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30 May 2016

Mr Chris Pattas
General Manager Networks Investment and Pricing
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Submitted via email to: Ringfencingguideline2016@aer.gov.au

Dear Mr Pattas,

Re: Electricity Ring-Fencing Guideline: Preliminary Positions

Red Energy (Red) and Lumo Energy (Lumo) welcome the opportunity to make a submission to the Australian Energy Regulator's (AER) Electricity Ring-Fencing Guideline Preliminary Positions paper (the Positions Paper).

Red and Lumo are 100% Australian owned subsidiaries of Snowy Hydro Limited. Collectively, we retail gas and electricity in Victoria and New South Wales and electricity in South Australia and Queensland to approximately 1 million customers.

In general, we support the AER's positions as presented in the Positions Paper. Red and Lumo firmly agree that ring-fencing obligations must set out very clear requirements for an arm's length transactions and be accompanied by rigorous compliance and enforcement activities. At the same time it is important for the guidelines to be developed in a manner that ensures clarity of purpose, predictability, and reasoned flexibility accompanied by a strict monitoring and compliance process.

Under the current regulatory framework, Distribution Network Service Providers (DNSPs) have a competitive advantage in supplying contestable services beyond the meter. DNSPs have the ability to:

- move their shared costs between entities to cross subsidise contestable services;
- receive a network support allowance for investments beyond the meter allowing them to cross subsidise contestable services like Distributed Energy Resources (DER); and
- recover a financial allowance under the Demand Management Incentive Allowance (DMIA) scheme that allows them to develop capabilities for supplying competitive services.

Red and Lumo firmly believe that the framework for all contestable services provided to consumers must be competitively neutral in order for effective competition. Due to the infancy of this market it is important that the policy settings are such that competition is encouraged.

The AER has made it clear in its Positions Paper that whether the broader issue of structural separation should be applied in relation to the provision of contestable services beyond the meter is beyond the scope of the current National Electricity Rules (the NER).

Red and Lumo Energy strongly support a policy position that excludes DNSPs from supplying contestable services (either directly or through a ring fenced business) from beyond the meter as it has the potential to distort competition in the market for these

contestable services. This approach would guarantee that DNSPs were incapable of distorting competition in this emerging market.

As such, in the absence of any policy change to strengthen such requirements, the clear exclusion of DNSPs supplying contestable services from beyond the meter is a matter that could be resolved by state governments. This could potentially include provisions in DNSPs licenses that would effectively restrict them from operating in these contestable markets. Such a policy would make it illegal for DNSPs to supply contestable services behind the meter.

Given these limitations, our submission to the Positions Paper will be restricted to what is currently within the AER's scope given the current NER framework. This submission will address the background, key recommendations to support the AER's development of a national electricity distribution ring-fencing guideline (the Guideline) and a response to the questions raised in the Positions Paper.

Our positions suggest a broad range of enhancements to the development of the Guidelines that are intended to ensure competitive neutrality in the supply of contestable services.

Red and Lumo thank the AER for the opportunity to respond to this consultation. For any further enquiries regarding this submission, please call Con Noutso, Regulatory Manager on 03 9976 5701.

Yours sincerely

A handwritten signature in black ink, appearing to be "Ramy Soussou". The signature is stylized with loops and a long horizontal stroke at the end.

Ramy Soussou
General Manager Regulatory Affairs & Stakeholder Relations
Red Energy Pty Ltd
Lumo Energy Australia Pty Ltd

Red Energy and Lumo Energy Submission

Introduction

The market for the supply of contestable services in energy including metering, solar PV, and storage is forecast to grow dramatically in the next 20 years. As the demand for these services continues to gather pace, competition for a share of these markets will also increase.

