Territorians in 90 different (mostly unconnected) communities across 1.3 million square kilometres, as highlighted by Figure 1 below. The essential services we provide are, for the most part, non-contestable and governed by a range of statutory and licence requirements.

**Figure 1 – Our services**



It is important to note that only a portion of Power and Water's total business is subject to economic regulation by the AER, and therefore subject to ring-fencing requirements under the AER's Guideline. Specifically, the Guideline only applies in respect to Power and Water's Darwin-Katherine interconnected system, Alice Springs, and Tennant Creek systems, which services communities with a population in the order of 185,000 people and is only slightly more than the total population of Randwick (156,619).<sup>1</sup>

Power and Water also owns and operates a number of electricity networks which are not subject to AER oversight.<sup>2</sup> These networks supply electricity (and in limited areas generation and retail services)<sup>3</sup> to approximately 59,000 customers (including 72 remote communities). The costs associated with our non-regulated networks are either recovered via Community Service Obligations from the Department of Housing or directly from retailers.

Consequently, the supply and conveyance of electricity represents just one of the essential services that Power and Water provides to Territorians.

<sup>1</sup> ABS, Estimate Residential Population: Randwick City, 30 June 2020.

<sup>2</sup> Refer to Utilities Commission, Power and Water Corporation – Network Licence, 31 March 2020, clause 15.

<sup>3</sup> Refer to Utilities Commission, Power and Water Corporation – Retail Licence, 30 April 2015, Schedule 2 and Utilities Commission, Power and Water Corporation – Generation Licence, 30 June 2015, Schedule 2.

### ***Most services deemed ‘contestable’ by the Guideline do not have alternative service providers***

Compliance with the AER’s Guideline requires Power and Water to treat all its remote and regional electricity networks, as well as its market operator and system control functions, as ‘contestable electricity services.’ This assumes that Power and Water *chooses* to provide these services to capture additional revenue streams and earn commercial profits. While this assumption may hold true in other jurisdictions, it is not the case in the NT. Power and Water is *required* to provide these services, as part of its licence conditions, as there are no other service providers willing or able to provide these services to customers located in parts of our network operating area (typically those outside of urban areas).

Because the Guideline is based on the assumption that all services not classified as ‘direct control services’ are contestable and must be ring-fencing from the regulated activities of the DNSP, it results in the Guideline treating Power and Water’s non-AER regulated electricity activities as ‘contestable electricity services’ by default. Full application of the Guideline dictates legal and functional separation of some of these services into affiliate entities. Modifications to the Guideline under the *National Electricity (Northern Territory) (National Uniform Legislation) (Modification) Regulations 2016* (NT NER) removed the need for legal or functional separation, recognising Power and Water’s status as a multi-utility. However, this also complicated the compliance requirements of these services within the existing entity. This results in the application of the Guideline being too broad and the need to implement controls, despite the fact that competition for the provision of these services in most cases does not exist.

This is particularly problematic for Power and Water under its new Operating Model, which groups services by ‘like’ function rather than line of business. We have adopted this structure in an attempt to capture economies of scope, as the NT does not have the same opportunities to capture economies of scale as other jurisdictions.

An unforeseen consequence from our Operating Model and the default treatment of our non-AER regulated electricity activities as contestable, is that this results in several of Power and Water’s business units (or parts of these business units) being classed as a ‘related electricity service provider’ (RESP) or part RESPs. The classification of these services as contestable and the need to identify RESPs and report at a transactional level has made achieving compliance with the Guideline burdensome and complicated. We are concerned that meeting Guideline requirements relating to the treatment of RESPs will drive higher costs and significant operational inefficiencies across the business without commensurate benefits to customers or the market.

### ***Different competitive pressures and market conditions exist in the NT relative to other jurisdictions***

The NT has a relatively small (246,500)<sup>4</sup> yet geographically diverse population, which is comparable to the population of Wollongong (219,7985)<sup>6</sup> but is spread over a network operating area that roughly equates to the size of New South Wales (including ACT) and Victoria combined. Consequently, relative to other jurisdictions the NT is a high fixed cost to serve area, which is also subject to harsh climatic conditions. It does not have the same opportunities for capturing efficiencies of scale and scope as other jurisdictions, meaning that there is less appetite for service providers to operate in the NT.

