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

Submitted via email to: [Ringfencingguideline2016@aer.gov.au](mailto:Ringfencingguideline2016@aer.gov.au)

Dear Chris

## Re: AER Draft Ring Fencing Guideline - Exposure Draft

### Introduction

Red Energy (Red) and Lumo Energy (Lumo) welcome the opportunity to respond to the Australian Energy Regulator's (AER) Distribution draft Ring Fencing Guideline (the Guideline) - Exposure Draft (Exposure Draft).

We understand changes to the Exposure Draft were made to give the AER greater flexibility in applying the Guideline, but we are concerned with some of the changes. Specifically, we:

- do not support of the decision to permit waivers to core ring fencing obligations like legal separation, cross promotion and co-branding. As such:
  - the circumstances under which these waivers are granted must be restricted; and
  - the principles under which they are provided must be clearly articulated in the ring fencing guideline.

Preliminary discussions with the AER indicate that waivers from legal separation for Distribution Network Service Providers (DNSPs) to directly compete in the Behind the Meter (BTM) contestable services energy market would not be permitted.

- strongly oppose the proposal for DNSPs to share staff or offices where doing so would compromise compliance with the Guideline. This has the potential to breach the non-discrimination provisions and allow DNSPs to cross subsidise BTM contestable services.
- do not support the proposal to include interim waivers.
- consider a firmer approach to compliance is warranted including a financial penalty regime.
- are disappointed that the AER has made significant changes to the Guideline at this late stage of consultation, without giving stakeholders a reasonable time to respond.
- are concerned that we do not have the opportunity to review the Explanatory Statement to the Exposure Draft so that we can properly respond to the AER's reasons for these proposed changes. Particularly as we have resorted to having discussions with key AER personnel to understand the rationale applied to the Exposure Draft.
- support for the proposal to remove the \$500,000 threshold for DNSPs to undertake non-distribution services.

The changes to the Exposure Draft have the potential to hamper the Guideline's ability to protect market participants in the BTM contestable services energy market from non-discrimination and cross subsidisation by DNSPs. This could potentially threaten the Guideline's ability to deliver competitive neutrality in this market.

### **Permitting waivers for legal separation, cross promotion and co-branding**

Red and Lumo do not support the decision to permit waivers for legal separation, cross promotion and co-branding.

The AER's reasons for restricting waiver applications from core ring fencing requirements like legal separation in its draft guideline was to provide protection against cross subsidies.

Permitting waivers for legal separation provides an opportunity for DNSPs to game the waiver application process. As a result more waiver applications may be granted for legal separation with the potential for cross subsidisation increasing.

The AER has advised us that it has initiated this change to give it the flexibility to deal with some specific situations where regulated monopolies are required by state governments to supply electricity to rural areas.<sup>1</sup> It argued that in some specific circumstances it makes economic sense to waive the requirement for legal separation and cobranding.

If the AER maintains the draft decision to allow waivers for legal separation, then we would expect at a minimum that:

- the circumstances under which those waivers are granted must be restricted to those specific circumstances; and
- the principles under which they are provided need to be clearly articulated in the guideline.

In discussions with the AER, they have indicated that waivers from legal separation for DNSPs to directly compete in the BTM contestable services market will not be permitted. As such, we expect that this is specifically applied by the Guideline.

Red and Lumo do not support the AER's decision to allow waivers for cross promotion and co-branding. The AER have argued that these waivers would only be granted in rare circumstances. The AER's reiterated its position that it intends for DNSPs compete in the BTM contestable energy services through an independent affiliate via an independent brand.

Nevertheless, if the AER decides to include this additional flexibility in the Guideline, then the specific circumstances where the AER would permit legal separation should also apply to branding. As such, we expect these applications would only be granted in these limited circumstances.

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<sup>1</sup> An example provided by the AER is Ergon Energy's requirement to provide electricity to rural islands in Queensland which are not connected to the NEM. Under the AER's ring fencing guideline, these electricity networks do not satisfy the definition of "distribution services". They are deemed to be "other electricity services." As a result, Ergon is required to provide these services via a separate legal company which is inefficient. To deal with situations like this in the future, the AER suggested it requires flexibility. Another example used by the AER has been ActewAGL who required to provide gas to meet jurisdictional requirements; however, this is not relevant in the context of the Guideline as it only applies to electricity.

## **Permitting DNSPs to share staff or offices where doing so would not compromise compliance with the Guideline**

Red and Lumo do not support the decision to permit DNSPs to share staff or offices, as we believe that this would always compromise compliance with the Guideline.

The Exposure Draft allows for staff sharing arrangements that will only apply to staff that perform services that do not have access to *electricity information* (such as general administration, accounting, payroll, human resources, legal or information technology support services). The Guideline protects against non-discrimination by DNSPs by not allowing staff sharing for staff that have access *electricity information*.

