28 September 2016

Tasmanian Networks Pty Ltd
ABN 24 167 357 299
PO Box 606
Moonah TAS 7009

Mr Chris Pattas
General Manager, Network Regulation
Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001

Lodged online at Ringfencingguideline2016@aer.gov.au

Dear Mr Pattas

RE: AER Draft Ring-fencing Guideline

Tasmanian Networks Pty Ltd (**TasNetworks**) welcomes the opportunity to comment on the Australian Energy Regulator's (**AERs**) Draft Ring-fencing Guideline (the guideline). We have also contributed to and support the positions put forward to the AER by the Energy Networks Association (ENA) on the guideline.

Our detailed submission is attached for your consideration. The key points we would like to highlight are:

- The introduction of the guideline in its current form has the potential to unwind many of the efficiencies achieved to date by our operation as an integrated network business.
- The Tasmanian market is characterised by limited providers in a number of specialised areas and limited economies of scale in the provision of some services. There are currently limited opportunities for the harms the guideline attempts to avoid to actually occur in Tasmania.
- The implementation of this guideline would not result in a proportionate regulatory response to the perceived harms the guideline is seeking to prevent. Existing regulatory controls are already in place to mitigate the perceived risks of harm the guideline is seeking to prevent.
- The waiver provisions in the guideline should be extended to include consideration of relevant market circumstances.
- The transitional periods outlined in the guideline are likely to be difficult to comply with given current levels of uncertainty in relation to the guideline. They are also inconsistent with the existing framework and approach process for our business.

In the Tasmanian context we are principally concerned with the costs that functional separation (structural and/or locational) may impose on our customers, with potentially little or no benefit in return. As a result, we urge the AER to be mindful of ensuring that the National Electricity Objective is achieved for customers in regional areas, rather than taking a one-size-fits-all approach to the ring-fencing guideline.

In addition, we believe the guideline may have unintended implications for our non-prescribed transmission services. As a combined distribution and transmission network business the strict interpretation of the distribution ring-fencing guideline for our business

may require non-prescribed transmission services not intended for coverage by the guideline to be impacted. We welcome the opportunity to work directly with the AER to find a resolution to this issue as it is a material one for our business and customers.

We welcome the opportunity to collaborate and engage with the AER as it continues to develop the guideline, and we would like to meet with the AER to discuss the implications for our business and our customers. If you have any questions or require further information in relation to the matters raised above, please contact Kirstan Wilding on (03) 6271 6696 or at kirstan.wilding@tasnetworks.com.au.

Yours sincerely

Bess Clark
GM Strategy and Stakeholder Relations

RESPONSE TO AER's DRAFT RING-FENCING GUIDELINE

TasNetworks welcomes the opportunity to comment on the Australian Energy Regulator's (**AER**'s) Draft Ring-fencing Guideline (**Draft Guideline**). Our submission provides some overarching comments on the Draft Guideline along with specific comments on the intent and wording of the Draft Guideline.

As a member of the Energy Networks Association (**ENA**), we also contributed to and support the ENA's submission.

Overview

As a business formed on 1 July 2014, we are on a journey of transformation, principally to deliver the lowest sustainable electricity prices to our customers and appropriate returns to shareholders. We have realised many efficiencies through the merger of our distribution and transmission operations.

Our distribution revenue proposal for the 2017-2019 regulatory control period proposes further expenditure efficiencies, and reflects the engagement with our customers about their preferences. We are concerned the Draft Guideline has the potential to unwind many of the efficiencies achieved to date and will not promote competition in the Tasmanian market for a range of existing and emerging services.

Whilst the AER has made a number of changes to address stakeholder concerns in moving from the Preliminary Positions paper to the Draft Guideline, we do not believe the Draft Guideline delivers against the objectives of a targeted, proportionate, predictable regulatory framework. A framework delivering these objectives ensures that:

a. distribution services are provided efficiently in accordance with the National Electricity Objective (NEO); and

b. competition in contestable markets is not harmed by the participation of Distribution Network Service Providers (**DNSP**s), or their related affiliates, in those markets.

In the Tasmanian market context, these objectives can be met by appropriate cost and information ring-fencing requirements. In contrast, the Draft Guideline requirements appear unduly onerous, and will add cost to the provision of Tasmanian distribution services, with no offsetting benefits to customers of these services.

Given the small size of the Tasmanian market, TasNetworks has been able to achieve economies of scale and scope in the provision of electricity distribution, transmission, telecommunications and related services.

In doing so, TasNetworks can deliver lower prices and a wider range of services to customers across Tasmania than would otherwise be available – to the benefit of customers of network and other services. It is important to emphasise that electricity prices are of principal concern to Tasmanian customers, especially considering affordability issues for the 38 per cent of our residential customers receiving concessions. Extensive feedback from our customers through our revenue determination processes, for both transmission and distribution services, has affirmed this expectation to deliver a wide choice of services at the lowest sustainable price.

The national energy market is rapidly evolving and experiencing the emergence of new products and services underpinned by technological innovations, and entry of new market participants. We support the efficient delivery of services provided by Distribution Network Service Providers (DNSPs). We also support competition, where feasible, in the electricity supply chain and in related services. This includes competitive provision of services at the retail customer level where demand for, and supply of, existing and new energy services is increasingly driven by customers' evolving choices regarding their energy needs.

It is important to get regulatory settings right for all market participants (existing and future) such that the long term interests of consumers are promoted. TasNetworks does not consider that the Draft Guideline has these settings right.