It is also important to note that electricity competition in the NT is still very much in the early stages of development. Up until 2016, the electricity supply chain in the NT was vertically integrated. Retail competition is relatively limited, with only five retailers - of which Jacana Energy dominates with approximately 90% of market share.

In addition, unlike other jurisdictions, prices are regulated regulation in the NT for all customers consuming under 750 MWh per annum. The ministerially imposed Pricing Order sets a cap on the prices that customers can be charged for electricity and related services, regardless of whether customers are connected to Power and Water’s regulated or non-regulated network.<sup>7</sup> While the Pricing Order acts as an important safeguard for promoting a level playing field and ensuring that customers receive commensurate prices regardless of their service provider – this may act as a disincentive for service providers, and as a result there are very few customers below 750 MWh per annum on a retail market contract.

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<sup>4</sup> <https://nteconomy.nt.gov.au/population>

<sup>6</sup> Australian Bureau of Statistics (ABS), Estimate Residential Population: Wollongong, 30 June 2020.

<sup>7</sup> <https://utilicom.nt.gov.au/electricity/price-regulation/electricity-retail-pricing>

It is also worth noting that the Northern Territory Electricity Market (NTEM) is currently going through a period of significant transition change. The NT Government is currently consulting on the optimal design of the market and the associated market reforms to:<sup>8</sup>

- facilitate increasing market participants; and
- support the update of emerging technologies to enable the achievement of NT Government's 50% renewable energy target by 2030

while maintaining secure, reliable and least cost electricity for Territorians.

Given inherent differences in the NT's operating circumstances, competitive pressures, market conditions, and limitations associated with our ICT systems - applying a Guideline developed for NEM jurisdictions in the NT results in complications which are difficult to resolve and outcomes which are disproportionate to the risk of market harm. When combined with obligations which are intentionally rigid in order to achieve consistency, as well as a high compliance threshold, Power and Water's ability to achieve compliance with Guideline requirements in a short period of time become particularly challenging without incurring significant additional cost.

This is a significant concern for Power and Water. Our cost per customer are already higher than our peers and we have the smallest customer base of any network service provider regulated by the AER. Ultimately the cost of complying with obligations under the Guideline is a cost borne by consumers. We are particularly concerned that this may result in Territorians having to pay higher than necessary electricity prices from Guideline obligations creating inefficiencies in our operations and restricting our ability to flexibly manage our network, utilise least cost options, and deliver services that our customer's value.

We have proposed a range of minor amendments to the Guideline so that the benefits from ring-fencing outweigh the associated cost of compliance and better achieve the intended policy outcomes and objectives. Further details on proposed amendments are further discussed in Section 3.

## 2. Promoting greater transparency and clarity of obligations

Under current arrangements, there is only one published version of the Guideline. We consider that there is the need for a separate NT version of the Guideline to be published (which would reflect the current Guideline amended for any modifications applied by the Northern Territory Government). This would help in clarifying how ring-fencing obligations apply in the NT and would allow the AER to better tailor obligations under the Guideline to better accommodate the NT's unique operating circumstances whilst still ensuring that competitive neutrality and market confidence is maintained.

### ***The need for a separate published version of the Guideline for the NT***

Under both the existing (version 2) and proposed version 3 of the Guideline it is not readily apparent to readers that the Guideline applies differently in the NT. We consider that this has the potential to create confusion with both stakeholders and service providers, and may give rise to the expectation that the Guideline applies in the same way as it does in other jurisdictions.

Modifications were made to how the Guideline applies in the NT through the *National Electricity (Northern Territory) (National Uniform Legislation) (Modification) Regulations 2016* (NT NER). Specifically, changes were introduced under clause 6.17.1B of NT NER, which amends the application of certain definitions under the Guideline and removes restrictions around the need for legal separation, staff and office sharing, and branding. These changes were made to accommodate Power and Water's role as a multi-utility providing a broad range of essential services (including gas, electricity, water, and sewerage).