This decision can compromise the non-discrimination provisions that apply to DNSPs in the Guideline. The fact is, it will be much easier for a DNSP to share competitive information with its ring-fenced affiliate in these circumstances.

Take the example of a meeting of shared resources between a DNSP and its ring fenced affiliate. In these circumstances, it is almost impossible to scrutinise how commercial information that a DNSP has learned about one of its competitors is not unintentionally shared with its ring-fenced affiliate. This sort of behavior is very difficult to monitor and could potentially erode the core ring fencing provision of non-discrimination.

Also, we note that the National Electricity Rules (NER) do not include any rules regarding the allocation of costs from DNSPs to non regulated services. While we acknowledge that any labour sharing agreements between a DNSP and its ring-fenced affiliate would need to be reported in a transparent manner, this arrangement could lead to cross subsidisation.

For example, a DNSP in-house legal counsel can be outsourced to a ring-fenced affiliate. As we have argued above, the NER does not include principles that outline how the labour costs would be allocated from the DNSP to the ring-fenced affiliate. The NER only deals with cost allocation rules that apply to the regulated - direct control services. This has the potential to allow a DNSP to allocate a significant proportion of the labour costs to the DNSP (artificially inflating the regulated price) and allocate a small portion of the labour costs to the ring-fenced affiliate (in effect creating cross subsidy that benefited the independent affiliate).

We accept the AER needs additional flexibility to practically administer the Guideline in the future. Nevertheless, the AER must ensure that its changes do not threaten the core principles of cross subsidisation and non-discrimination, the very foundations that the Guideline was established on.

Finally, the Guideline allows staff sharing to apply senior executives that set the strategic direction of an organisation. Sharing information at this level of a DNSP and a ring fenced affiliate competing in the BTM contestable energy services market impacts competitive neutrality in the BTM contestable energy services market. We urge the AER reverse this position.

## **Compliance regime should include financial penalties**

Red and Lumo consider a firmer approach to compliance is warranted that includes financial penalties that reflect the potential consumer detriment from the actions of the DNSP in frustrating competition.

The AER has created compliance regime that requires DNSP to demonstrate yearly compliance with the guideline. In addition, it requires compliance breaches to be self-reported to the AER within 5 business days.

The AER's approach to compliance creates incentives for DNSPs to create compliance culture that encourages compliance. At the same time, it encourages DNSPs to highlight any non-compliance.

We suggest an approach that implements significant financial penalties for non-compliance would be more appropriate in this case. Given that the market for BTM contestable services is predicted to be significant in financial terms, competition in this space will be fierce.

It is important for all market participants to get the opportunity to compete for a share of this market in a competitively neutral manner. A fine based approach to non-compliance would help achieve this goal.

Thus, the final Guideline should include a financial penalty regime. The penalties for non-compliance should be substantial, commensurate with similar penalties for competition breaches available to the Australian Competition and Consumer Commission.

This enforcement action is warranted to reflect the potential consumer detriment from the actions of the DNSP in frustrating competition in services and impacting competitive neutrality.

### **Removal of \$500,000 threshold that applies to non-distribution services**

Red and Lumo support the decision to abolish the \$500,000 threshold for DNSPs to undertake non-distribution services.

The AER's decision to include a \$500,000 threshold for DNSPs to undertake non-distribution services undermines the real intention of ring fencing. The rationale for providing this allowance was never clearly articulated by the AER.

While the AER has advised us that this allowance was never intended to act as a cross subsidy, it would in effect act like one. As such, we support this decision.

### **Permitting interim waivers**

Red and Lumo do not support the decision to permit interim waivers. We consider that granting interim waivers adds risk, sets precedents and can lead to breaches of the Guideline.

Given the complexity of the issues that are being assessed by the AER in these applications, it is most likely going to require a reasonable amount of time to grant a waiver. We understand that the AER may require flexibility in the timeframes for assessing waiver applications, the risk associated with providing interm waivers is too great. As such, we do not support it.

### **Conclusion**

Red and Lumo are pleased with the proposal to remove the \$500,000 threshold for DNSPs to undertake non-distribution services.

However, whilst we understand the AER requires greater flexibility to allow for some specific waivers for legal separation, cross branding and cross promotion we are concerned that this will be exploited by DNSPs.

As such, the challenge for the AER is to ensure that its drafting of the changes to the guideline are impregnable and restricted to limited circumstances. A failure to achieve these goals will undermine the very fabric of the ring fencing guideline itself. That is to protect against any cross subsidisation and non-discrimination delivering competitive neutrality.

Finally, we would welcome the opportunity to discuss these latest changes with the AER prior to the release of the final Guideline. It makes sense given that we have not had the opportunity to review the AER's Explanatory Statement to properly understand the reasons for these latest changes.

We thank the AER for the opportunity to the Exposure Draft. 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**