We are firmly of the view there are more proportionate ring-fencing approaches to address potential cross-subsidisation and discrimination harms. This includes ring-fencing provisions that are flexible enough to accommodate jurisdictional differences in the maturity and depth of distribution and contestable services markets. We welcome the opportunity to engage with the AER and the Tasmanian community, to ensure that ring-fencing requirements deliver appropriate customer outcomes at efficient cost.

Key issues

Tasmania's electricity sector characteristics

Tasmania's electricity sector:

- serves a small and geographically diverse population base;
- serves four transmission-connected customers that use more than half the energy in the state;
- is connected to the NEM via an unregulated interconnector;
- is dominated by one generation business with a range of small, dispersed generators around the state; and
- is dominated by one major retailer and there is no competition in the retail market for the residential customer.

The Tasmanian electricity sector has undergone a number of structural reforms since 2012 to deliver economic efficiencies and in so doing place downward pressure on electricity prices, based on the recommendations of the Electricity Supply Industry Expert Panel.

From a network perspective, the most notable structural reform has been the merger of Tasmania's transmission and distribution networks to form TasNetworks in 2014. The purpose of the merger was to 'improve network management and capture ongoing efficiencies and cost savings, estimated to be around $8 million per annum'[1]. These savings were expected to arise predominantly from the rationalisation of duplicate functions and assets, and the co-location of network and network services staff.

Delivering economic efficiencies for Tasmanians

The positive efficiency benefits of rationalisation and co-location of staff was acknowledged at the time of granting TasNetworks a waiver from the transmission ring-fencing obligations; allowing our business to provide both transmission and distribution services. As noted at the time[2]:

> *the public benefit of compliance through the maintenance of legally separate transmission and distribution businesses is minimal. The waiver will not affect other existing obligations on the TNSP and DNSP businesses which protect the interests of consumers, such as the regulatory accounting regime and restrictions on preferential dealing and sharing confidential information.*

The merger of network businesses has allowed us to realise many savings through integration of a range of common corporate, customer relationship, asset management, asset operations, works and service delivery functions. Team members have been co-located, with site rationalisation of office and works facilities to ensure the most efficient delivery of electricity services to Tasmanian customers. To date we have reset our operating cost base from $174 million (prior to merger) to $140 million. We have delivered $34M recurring savings expenditure as a result of the merged business efficiencies.

In light of the Tasmanian context, rationalisation and co-location are consistent with the NEO in ensuring we, as the DNSP, act in the most efficient manner in supplying electricity services for the long term benefit of the electricity customers we serve. This is reinforced through the AER's use of external economic benchmarking tools in its expenditure assessments, which encourages such actions in order to deliver efficiencies in service delivery, and the use of capital and operating expenditure schemes that reward sustained cost savings. Recent benchmarking analysis and revenue plans demonstrate the efficiencies achieved by the business.

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1 Electricity Supply Industry Expert Panel, 2012. *An Independent Review of the Tasmanian Electricity Supply Industry: Final Report, Vol 1*. March. P iix. This figure is also consistent with the findings of PricewaterhouseCoopers' estimates of network integration cost savings.

2 AER. 2014. *TasNetworks Application for Waiver from Transmission Ring-fencing Guidelines: Final Decision*. May. p 9.

However, if the Draft Guideline applies in Tasmania, previously accepted measures to improve efficiency now appear to be in question. A range of services provided for network and non-network purposes could be subject to legal and functional separation, such as the provision of wholesale telecommunications, training, and field services.

A waiver may be sought in relation to functional separation to mitigate the adverse operational cost implications of the Draft Guideline. However, the costs associated with seeking a waiver, the challenge that waivers apply only for one or two regulatory periods, and the operational and financial risks of a waiver being removed, will all result in increased costs for Tasmanian electricity customers.

The increased costs associated with the Draft Guideline appears to be recognised by the AER, with Commissioner Jim Cox noting at the recent AER/ACCC conference that there would be a short-term reduction in productive efficiencies (ie costs would go up), in order to achieve longer term dynamic efficiencies (new benefits in the long run) from greater competition. Our principal concern is that in the Tasmanian market context the up-front and ongoing costs of implementing the Draft Guideline will eventuate and be reflected in higher distribution services prices (through lack of economy of scale and scope efficiencies). But the customer benefits from a perceived view that greater competition will eventuate are less certain. This is evidenced by the lack of competition in Tasmania's retail electricity market for residential customers, despite full retail competition being possible for a number of years.

We consider that there needs to be a level of flexibility within any ring-fencing approach and there are far more proportionate ring-fencing approaches than what is proposed in the Draft Guideline.

The decision to apply the most restrictive ring fencing provisions should only be implemented where cross-subsidisation and discriminatory behavioural harms are clearly evident. The Ring-fencing Guideline should offer flexibility to consider the differing nature of respective jurisdictional markets such as Tasmanian market circumstances.

We are offering to work with the AER on ensuring appropriate ring-fencing measures can be implemented in a proportionate manner. We have identified a number of changes to specific provisions in the Draft Guideline in more detail in our submission below.

Tasmanian market conditions

Following extensive consultation both within the energy industry and with the Tasmanian community (through consultation processes, formal submissions and public hearings) an expert panel delivered its final report in March 2012 which recommended all services within the State-owned network businesses be combined to form one business.[3]

[3] Electricity Supply Industry Expert Panel; "An Independent Review of the Tasmanian Electricity Supply Industry", Final Report, Volume 1, March 2012, page vii-vii.