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<sup>8</sup> Refer to Northern Territory Government, Department of Industry Tourism and Trade, Northern Territory Electricity Market Reform Program (<https://industry.nt.gov.au/projects-and-initiatives/business/northern-territory-electricity-market-priority-reform-program>)



Not having a separate NT version of the Guideline creates confusion and complexity in trying to determine how the Guideline applies in the NT. It has also made it more difficult for Power and Water to assess how proposed changes under version 3 of the Draft Guideline are likely impact our operations and has made communicating our ring-fencing obligations to other stakeholders (particular service providers) challenging.

Publishing a separate NT version of the Guideline is likely to promote greater transparency and clarity on how ring-fencing applies in the NT. We consider that this would be more preferable than including drafting notes and maintaining the one version of the Guideline. We consider the inclusion of drafting notes may add further complexity to the Guideline and give rise to the risk of stakeholders and/or service providers confusing what ring-fencing restrictions apply in the NT versus other jurisdictions.

We note similar precedent already exists for adopting this approach, with the Australian Energy Market Commission (AEMC) publishing and maintaining a separate version of the National Electricity Rules (NER) for the NT to reflect its modified application and unique operating circumstances.

### 3. Improving the Guideline's workability and effectiveness in the NT

The following section outlines minor NT specific amendments to the Guideline aimed improving the operation of the Guideline to address issues and concerns outlined in section 1. Amendments and their rationale discussed in this section include:

- Improving the flexibility of the Guideline by removing restrictions on the ability to seek waivers
- Amending the definition of 'contestable electricity service' so that it is more targeted towards capturing services that are actually subject to competition
- Removing the requirement to report accounting and information flows at a transactional level
- The need for longer transitional timeframes.

#### ***Improving the flexibility of the Guideline by removing restrictions on the ability to seek waivers***

Power and Water's ability to meet its obligations under the Guideline would be significantly enhanced if it had the ability to seek a waiver from all requirements under the Guideline. Currently the ability to seek a waiver from obligations under the Guideline is limited to obligations under clauses 3.1, 4.2, 4.4.1(a).

In our correspondence to the AER on 19 April 2021, we identified a number of practical issues associated with meeting certain Guideline requirements.<sup>9</sup> These issues primarily relate to existing limitations with ICT systems, which do not allow for classification of data and information flows at a granular level, and legacy issues surrounding the consistent treatment and use of terminology for alternative control services (ACS) and standard control services (SCS) for work relating to Power and Water's regulated and non-regulated networks.

Unfortunately the areas where we are experiencing difficulty in achieving full compliance, are areas in which we cannot seek a waiver from (specifically requirements imposed under clause 3.2.1(a), 4.3.3, 4.3.4, 6.2.1(b)(iv), 6.2.1(c)). Our preference would be to have the ability to seek a waiver from all requirements under the Guideline, rather than relying on a letter of no action from the AER for gaps in our compliance we know cannot readily or easily addressed due to legacy and system limitation issues.

The ability to seek a waiver from any of the requirements under the Guideline would allow the AER more flexibility to address Power and Water's unique operating circumstances, and differences in market conditions and competitive pressures in the NT. It would also enable Power and Water to propose alternative measures for meeting the Guideline's requirements, without compromising the consistent application in NEM states or the robustness of

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<sup>9</sup> Refer to Power and Water Corporation Ring-Fencing Compliance – Progress Update (D2021/145020), 19 April 2021.

Guideline protections aimed at promoting competition. This is because the ability to seek a waiver does not necessarily mean that a waiver will be granted. Rather, the granting of a waiver is predicated on the DNSP being able to demonstrate:

- extenuating circumstances justifying the need for the waiver;
- any additional measures the DNSP proposes to take should the waiver be granted;
- the potential for cross-subsidisation or discrimination should the waiver be granted; and
- that the benefit to consumers from granting the waiver outweighs the cost of the DNSP complying with that obligation.