The potential size of the market in Distributed Energy Resources (DER) alone was highlighted in a recent study by the Energy Networks Association (ENA) and the CSIRO titled the Electricity Network Transformation Roadmap (Roadmap). The Roadmap indicated that between \$225 billion to \$340 billion dollars of capital would need to be invested in DER between now and 2050 to satisfy the demand in two of the four forecasts included in the study.¹

As DER begins to penetrate the market further it is expected DNSPs will look to diversify their revenue streams by obtaining a larger share of the market for contestable services. As a result the current DNSP business model will change from primarily being a monopoly supplier of network services to end consumers, to a competitive business partially operating in unregulated markets. Should DNSPs begin to explore the viability of different business models, it is imperative that the Guidelines adequately enforce the separation between regulated and unregulated services.

In order to provide these services to consumers, and as potential competitors to DNSPs, it is imperative that the AER establishes a competitive neutrality framework. To ensure that competitive neutrality is achieved under the current regulatory framework, substantive changes to the Guidelines are required. The changes will need to make sure that the Guidelines are robust and fit for purpose and ensure no individual DNSP gets an unfair advantage when it or one of its affiliates competes in a contestable market.

The original Guidelines established in the early 2000s focused were on achieving the vertical and structural separation of generation, transmission, distribution and retail. It was not foreseen that the emergence of a contestable market for the supply of metering, solar PV, and storage. We agree with the AER that the Guidelines were developed by considering many of the overarching competition principles required at the time and represent a good place to start the reform process.

Key recommendations

In addition to the positions made below in response to the consultation questions, Red and Lumo submit the following key recommendations for the AER's consideration in development of the Guidelines.

Legal separation

DNSPs should be required to supply contestable services from a legally and financially separated ring-fenced affiliate. Ring-fenced affiliates should be completely independent and maintain their own individual financial accounts. The directors of ring-fenced affiliates should have specific fiduciary duties to the affiliate company under the Corporations Law.

¹ CSIRO and Energy Networks Association 2015, *Electricity Network Transformation Roadmap: Interim Program Report*. P.62 Figure 2.16

Allocation of costs

DNSP cost allocation methodologies that demonstrate how costs are allocated between contestable services and regulated services need to be developed further with more prescription in the Guidelines regarding the basis of allocating shared costs.

The general nature of the cost allocation principles in the NER and the jurisdictional guidelines that apply to DNSPs means that appropriate allocation of shared costs between a DNSP and a ring-fenced affiliate cannot be guaranteed. For competitive neutrality to be achieved in contestable markets, the costs of supplying contestable services should only be recovered through the ring-fenced affiliate that supplies these services.

The importance of restricting the inappropriate allocation of costs between the DNSP and its ring-fenced affiliate in supplying contestable services cannot be understated, and is essential to the development of such markets.

Service agreements between DNSP and a ring-fenced affiliate

Service agreements between a DNSP and a ring-fenced affiliate must not allow the affiliate to be cross subsidised. This means that the Guidelines for allocating shared costs must be developed in a more prescriptive manner than is currently the case to prevent a cross subsidy from a DNSP and its ring-fenced affiliate.

The Guidelines must be capable of being applied to complex contractual arrangements that could be put in place to cross subsidise the contestable activities of a ring-fenced affiliate.

Access to information obtained or owned by the DNSP

Unrestricted flow of information between the DNSP and its ring-fenced affiliate must be prohibited. DNSPs must have auditable procedures in place that guarantee a ring-fenced affiliate does not get access to any commercial information that would give its affiliate a competitive advantage over other market players.

Physical and functional staff separation

Physical staffing and functional separation should be required between the DNSP and the ring-fenced affiliate. DNSPs and its ring-fenced affiliates should be required to have offices in different geographical locations in order to achieve this goal.

DNSP discrimination in favour of an affiliate to be prevented

DNSPs must not be able to favour a ring-fenced affiliate operating in a contestable market.

A DNSP ring-fenced affiliate should not be able to get access to the shared network on more favourable terms and conditions than a competing third party service. While we do not envisage this restriction to be onerous, the Guideline should nevertheless prevent this from happening.

It is more important that the Guidelines ensure that DNSPs do not use the terms and conditions for which they provide unaffiliated entities regulated services to give their ring-fenced affiliate a competitive advantage in supplying contestable services.