The savings to be achieved from integrating the businesses, to create what is now TasNetworks, were predominately from the rationalisation of duplicate functions and assets and the co-location of our people.

The provision of these services has been driven by the Tasmanian energy reform objectives[4] which are to:

- assist in ensuring the prices that customers are charged for electricity are as low as is consistent with ensuring the financial viability of the electricity supply industry.
- ensure that the supply of electricity in Tasmania is safe, secure and reliable.
- ensure that the advantage to Tasmania of generating electricity by means of renewable energy sources is maximised.
- ensure that State-owned electricity entities are financially viable and operated efficiently and effectively and that their overall economic benefit to Tasmania is maximised.

These objectives are already and will continue to deliver benefits to Tasmanian customers through opportunities to realise economies of scale and scope and deliver the resulting efficiencies, lower costs, and a wider choice of electricity and wholesale telecommunications services to the customers we serve. The breadth of services we offer are complementary services that enable us to have greater resource flexibility, more effectively manage the peaks and troughs in network services and have more efficient use of overhead services.

As a State-owned entity, the shareholder sets clearly defined Member expectations (our constitution), which allow our business to perform transmission and distribution services, and any other activity related to or associated with transmission or distribution services.[5] However, there are restrictions on our ability to perform activities in related businesses.

Most importantly, the Tasmanian Government, as the owner of TasNetworks, has set out clear expectations for the business including to deliver the lowest sustainable prices for regulated services to our customers.[6] The statement of expectations supports our continued activities, such as retail telecommunications services in Tasmania, and activities in what could be considered 'energy-related services', such as:

- utilisation of small scale generation for the purpose of emergency management, system security and remote supply;
- provision of wholesale telecommunications infrastructure service in Tasmania to facilitate infrastructure-based wholesale competition in Tasmania; and

[4] Section 5 of the Electricity Reform Act 2012.

[5] The Members are the Treasurer and the Minister for Energy

[6] Tasmanian Government (July 2014), Members' Statement of Expectations – Tasmanian Networks Pty Ltd, p4

- provision of services to support the National Broadband Network in Tasmania.

In undertaking these activities, we are required to operate on a commercial basis, with no cross-subsidisation by electricity customers and to include appropriate debt funding and other costs to meet competitive neutrality principles.[7] All of these requirements are consistent with the intent of the ring-fencing guideline in regards to mitigating the potential for competitive harm to occur in the electricity and telecommunications services markets in Tasmania.

Proportionality of regulatory response

It appears that an unsubstantiated assumption underpinning the Draft Guideline is that distribution networks will exert significant market power in any and all unregulated service markets that they currently or prospectively participate in. Consequently, the Draft Guideline incorporates strict ring-fencing requirements to prevent the exercise of this perceived significant market power to ensure competition in unregulated service markets is not harmed.

By harm, economists generally recognise damage being caused to competitors of the integrated entity – in this case through raising the costs of competitors and/or selling services in the competitive market below cost – which if successful will ultimately result in significantly higher prices, lower service quality or less product variety for consumers of the relevant service than would otherwise be the case.

In contrast to the AER's apparent underlying assumption, there is substantial economic literature to indicate that integration (resulting from for example, distribution networks participating in contestable service markets) will not always result in harmful effects but can actually be pro-competitive. In other words, there is an economic efficiency or welfare enhancing benefit to consumers from integration including through the exercise of economies of scale and scope in contestable markets as part of the competitive interaction between market participants. It very much depends on the market circumstances that are present and must be assessed on a case-by-case basis.

Put simply, integration that does not eliminate competitors or raise entry barriers, and therefore does not increase market power of a participant in the relevant services market, is highly unlikely to have adverse consequences for customers. This is the inherent circumstance of the Tasmanian markets into which we are currently supplying a range of electricity and wholesale telecommunications services. The nature of the Tasmanian market is inherently recognised by the State of Tasmania in setting TasNetworks' Member expectations.

[7] Tasmanian Government (July 2014), Members' Statement of Expectations – Tasmanian Networks Pty Ltd, p5.

We submit existing regulatory controls, together with the Tasmanian market conditions, means that there is little or no opportunity to engage in the perceived harms the Draft Guideline is seeking to prevent.

Cross-subsidies can be managed through existing mechanisms

We apply an AER-approved Cost Allocation methodology (**CAM**) to all our business activities, to ensure appropriate allocation of costs. This is complemented by application of the AER's Shared Asset Guideline (**SAG**). Section 3 of our CAM states that a single CAM has been developed to allocate direct and shared costs to all services that are provided, including unregulated and unclassified services. Assets that are directly attributable to a particular service are allocated accordingly with the exception of assets that meet the definition of shared assets, which are subject to the SAG.

We consider that these existing regulatory requirements are sufficient to ensure appropriate cost allocation and prevent cross-subsidisation between regulated and unregulated activities.

We are therefore concerned that the legal separation obligations set out in the Draft Guideline are unnecessary and will require an unwinding of the achieved economies of scope and scale that have delivered reductions in transmission and distribution prices to our customers.

We understand a key reason for the Draft Guideline requiring separate legal entities to offer network and non-network services is the view that the existing legal frameworks prevent the accounting separation within a business for more than network services. We would be prepared to offer an undertaking to (continue to) apply our CAM to the whole of our operations, including non-network services. This is the proportionate approach to address the cross-subsidy concern; legal separation is not.