Power and Water believes that the waiver requirements outlined in clause 5 of the Guideline are rigorous. This process balances the need to accommodate individual circumstances against the need to maintain competitive neutrality and market confidence.

### ***The need to amend the definition of ‘contestable electricity service’***

Many of the compliance issues could be resolved if an NT specific definition of ‘contestable electricity service’ was applied. While the definition refers to “contestable” services, it is in fact neutral as to whether or not the ‘other distribution service’ or ‘other electricity service’ is provided in a competitive market or whether there is the potential for such a market to develop. The definition is able to hold in NEM jurisdictions with an interconnected grid under a single regulatory and market framework, but does not consider the multi-layered regulatory arrangements in the NT. The current definition therefore captures a broad range of services and activities that Power and Water provides which are not contestable.

This is particularly problematic under Power and Water’s new Operating Model as it results in several business units being classified as RESPs under the Guideline. We have found designing and implementing controls to meet obligations in respect to RESPs to be challenging and complex. We are concerned that complying with this obligation (as currently drafted) is likely to introduce inefficiencies that erode the benefits and cost savings anticipated from adopting our new Operating Model.

Power and Water has identified the potential for this issue to be addressed by amending the definition of ‘contestable electricity service’ so that it places greater emphasis on the existence of, or the potential for, competition in the market for the provision of the good or service. Adopting this change would mean that unregulated distribution services currently provided by Power and Water, such as:

- ‘other distribution services’ to remote communities and minor centres on our unregulated network; and
- ‘other electricity services’ such as Power and Water’s Market Operator, System Control, and retail centre functions

would not be captured by the definition of the ‘contestable electricity services’ as competition for the provision of these services does not exist in the NT. This would allow the Guideline to operate in a more targeted manner and would significantly reduce both the complexity and compliance burden on Power and Water in seeking to meet its obligations under the Guideline.

Adopting this approach would also achieve greater alignment with Power and Water’s obligations under the UC Ring-Fencing Code, allowing Power and Water to streamline its processes and controls to meet obligations under both its ring-fencing regimes rather than have to develop separate and potentially duplicative controls. The UC Ring-Fencing Code also imposes limitations around the provision of ‘contestable’<sup>10</sup> services however a key difference between the UC Ring-Fencing Code and the Guideline is that obligations place a greater emphasis on competition and are more closely linked towards preventing harm, or the potential for harm, to ‘competitors’.<sup>11</sup>

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<sup>10</sup> ‘Contestable’ is defined under the UC Ring-Fencing Code as ‘in relation to goods or services within the Electricity Supply Industry means goods or services in relation to which there exists or potentially exists competition in a market in relation to the supply of the relevant goods or services.’

<sup>11</sup> ‘Competitors’ is defined under the UC Ring-Fencing Code as ‘an entity (whether identifiable, actual or notional) which either actually or potentially may be in competition with the Related Contestable Business.’

### ***Removing the need to report accounting and information flows at a transactional level***

Power and Water is finding it challenging to meet its obligations in respect to maintaining account separation between its regulated activities and its RESPs, in part due to the broad scope of services that are classified as RESPs under the Guideline, and also due to the prescriptive nature of the obligations which require the ability to demonstrate and report at a transactional level.

Obligations under the Guideline in respect to information disclosure and accounting separation differ significantly from Power and Water's obligations under the UC Ring-Fencing Code. Specifically, obligations under the Guideline require the establishment of controls and the ability to report at a much more granular level than under the UC Ring-Fencing Code, which focuses on the nature of transactions and reporting on a more aggregate basis.

As noted in our correspondence to the AER on 19 April 2021, our existing ICT systems lack the necessary capability to undertake reporting at a transactional level. While Power and Water intends on upgrading its systems this needs to be undertaken under a phased approach, as part of Power and Water's broader transformation program to avoid bill shocks to customers. Power and Water has the smallest customer base and largest network operating area relative to other DNSPs in the National Electricity Market (NEM).

While the need to replace aging systems may not impose significant costs for other networks, it results in a significant uplift in costs for Power and Water due to our small pool of customers to recover costs from. Consequently, the replacement and timing of legacy needs to be prioritised and balanced against the broader needs of Power and Water's business as a whole to reduce price impacts on customers.