This could require, for example, that DNSP processes for connecting contestable assets like battery and storage behind the meter must be applied in a competitively neutral manner to all connection applicants, irrespective of their ownership.

Responses to Consultation Questions

What aspects of the current jurisdictional ring-fencing arrangements have or have not worked well?

The jurisdictional ring-fencing arrangements, including the provisions for legal, accounting, and functional separation as well as restrictions on information and staff flows, have generally been ineffective. Unfortunately, the general nature of the Guidelines applied in each separate jurisdiction has made it easy for them to be bypassed by DNSPs, rendering them futile.

The specific nature of our concerns relating to the current jurisdictional guidelines is provided in more detail below.

Allocation of costs

The general nature of the cost allocation provisions in all of the jurisdictions provides DNSPs with the opportunity to allocate shared costs (i.e. overheads, legal, and accounting costs) between the regulated and competitive affiliates with too much freedom.

DNSPs should have a limited degree of freedom available to them in the manner in which they allocate their costs between their direct control services and the other services they offer. However, the general ease in which DNSPs are able to inappropriately allocate the costs between these services currently appears to allow DNSPs to cross subsidise contestable services.

The relevant provisions in the revised Guidelines that apply to cost allocation must be tightened up and made more prescriptive for them to be effective.

Legal separation

Some of the jurisdictions have made it compulsory for a DNSP to legally separate the business that provides standard control services from the one it owns that supplies contestable services, however this has not been applied universally.

Even where a jurisdiction has made it compulsory for this form of legal separation the general nature of the jurisdictional cost allocation provisions can allow shared costs to be moved around to benefit a ring-fenced affiliate. This raises serious questions in relation to whether the objectives of legal separation have been achieved under the current guidelines.

More work will be needed in this area to ensure the overall benefits of having legal separation are achieved.

Physical staffing and functional separations and limitations on the flow of information

Physical staffing and functional separations, and limitations on the flow of information between DNSPs and their affiliates that provide contestable services have not been controlled well in some jurisdictions.

Significant improvements in compliance monitoring are required to make this provision more effective.

Waivers

Waivers from the current ring-fencing guidelines have been applied too leniently in some jurisdictions.

A key example of this is that DNSPs have been permitted to use funds under various incentive schemes to undertake research and development activities aimed at implementing batteries for demand side management beyond the meter.

This has allowed some DNSPs to gain vital intellectual capital in the process of installing storage from behind the meter, and in doing so, DNSPs have gained an unfair competitive advantage in this space.

Do you consider that these objectives discussed in section 2.1 adequately reflect the harm that ring-fencing is seeking to avoid and the benefits of an even playing field?

The AER suggests that there are 4 objectives for ring-fencing:

1. avoid the anti-competitive effects of cross-subsidies between the contestable and non-contestable activities offered by an NSP that would adversely affect markets for contestable services or the efficient provision of regulated services;
2. avoid discriminatory interactions between the contestable and non-contestable services offered by an NSP that would adversely affect markets for contestable services or the efficient provision of regulated services;
3. avoid providing a preferred or related party with an unfair advantage in offering contestable service that stem from information acquired in providing a regulated services; and
4. in achieving the first three objectives, promote an even playing field that may encourage market entry.²

Red and Lumo agree that these objectives adequately reflect the harm that ring-fencing is seeking to avoid and create the benefits of an even playing field.

We consider that important matters including:

- the significance of ensuring contestable services are not cross subsidised;
- the avoidance of anti-discriminatory interactions between the contestable and non-contestable services offered by a DNSP; and
- providing a related party with commercially sensitive information is covered in the objectives.

The AER notes that ring-fencing compliance is not without cost. We consider that, where ring-fencing is required to separate from the existing DNSPs, these costs should be borne by the competitive business. It is difficult to envisage how establishment of appropriate ring-fencing arrangements can be incorporated into the regulated business, and at what benefit it may have for the general consumers of the DNSP.

² AER, Electricity ring-fencing guideline – Preliminary Positions, 2016, pp16-17

It is the general nature and lack of prescription in the current Guidelines that has delivered poor outcomes, despite the objectives of the current Guidelines being well expressed. For this reason it is important that the proposed Guideline focuses on the mechanisms to ensure objectives are reached.