Barriers to entry are critical when considering ring-fencing requirements

Barriers to entry are critical to the degree of competition likely to prevail in individual markets. Any such barriers will be especially important in the context of newly emerging energy retail service markets driven by new technologies.

In practice, barriers to entry will be low or non-existent if all participants in a specific contestable services market (including the DNSP and non-related new entrants) have the same technological and market opportunities. In other words, there is a competitively neutral market where the suppliers with the best price-service offering are most commercially successful.

A barrier that imposes extra costs on networks or their related entities entering contestable markets will distort competition in that market. We consider that the Draft Guideline imposes such costs as part of an apparent intention to level the playing field of any contestable markets that DNSPs or their affiliates enter by raising their costs in order to encourage new non-related entrants. This appears to be contrary to the underlying efficiency basis of the NEO as it applies to electricity services.

We recognise that access to our network is a potential barrier to entry for new or existing electricity service providers who require specific network services to provide their own services to the market. This has the potential to create a barrier to entry for if we were to prevent these access seekers gaining access to the network or did so on unfavourable terms (such as not reflecting the costs and risks of providing access to the service provider). However, we are obliged under the national electricity regulatory framework to provide non-discriminatory access to our network such that the potential discriminatory barrier to entry is not relevant.

Moreover, the Draft Guideline proposes a range of additional non-discriminatory provisions to supplement the open access obligations we have under the national electricity regulatory framework. We provide further comment on the specific non-discriminatory provisions in the Draft Guideline later in our submission.

Market failure risks

The approach taken by the AER to guideline development needs to be commensurate with the nature of the market failure risks, if any, presented by DNSPs operating in existing distribution service or non-distribution/contestable markets.

Failure to properly take account of market conditions prior to implementing the Guideline may result in DNSPs unnecessarily creating market failure given the potential costs to deliver services to some customers who value or need those services. An example may be private asset restoration works: presently where TasNetworks is replacing damaged network assets serving a customer, we may also restore private assets at the customer's request and cost. A further example is the provision of small-scale generation to support network reliability, where market providers do not offer the service at efficient cost. If onerous ring-fencing obligations are imposed, these services may no longer be offered by TasNetworks or may be offered at higher end customer cost.

These outcomes are not desirable from an efficiency perspective, both in terms of higher prices and/or the possibility that there may be no service providers in the market offering services. We consider this issue to be particularly pertinent in the Tasmanian energy and telecommunications services markets today because these markets lack the depth and maturity of the largest jurisdictions, with a much smaller pool of service providers willing to provide services in Tasmania, including to the many remote Tasmanian communities.

Framework and Approach

In principle, we are supportive of the use of the AER's Framework and Approach process as the means of classifying services, which consequentially identifies services that should be subject to the ring-fencing. However it must be noted that there remains a significant element of uncertainty from a transitional perspective for our business due to our revenue determination timelines.

This is primarily because the Framework and Approach requires a periodic assessment of the suitability of the classification of services and associated forms of price controls in the context of prevailing market circumstances. The service classification assessment needs to be robust and recognise the inherent differences in market circumstances across jurisdictions, and DNSPs, in the range of services they provide. The impact of different legal frameworks across jurisdictions may also be relevant.

Currently the outcomes of the Framework and Approach process are not consistently applied across the NEM, including as a result of different legal frameworks in each state. That is, some DNSPs have submitted distribution and non-distribution services for classification, whilst others have only sought to have distribution services classified. We consider that different ring-fencing treatment of distribution services and other services should arise only from different market circumstances and legal requirements across jurisdictions, and not from service definition differences.

Furthermore, we note that we have a number of regulatory periods and Framework and Approaches affecting the form of regulation of our services:

- we have existing arrangements under our distribution and transmission revenue decisions, to 30 June 2017 and 30 June 2019 respectively;
- we are expecting our draft revenue decision for the 2017-19 distribution regulatory period on 29 September 2016 and our final decision (which will confirm the next Framework and Approach) in April 2017;
- we will lodge our submission on our proposed Framework and Approach for our combined 2019-24 transmission and distribution regulatory periods in October 2016; receive the AER's proposed Framework and Approach in July 2017, a draft decision on the revenue determinations in September 2018 and final decision on the revenue determinations in April 2019.

Transitional issues associated with managing these changing Framework and Approach outcomes, and associated compliance implications, need to be addressed.

Transitional arrangements

While supporting a central role for the Framework and Approach process, the proposed transitional arrangements in the Draft Guideline are inconsistent with this intent. For example, we may be required to incur significant compliance costs based on the classification of services changing within less than 18 months from proposed December 2016 date of commencement.

Further to this point, we note the recent Rule change request submitted by the COAG Energy Council which addresses a number of issues directly or indirectly addressed in the Draft Guideline i.e. service classification definitions, and boundaries of services to be provided by DNSPs. The uncertainty created by this Rule change request provides further weight to the need for a longer transitional period.

Under the Draft Guideline, a DNSP's compliance obligations may vary over time due to changes in services classification under the Framework and Approach. Currently the Draft Guideline is silent on the associated transitional arrangements with service classification changes, whether proposed by a DNSP or required by the AER. Due to the frequency in which these events will possibly occur, the transitional arrangements need to be expanded to recognise these circumstances and the ambiguity it introduces for our customers.

The remainder of our submission presents comments on specific provisions of the Draft Guideline aligned to the subject matter headings.

AER's Draft Guideline

The following discussion addresses each of the Draft Guideline's key components.