In our view, achieving full compliance with our obligation to report accounting and information access and disclosure arrangements at a transactional level is likely to increase costs to customers with little corresponding benefits given the low risk of harm to competitive markets in the NT. This is because this work would need to be done on a manual basis and would likely take significant time and cost to achieve given existing data quality issues.

We consider a more proportionate response for addressing the potential risk of market harm would be to impose restrictions at a more aggregate level. This could be achieved by amending requirements under clause 3.2.1(a)(ii) to report on transactions between the DNSP and its RESPs to instead require the DNSP to 'report on the nature and extent of transactions'; and similarly to amend requirements under clause 4.3 to require the disclosure of the 'nature of information sharing.'

Making these minor amendments would significantly reduce Power and Water's compliance burden in meeting its obligations under the Guideline and represents a more proportionate response to the risk of market harm in the NT. It would also allow for greater alignment and harmonisation of ring-fencing controls under both regimes.

### ***The need for longer transitional timeframes***

Power and Water is still in the early stages of adopting the NT NER and only recently became subject to Guideline requirements on 1 July 2019. As such we are on a journey to maturing our compliance management framework to better align with our obligations at a national level. While we are committed to evolving our activities to ensure effective compliance with relevant regulatory obligations, we have found reconciling jurisdictional ring-fencing requirements with requirements under the Guideline to be both challenging and complex.

We appreciate the AER's willingness to clarify interpretation issues and work with Power and Water to better understand its obligations under the Guideline. As flagged in our first annual compliance report to the AER, Power and Water required longer timeframes to implement controls to enable it to enhance its compliance under the Guideline due to confusion around the interpretation of some requirements, system and data limitations, and the need to unravel existing jurisdictional controls to determine whether there is opportunities to streamline compliance.

Given that Power and Water is still implementing measures to better meet its requirements under the version 2 of the Guideline, we require a longer transitional timeframes to develop measures that would enable us to comply with proposed obligations under version 3. We propose that Power and Water be afforded until 31 December 2022 to fully comply with obligations under version 3. This would allow sufficient time to assess the need for any waivers and to collate evidence to support a waiver application.



# Appendix 1: Background on Power and Water's operating circumstances

Figure 1 - Geographical spread of operations



Table 1 – Licences and operating areas

Power and Water holds operating licences for electricity and water supply chains for the majority of the NT. The following table illustrates the types of operating licences held and the areas for which it is licenced to deliver those services.

| License Type                | Areas  |
|-----------------------------|--|
| System Control              | Darwin to Katherine, Tennant Creek and Alice Springs   |
| Electricity Generation      | Elliott, Daly Waters, Ti Tree, Timber Creek, Borroloola and IES communities  |
| Electricity Network         | <b>Regulated Networks:</b> Darwin, Katherine, Tennant Creek and Alice Springs<br><b>Non-regulated networks:</b> Daly River, Jabiru, Borroloola, Timber Creek, Daly Waters, Elliot, Newcastle Waters, Yulara, Ti-Tree, Kings Canyon, Nhulunbuy (surrounding rural areas only), Groote Eylandt and IES communities                         |
| Electricity Retail          | Jabiru, Nhulunbuy, Alyangula and IES communities   |
| Water including Retail      | <b>Major Urban:</b> Greater Darwin, Katherine, Tennant Creek, Alice Springs and Yulara<br><b>Minor Urban:</b> Batchelor, Adelaide River, Pine Creek, Borroloola, Timber Creek, Daly Waters, Elliott, Newcastle Waters, Ti-Tree, Larrimah and Mataranka<br><b>Restricted service area:</b> Cox Peninsula-Wagait Beach and IES communities |
| Wastewater including Retail | <b>Major Urban:</b> Greater Darwin, Katherine, Tennant Creek, Alice Springs and Yulara<br><b>Minor Urban:</b> Batchelor, Adelaide River, Pine Creek, Kings Canyon, Borroloola and IES communities  |