Do you agree with the service classification approach to ring-fencing which is discussed in section 3.3? Is there a better alternative?

Red and Lumo argue that DNSPs should be excluded from directly supplying competitive services beyond the meter. One way to achieve this would be for the AER to prohibit DNSPs from acquiring and using certain assets (asset ring-fencing) like energy storage services beyond the meter. Such an approach would guarantee that DNSPs were unable to distort competition in these emerging markets. However, the AER has argued that the outright prohibition of DNSPs supplying contestable services would not be compliant with the NER. Hence, as part of this process we need to put forward ring-fencing options that meet the NER.

Assuming the AER's assertion is correct, we believe the service classification approach to ring-fencing discussed in section 3.3 is appropriate. The reason for this is there are strong similarities between the purpose of service classification and the purpose of ring-fencing. In determining the classification of a particular service the AER is required to consider a range of issues which are set out in the National Electricity Law (NEL).

We support the AER determining ring-fenced services that would be subject to the Guideline at the beginning of a regulatory period. The AER framework and approach to rate reviews currently classifies services at the beginning of every price review. Where there is scope for the competitive provision of a service by a third party then that service will be supplied to the market in a competitive manner.

Once the AER has determined the classification of a service in terms of whether it should be a direct control service or otherwise, all contestable services determined would be captured under the proposed Guideline and would need to be ring-fenced.

Such an approach would ensure that if there was a need for other services to be captured under the Guideline then it could be easily achieved. There would be no need to introduce a separate regulatory process each time a new service was introduced.

The key matter that must be considered by the AER in determining the classification of a service is whether there is scope for the competitive supply of that service by third parties or whether the services exhibit monopoly characteristics and should therefore be regulated under CPI-X incentive based regulation. The implication of this approach that all services offered by an NSP that are not direct control services would be ring-fenced unless a waiver is granted is appropriate.

This therefore assumes that ring-fencing is beneficial to consumers, and provides benefits to the development of contestable markets. Under this approach, DNSPs still have the option to apply for a waiver under the proposed ring-fencing guideline where the benefits exceed the costs.

The alternative approach to achieving option 3 noted by the AER in its Positions Paper is inappropriate. Any approach that places the onus on consumers or other stakeholders to identify a situation where the service offered by the DNSP could result in harm to consumers or impact the development of competitive markets is not supported. The potential for a DNSP to take advantage of this alternative approach and gain a competitive

advantage when providing contestable services would be not insurmountable. Given the importance of achieving competitive neutrality in this emerging market such a risk is not warranted.

With respect to the services that would be subject to the ring-fencing guideline, we support that the AER's option 3 be selected. This means the services offered by a DNSP that are not direct control services would be subject to ring-fencing at the time of rate reviews (forming part of the Framework and Approach taken by the AER). The key advantage of this approach is it would not require any cumbersome regulatory decision making process to be set and be implemented each time a new service was provided.

The alternative approaches discussed in the AER's Positions Paper (Options 1 and 2) that assume no harm is caused by a DNSP offering services into a contestable market unless a net benefit from ring-fencing can be demonstrated would be a threat to competition in contestable markets.

Does the proposed approach to ring-fencing adequately deal with the prospects for development of the contestable market for DER?

Red and Lumo have concerns with the proposed ring-fencing approach put forward by the AER to deal with the development of the contestable market for DER.

Our preference is that DNSPs is not permitted to provide DER, similar to network support directly from beyond the meter. This approach would guarantee that DNSPs were incapable of distorting competition in this emerging market. Nevertheless, we accept this is not a valid option under the current Rules.

The AER Positions Paper describes three ways in which an NSP could employ DER behind the meter under the current regulatory arrangements. This includes:

- Option 1 – DNSP to acquire DER device and provide direct control services only;
- Option 2 – DNSP ring-fenced affiliate buys DER. DNSP leases DER from affiliate paying for it through opex allowance;
- Option 3 – DER leases DER from third party provider paying for it through opex allowance.