Nature and authority

Objective of ring-fencing

The Draft Guideline does not establish a clear objective beyond identifying the NEO and potential behavioural harms (cross-subsidisation and discrimination) that it seeks to prevent through accounting and functional separation of direct control services provided by DNSPs from other services that they or their related body corporates provide.

Consistent with the distribution revenue and pricing principles, TasNetworks considers that a clearer objective for the ring fencing guideline would be:

> *the overriding objective of the distribution ring-fencing guideline should be to ensure*
>
> *a. the provision of efficient distribution services by DNSPs and*

b. facilitation of competitively neutral distribution and non-distribution service markets where competitors of the DNSP or its related body corporates are reasonably foreseeable.[8]

We agree with the AER that clear cases of cross-subsidisation and discrimination (preferential self-dealing) are the critical behaviours that are appropriately targeted under a ring-fencing guideline. Our proposed objective clearly identifies the reasons why ring-fencing of the distribution networks is required by specifically addressing these behaviours through its focus on:

- efficient distribution service provision, which implies subsidy-free prices for these services in the face of other potentially contestable non-distribution services provided by the DNSP or its related entity; and
- facilitation of competitively neutral distribution (if competition is feasible) and competitive non-distribution service markets, which requires no discrimination exercised by the DNSP in relation to the competitors of itself or a related body corporate(s) in these markets.

Further, we consider long term consumer benefit rather than the promotion of competition per se should be the ultimate objective of the ring-fencing guideline. To this end, we note our concern that the Draft Guideline appears primarily focussed on promoting competitive market outcomes, including new entrants in 'energy-related markets', at the expense of imposing additional costs on the networks who are already operating in, or decide to operate in, specific contestable markets.

If we have a lower cost to serve in a contestable market than competitors, and this cost advantage has not arisen from preferential self-dealing or cross-subsidisation of prices in the competitive market, then there is no good reason for us to be prevented from or hindered in serving the market through restrictive ring-fencing provisions that increase its cost to serve. This inefficiency will ultimately be borne by consumers in these markets who will pay for a higher priced service than would otherwise be the case.

[8] Distribution service is defined as per the NER. Non-distribution services are any services that do not meet the distribution service definition.

Relationship with other Regulatory Instruments

One of the key principles of ring-fencing is to ensure there is no cross-subsidisation between the regulated monopoly services and those provided in a competitive market. This is to ensure consumers of the monopoly services are only paying efficient costs and that DNSPs participate on a level playing field with other service providers in competitive markets. This principle is currently addressed and implemented via the CAM and supplemented by the SAG.

The Draft Guideline identifies that the SAG provides for the adjustment of our Maximum Allowable Revenue (MAR) where it has been identified that the CAM no longer accurately reflects how its regulated assets are used. Our CAM (supplemented by the SAG) provides the assurance to the AER that our business does not cross-subsidise between our regulated and non-regulated businesses.

For example, a service that many DNSPs provide, including TasNetworks, is the rental of 'space' available on distribution poles to telecommunications businesses to attach their cables, which avoids the duplication of poles and significant costs to communities. Under the Draft Guideline direct control services are to be functionally separated from 'energy-related' services provided by a DNSP's related party. As a result, services such as pole rental, must be in a separate legal entity and may also be subject to functional separation (i.e. located separately and unable to share staff).

Under the current classification of services, this obligation cannot be practically implemented as the pole rental service is directly related to the use of network assets. Also, the staff employed to negotiate with customers for this service need to be DNSP staff because the assets primarily provide a regulated network service. Furthermore, as this service is primarily about access to the DNSP's assets, it does not make sense to market this activity under a separate brand. We consider this type of activity should be undertaken by the DNSP as it is being captured and reported under the SAG and can be classified as unregulated distribution services.

Box 1 Summary of TasNetworks' proposed changes

TasNetworks proposes the following changes to the Draft Guideline:

- Services covered by the SAG should be able to be provided by the DNSP and not require a related body corporate

Prevention of cross subsidies

Possible approaches to separation under ring-fencing guidelines include ownership (structural separation), prohibition on providing defined services, legal, financial, and functional (physical/geographic). The Draft Guideline proposes to apply all forms of separation except for ownership and prohibition, with waivers only available for functional separation.

As described earlier in this submission, the small size and geographic spread of the Tasmanian market suggests that scale and scope economies can be achieved by our participation in a broader range of services, including in contestable markets, such as telecommunications. Consequently, strict separation and the associated duplication of costs will have a material adverse impact on our unit costs because service outputs (distribution and non-distribution) are relatively small when compared to peer network businesses. Separation requirements unrelated to market circumstances are therefore inconsistent with efficient distribution/network service delivery, increasing cost with questionable and highly uncertain offsetting competition benefits.

In our view, legal and functional separation are not necessary to prevent the exercise of cross-subsidisation or for non-discriminatory third party access to the networks. Existing regulatory measures, particularly the CAM is effective in preventing cross-subsidisation and harm to competitors operating in contestable markets.

Legal separation

As previously noted, we support the objective of preventing DNSPs from cross-subsidising between contestable and regulated services to avoid inappropriate increases in network services prices or adversely impacting competition in contestable markets. However, we do not agree that legal separation is necessary to achieve this separation. Cross-subsidisation is fundamentally a cost attribution and allocation issue.

Service definition inconsistencies

In considering the proposed requirements for legal separation, we note that there are a range of definitional inconsistencies within the Draft Guideline and the Explanatory Statement and that there are a number of undefined terms. There is also inconsistency between what are defined as *network services* and existing Framework and Approach decisions relating to *distribution services*. The AER's case studies also appear to confuse the definitions of *network services* and *distribution services*.

Further, we support the ENA position that transmission issues should be considered thoroughly and holistically in an independent review process. Any review of the existing ring-fencing obligations on transmission businesses must carefully consider the regulatory framework as it applies to transmission networks and should not simply apply the same framework that the AER seeks to apply to DNSPs. In the Tasmanian context, care should be taken to ensure that the principles of the existing transmission ring-fencing waiver continue to be reflected in the new arrangements. This is discussed further below.

Overall, the definitional inconsistencies directly impact on where the boundary for legal separation sits within DNSPs' existing organisational structures and hence the associated operational and cost implications of separation. These matters are explored more fully in the ENA submission and we welcome the opportunity for the AER to work directly with us on how the definitions will apply given our business context.

Extension of waiver to legal separation

We consider the ring-fencing waiver provisions are critical to recognition of different market circumstances across the NEM and hence the proportionality of the ring-fencing obligations that are applied. The AER has acknowledged that different market conditions exist across the NEM by linking the ring-fencing guideline to the Framework and Approach process, which requires the AER to take into account the specific market circumstances when classifying distribution services. We consider that the ring-fencing guideline should call out that prevailing market conditions are a critical consideration in determining the application of ring-fencing obligations.

Furthermore, the Explanatory Statement explains that the materiality threshold being applied is to recognise that a DNSP should be able to undertake incidental non-distribution services that do not have a materially adverse impact on competition in the market for non-distribution services. We consider that a blanket threshold with no waiver provisions for legal separation does not take into account the prevailing market conditions for the relevant service.

Consequently, we consider that the waiver application process should be extended to the legal separation obligations of the ring-fencing guideline to ensure that the costs and benefits of doing so can be weighed up in these types of market circumstances.

We question the benefits that customers will realise from legal separation to offset the compliance costs that TasNetworks will incur. Moreover, under the Draft Guideline, we will also be required to create a new brand for our non-network service business, with the associated costs, whereas services such as telecommunications and training are currently co-branded with TasNetworks' electricity network businesses. There is also no waiver available in relation to this restriction.

Recognising the Tasmanian market context we consider the AER should replicate the nature and intent of the transmission ring-fencing waiver that exists.[9]

Threshold to provide non-network services

We support the intent behind the inclusion of the materiality threshold for legal separation. However due to the size of the threshold, at up to $500,000 of costs per annum in providing non-network services, it is highly questionable whether it will achieve the objective of providing DNSPs with sufficient flexibility to minimise the need to seek waivers.

[9] AER. 2014. *TasNetworks Application for Waiver from Transmission Ring-fencing Guidelines: Final Decision*. May.

Whilst the use of a threshold is supported from an administrative perspective and that it will allow the DNSP to leverage economies of scope to encourage innovation, it fails to directly consider the impact on competition or market development of the DNSP providing non-network services.

The ring-fencing obligations link directly to the Framework and Approach. In classifying services, the AER must take into account a number of factors including the potential for development of competition in relevant markets. As a result, the classification of services in each DNSP's Framework and Approach may not align due to different market circumstances.

The AER has stated that consistency across DNSPs was the basis for its proposed fixed $500,000 dollar threshold for all DNSPs and its size reflects the likely impact on the development of contestable markets and the confidence of parties other than DNSPs operating in these markets. However, we consider that the high degree of uncertainty regarding the size of a potentially wide range of contestable markets comprising businesses of varying sizes from large to small invalidates such a small fixed dollar threshold.

We propose that a percentage threshold would be more appropriate and a percentage of maximum allowable revenue, consistent with other materiality thresholds applied may be more appropriate.

Accounting separation

Section 3.2.1 of the Draft Guideline requires a DNSP to establish and maintain internal accounting procedures to ensure appropriate cost allocation between its DNSP delivering *network services* and its related parties providing all other services. A DNSP may also be required to report on transactions between it and its related parties as part of the Regulatory Information Notices (RIN) process.

As noted earlier in this submission, one of the key principles of ring-fencing is to ensure there is no cross-subsidisation between the regulated monopoly services and those provided in a competitive market. This principle is currently addressed and implemented via the CAM and supported by the SAG. However, the Draft Guideline appears to seek to go beyond this key principle by requiring a DNSP to report on transactions between it and its related body corporate (3.2.1 (b)). We note that related party transactions are required to be reported as part of the AER's annual RIN template. We consider that any duplication of existing regulatory obligations, such as section 3.2.1 of the Draft Guideline, should be removed.

Cost allocation and attribution

Section 3.2.2 of the Draft Guideline requires cost allocation to *distribution services* and non-distribution services, consistent with the cost allocation principles in the AER-approved CAM for each DNSP.

We support the use of the CAM as the existing regulatory instrument that ensures appropriate cost allocation for *distribution services* and other services provided by TasNetworks. The CAM is the primary mechanism by which the economies of scale and scope in network service provision are shared with other services that we provide.

Box 2 Summary of TasNetworks' proposed changes

TasNetworks proposes the following changes to the Draft Guideline:

- all service-related terms should be defined, including 'energy related service' and inconsistencies in the use of network services and distribution services resolved
- the waiver application provisions be extended to cover legal separation obligations, to ensure an appropriate assessment of costs and benefits to customers of requiring compliance.
- the AER should replicate the nature and intent of the waiver that exists for TasNetworks.
- the threshold before legal separation applies should be a percentage of a DNSP's maximum allowable revenue.
- the duplication of existing regulatory obligations contained in section 3.2.1 should be removed.