We are specifically concerned that competitive neutrality cannot be assured in the supply of DER under any of the three options proposed. As such, all three options would be inconsistent with the efficiency principles included in the National Electricity Objective (NEO).

The nature of the specific concerns that we have includes the following:

Allocation of costs - The broad nature of the costs allocation principles and jurisdictional guidelines would allow DNSPs to move around their joint costs with some degree of freedom. This could have the potential impact of allowing a DNSP to crowd out more efficient service providers from providing DER to the market. This would lead to inefficiently priced higher distribution tariffs in the long run.

Long term impact on competition - There could be a potentially serious impact on the level of competition in this emerging market even where a DNSP leases DER for network support through a third party or via its own ring-fenced affiliate. Given the potential infancy of this market it is important that the policy settings are such that competition is encouraged. The threat to competition under all three options in an emerging market in its

infancy would be very high. And the consequences of an uncompetitive market in the supply of DER would have a chilling effect on investment.

Nevertheless, if we assume that the Guidelines can achieve competitive neutrality in the supply of DER through legal separation, more prescriptive cost allocation arrangements and by including effective limitations on the flow of information between a ring-fenced affiliate and its parent, then our preference would be to support Option 2 or 3. However, we consider this a big assumption for the AER to make.

Even though it is permissible under the current Guidelines, we would not accept Option 1 allowing a DNSP to acquire a DER device behind the meter and trust that the DNSP would only supply direct control services from it.

Should asset sharing be restricted between regulated services and contestable service provision?

Yes, asset sharing should be restricted between regulated services and contestable services - behind the meter.

As noted above, we have serious concerns that allowing DNSPs to provide DER behind the meter may impact the competitiveness and efficiency of the market for contestable services given the relative infancy of the market.

We agree with the AER that functional separation allows for the separation of assets. We support clear obligations which provide the AER the ability to identify compliance and enforce any non-compliances.

Nevertheless, having argued this, asset sharing is acceptable between regulated services and contestable services – in front of the meter. As such, if a DER investment option in front of the meter represents the most efficient option under a RIT-D application then it should proceed.

In our preferred model, the DER capacity would be auctioned off, which should be considered by the AER. The revenue from the sale of the capacity would be dealt with appropriately under the AER Shared Asset Guideline (SAG).

The AER's SAG contains a specific methodology that the AER proposes to apply to calculate the reduction in building block revenues that applies when a DNSP earns revenue from shared assets by providing non regulated services.

The AER's SAG reduces the revenue a DNSP earns from its regulated revenues by 10% of the value of its total non-regulated revenues earned from shared assets in that year. This ensures that customers share in the benefits of shared assets – in front of the meter.

Do the factors set out above reflect the issues we should consider in deciding whether to grant a ring-fencing waiver?

The AEMC's recommendations from the Integration of Storage paper released late last year represent a reasonable starting point in terms of the issues that the AER should consider when considering granting a waiver. However, the AER needs to analyse these issues in more detail to determine how appropriate each specific issue is before deciding on which specific items to use to determine whether a waiver from the guidelines is warranted.

We consider that the AER should take a practical approach to permitting waivers to ring-fencing guidelines. We support a mechanism that permits DNSPs to apply for ring-fencing waivers are included in the Guidelines. In some circumstances the granting of a ring-fencing waiver may be appropriate especially where the benefits of the waiver exceed the costs.

The threshold that is applied under the test for granting waivers must however be set at a high benchmark. DNSPs would need to demonstrate a clear net market benefit for a ring-fencing waiver to be granted – which must include accounting for the intellectual property developed out of the service to which the waiver applies. The test for a waiver application developed by the AER must place a significant burden of proof on the applicant to prove that the costs of ring-fencing outweigh the benefits.

We have previously seen waivers applied to activities proposed by DNSPs to develop battery capabilities behind the meter under the Demand Management Innovation Allowance (DMIA). We consider this outcome unacceptable. This has allowed DNSPs to gain priceless intellectual property which will potentially benefit ring-fenced affiliates in the future.