Non-discrimination

General obligations to not discriminate

Section 4.1 of the Draft Guideline requires a DNSP to not discriminate between its related parties and its related parties' competitors, including in relation to information flows, its dealings with its related legal entity and the competitors of that entity, and the market.

We support the identification of contestable and non-contestable activities and obligations to ensure transactions between ourselves and related parties are undertaken at arm's length. However, the nature of the proposed non-discrimination provisions are disproportionate, having no regard to market circumstances and hence potential market harm. This is exacerbated by the lack of scope for waivers in relation to these provisions.

Most importantly, we query the need for co-branding restrictions between distribution and non-distribution services (paragraph 4.1(b)(vi)).

We have worked hard to build our brand in the Tasmanian market across both electricity network and wholesale telecommunications services over recent years, with the merger of these businesses under the TasNetworks name reinforcing a co-branding intent. In practice, a strong brand in the regulated electricity sector will come from identifying and exceeding customer expectations. We strongly believe that our strong branding allows us to better achieve our community objectives and deliver favourable outcomes for the Tasmanian community.

In our view, there are no economic grounds for denying a DNSP benefitting from such favourable associations in its participation in contestable markets. Competitors in these markets will similarly be seeking to use favourable associations with other services they provide.

There is clearly an economic benefit from consumers being able to make informed consumption decision in contestable market based on their prior buying experiences and knowledge of service providers, whether they be regulated or not. We consider that the co-branding restriction should be removed.

Specific obligations for functional separation

Section 4.2 of the Draft Guideline requires physical separation and restrictions of staff sharing between our *direct control services* and a related party's 'energy-related services'. These proposed functional separation obligations are significantly more onerous than the current Tasmanian ring-fencing provisions. Furthermore, we note that 'energy-related services' is not a defined term in the NER nor the Draft Guideline, and the functional separation provisions refer to staff that are 'directly involved' in *direct control services*, which is open to wide interpretation. This ambiguity in the Draft Guideline means that we do not understand the extent to which functional separation of our operations is required and consequently what measures will be required to ensure compliance. This ambiguity in drafting is material and needs to be resolved in finalising the guideline.

Importantly, the proposed physical separation and staff sharing restrictions where there is little prospect of a competitive market developing will create duplication and additional costs for customers of electricity services for no benefit. This is inconsistent with the NEO.

We also consider that if the physical separation obligations are to apply, they should be less onerous, such as separate floor space with restricted access. We consider that this would achieve a similar outcome in that day-to-day activities would be undertaken confidentially and customer information would not be shared. However, the ring fencing objective would be achieved at a significantly lower cost. Moreover, we have long-term property arrangements that would take time and be costly to unwind, and sourcing alternative office and services space due to functional separation would add significant costs to our current arrangements.

Information access and disclosure

Section 4.3 of the Draft Guideline requires DNSPs to treat the information provided by customers for direct control and regulated transmission services as confidential and to only use the information for the purpose for which it was provided.

We support the AER's intent to protect the information of *direct control services* customers.

However, under the Draft Guideline a DNSP is prevented from disclosing information acquired from the provision of direct control services to any party without obtaining the customer's informed consent. This section is unworkable as it is currently drafted. For example, the majority of information provided in RIN responses has been acquired from providing direct control services.

Section 4.3.3 of the Draft Guideline would therefore prevent us from completing the AER's RIN templates without obtaining the explicit consent of all customers. We suggest that these provisions be redrafted in line with the confidentiality provisions in Chapter 8, Part C of the NER.

Box 3 Summary of TasNetworks' proposed changes

TasNetworks proposes the following changes to the Draft Guideline:

- Section 4.2 be redrafted to resolve the ambiguity around the use of the term 'directly involved in' *direct control services*.
- The physical separation obligations set out in section 4.2.1 should be redrafted to enable a DNSP to meet these obligations by operating in separate spaces of the same building but with restricted access to prevent staff moving freely between areas.
- the co-branding restriction in paragraph 4.1(b)(vi) should be removed.
- the information access and disclosure provisions set out in section 4.3 should be aligned with Chapter 8, Part C of the NER.

Waivers

The Draft Guideline narrowly restricts access to a waiver to only the functional separation provisions.[10] This highly restrictive approach appears completely disproportionate as no regard has been given to the relevant market circumstances facing each DNSP.

We consider the ring-fencing waiver provisions are critical to recognition of different market circumstances across the NEM and hence the proportionality of the ring-fencing obligations that are applied. As set out earlier in this submission, we consider that the waiver provisions should be extended to apply to the legal separation and co-branding provisions.

In considering waiver applications, the Draft Guideline states that the AER will have regard to at least the NEO, the potential for cross-subsidisation and whether there is likely to be a net cost (balancing electricity consumer benefits with the DNSP's compliance costs) if it does not provide the requested waiver.

Given the Draft Guideline seeks to avoid monopoly businesses from using their market power in the provision of *network services* to adversely impact on competitive markets in which they or their related entity participates, we consider the assessment of a waiver application should incorporate a market-based test that assesses the potential impact on competitive markets of granting a waiver. This complements the NEO which is focused on efficiency of provision of electricity services.

Box 4 Summary of TasNetworks' proposed changes

TasNetworks proposes the following changes to the Draft Guideline:

- the waiver application provisions be extended to cover legal separation and co-branding obligations.
- the assessment of a waiver application should also incorporate a market-based assessment that takes into consideration the potential impact on relevant competitive markets of granting a waiver.

[10] AER (August 2016), Draft Ring-fencing Guideline Electricity Distribution, clause 3.1(e) and section 4.3.4

Compliance and enforcement

The lack of clarity around the scope of services that the proposed ring fencing obligations apply to needs to be resolved. Ambiguity will make it difficult for DNSPs to implement systems and processes to ensure compliance. A lack of clarity in the ring-fencing guideline will also create problems for the annual audit process as the auditor may not be able to determine whether a DNSP is compliant or not.

Under the Draft Guideline, we are required to undertake a compliance assessment by a qualified independent authority. This obligation should be further clarified to define the compliance assessment as a limited assurance review rather than an audit.

Box 5 Summary of TasNetworks' proposed changes

Subject to greater clarification of defined terms in the final Guideline, TasNetworks proposes the following changes to the Draft Guideline:

- the obligation to undertake a compliance assessment, set out in Section 6.2.1 should be clarified to define the compliance assessment as a limited assurance review.

Appendix A of the Draft Guideline requires DNSPs to comply with legal separation obligations within 12 months from the commencement date of the ring-fencing guideline (currently 1 December 2016). The legal separation of *network services* from other activities will be complex and costly to implement given the integrated nature of our organisational structure and operations, and the requirement to ensure operations comply with a range of State obligations, including those for State Owned Companies.

Appendix A of the Draft Guideline also requires DNSPs to comply with functional separation obligations within six months from the commencement date of the ring-fencing guideline. Given the lack of clarity around service definitions and other interpretation issues within the Draft Guideline, it is difficult to comment at this stage as to whether compliance with the functional separation obligations could be achieved within six months, but it appears unlikely.

We note that the transitional arrangements set out in the Explanatory Statement are inconsistent with the Draft Guideline. Section 7.2 of the Explanatory Statement states that the AER will enforce the functional separation obligations from 1 December 2016 (sections 4.1 and 4.2 of the Draft Guideline).

Finally, in recognition of the linkage between changes in AER-approved service classifications and ring fencing obligations, we propose that the transitional arrangements in the Draft Guideline be expanded to provide a 12-month transition period from the date of a DNSP's final distribution determination before compliance with the ring-fencing guideline is required for the affected re-classified services. The AER determination process should provide funding for the costs associated with giving effect to this change in regulatory obligations.

Box 6 Summary of TasNetworks' proposed changes

TasNetworks proposes the following changes to the Draft Guideline:

- legal and functional separation obligations in the Draft Guideline commence from 1 December 2017.
- transitional arrangements be expanded to provide a 12-month transition period from the date of a DNSP's final distribution determination before compliance with the ring-fencing guideline is required for any re-classified services.

The Appendix to this submission provides case studies of the impact of the Draft Guideline, as we understand it, for the AER's consideration.

A Appendix – Case Studies

We have prepared three case studies that set out our understanding of the impact of the Draft Guideline on our delivery of the following regulated distribution and contestable services:

- Telecommunications
- Training
- Field services.

We welcome the opportunity to discuss these arrangements with the AER, and highlight the unworkability of the AER's Draft Guideline using these services as a case study. In all cases we consider that the only clear implication of the Draft Guideline is that the costs of both regulated and unregulated services will rise because of the loss of efficiencies of scale and scope in their provision, increasing distribution and other service prices. It is not clear to us that any competition-related benefits to customers are likely to offset the efficiency losses.

A.1 Telecommunications services

We provide telecommunication services to support regulated and unregulated transmission and distribution network services, including to support major customers in the Tasmanian electricity industry, and to a number of other external parties. Our Members expectations reflect that TasNetworks' provision of telecommunications services facilitates competition in the Tasmanian telecommunications market.

The costs of shared assets used to deliver these services have been apportioned between regulated and unregulated services with all operating costs incurred to service the assets also apportioned. There are also dedicated unregulated telecommunications services assets and operating costs.

A.2 Training services

TasNetworks develops and delivers training to its employees as well as to external parties within the electrical services industry. These training services are provided to contractors and our own people who are required to work on our network assets. Practically, due to the specialised nature of this training, we are the only organisation able to provide these services in Tasmania and ensure relevant safety standards and regulatory compliance requirements are met.

These training services for network and other services are delivered using shared staff with specialised knowledge of our electricity network and are delivered at the same site using the same assets. The assets and operating costs that are used to deliver the services are apportioned as per our CAM.

A.3 Field services

TasNetworks' field staff, particularly in rural or isolated parts of Tasmania, undertake both regulated and unregulated work. There are material efficiencies of scope in electricity distribution staff being able to perform unregulated tasks, including lower labour and transport costs, reflected in lower electricity distribution prices.

The AER's Explanatory Statement Case Study 1 about DNSP regional depots has similarities to our field services in that it could mean more than one truck visit is required to complete a single job. Case Study 1 involves a crew to complete the regulated connections work and another crew to complete unregulated metering works. We question the benefit to customers of requiring two crews to complete a job of this nature, or requiring outsourcing of this service, when it may be more efficient to have a single crew undertake the work under existing arrangements.

In Tasmania, and particularly regional areas Tasmania, we question whether there are any material competition issues that have arisen or are likely to arise regarding our provision of regulated and unregulated field services work.