Previous decisions of the AER (for example the decision to grant a waiver to Energex for its Battery Energy Storage System project)³ have applied too narrow an assessment of these costs and benefits. The Energex decision found that the measurable benefits to consumers for ring-fencing the projects (which were minimal) were outweighed by the costs to Energex of setting up a ring-fenced entity to conduct the trial. There was no regard as to the benefits to Energex for not ring-fencing the project (such as a monetisation of the intellectual property created), nor the costs to consumers arising from the detrimental market outcomes likely to eventuate.

If waiver applications are granted too easily it could impact the supply of contestable services in these emerging markets, to the ultimate detriment of consumers.

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?

The AER notes in the Positions Paper that there may additional costs borne by the DNSP associated with complying with the ring-fencing provisions. Red and Lumo support the position put forward by the AER is that where a DNSP incurs costs due to its involvement with ring-fenced activities, that the customers of those ring-fenced services bear the incremental costs of ring-fencing compliance. We consider that this approach is consistent with the NEO as it does not unfairly discriminate against the general consumers of a DNSP who have not been beneficiaries of the ring-fenced service.

How else could the AER minimise the administrative cost of ring-fencing while maintaining the integrity of its approach?

In general, we support the inclusion of a variety of approaches to waivers available to the AER in order to reduce administrative costs of ring-fencing. However, we consider that all ring-fencing waivers should be subject to public consultation, similar to the approach that the AER undertakes for the retail exemptions, further we agree that all contentious applications should be subject to a more rigorous process that allows the AER to make their decision.

³ See: <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/ring-fencing-waivers/energex-ring-fencing-waiver-2015>

Is it reasonable for the AER to consider these transitional arrangements for the new ring-fencing guideline?

Red and Lumo expect that the revised ring-fencing guidelines will be difficult for some DNSPs to comply with. However, this does not imply non-compliance is acceptable.

The need to refine the ring-fencing guidelines so as they are robust and fit for purpose means that the existing guidelines will need to be changed. We agree that in a practical sense this will mean that some DNSPs will not comply with the revised ring-fencing arrangements upon the AERs final determination.

Whilst we consider that it is appropriate for DNSPs to be given a reasonable time frame to put in place alternative arrangements to ensure compliance with the revised guideline for legacy service offerings, this timeframe should not extend past 1 December 2017 in line with the commencement of the competition in metering rule change. Further, we do not consider that any new arrangements entered into once the final determination has been made should be subject to a transitional period.

The AER must balance the timeframe so as it allows DNSPs to comply with the revised guidelines without an ability for a DNSP to consolidate any competitive advantage that they can achieve under the Current Guidelines. This would be incompatible with the objective of achieving competitive neutrality in the supply of the contestable services to the market.

How can we ensure ring-fencing compliance is robust and effective without imposing excessive costs that may ultimately be borne by consumers?

Consistent with the intent of ring-fencing, Red and Lumo consider that ring-fencing compliance should be no less burdensome as the existing AER compliance obligations placed on competitive providers.

Red and Lumo believe the existing compliance measures proposed by the AER are insufficient. We believe an appropriate level of compliance would require:

- DNSPs to notify the AER of any breach of obligations of the guidelines as soon as reasonably practicable and in any case within 5 business days of becoming aware of the breach;
- DNSPs to conduct annual audits of the guidelines by an independent third party;
- DNSPs to submit to the AER half yearly reports describing the measures it has taken to ensure compliance with the guidelines and detailing any breaches determined in the period; and
- DNSPs to submit half yearly financial accounts for each ring-fenced entity indicating the size and the nature of any transaction with the DNSP.

We agree with the AER that DNSPs should be required to publish these documents on both the AER and DNSP websites, and accordingly there should be penalties imposed for any breaches of the guidelines.

We support the AER's proposal that where there are breaches of the guidelines, court enforceable compliance could be sought. Pecuniary penalties for breaches of compliance with the guideline would also be appropriate given the nature of ring-fencing and the impacts breaches have on consumer confidence in competitive markets.