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Mr Chris Pattas
General Manager, Networks
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

By email to: Ringfencingguideline2016@aer.gov.au

Dear Chris,

DRAFT RING FENCING GUIDELINES

United Energy appreciates the opportunity to provide this submission on the AER's draft Ring Fencing Guideline of August 2016. As a member of the Energy Networks Association, United Energy also supports the Association's submission.

The AER's position is that the National Electricity Objective will be promoted by avoiding the potential harm that may arise from:

- DNSPs cross-subsidising between regulated and contestable services; and
- DNSPs discriminating against other service providers.

The AER's concerns are that:

- Cross subsidies may have anti-competitive effects in non-regulated markets, and lead to higher network prices than would otherwise be the case; and
- Discrimination, including access to privileged information, may confer an unfair competitive advantage on DNSPs.

United Energy considers it is important that the Ring Fencing Guidelines recognise that the National Electricity Objective (NEO) will be promoted by DNSPs engaging fully in competitive markets and leveraging their expertise and regulated asset base wherever it is economic to do so. Therefore, a careful balance must be struck between protecting customers from the potential harm of cross subsidy and discrimination on the one hand, and ensuring that customers benefit as fully as possible from the DNSPs' engagement in the provision of new and emerging energy services.

The AER has partly recognised the need to get this balance right by making reference to COAG's principles of best practice regulation¹. In particular, the AER notes that regulation should be:

- targeted – at markets, services, and behaviours of concern;
- proportionate – with implementation, monitoring and compliance costs proportionate to actual or potential harm;
- predictable – for DNSPs and other stakeholders; and
- promote confidence – in markets and regulatory outcomes.

However, the current draft Ring Fencing Guideline does not satisfy these principles. In particular, the current draft would preclude DNSPs from providing 'non-network services'. As a result, some integral DNSPs functions – such as connection services – would need to be provided by a legally and functionally separate affiliate. Other services, such as pole rentals, could no longer be provided by any party. Evidently, such outcomes would be contrary to customers' interests.

United Energy notes that the impact of the AER's proposed Guideline may be unintentional. It is essential, therefore, that the AER consults with the network businesses to ensure that the ring fencing obligations are workable. United Energy strongly favours a more targeted, proportionate and predictable approach that:

- Precludes DNSPs from providing services only where there are genuine competition issues to be addressed;
- Ensures that DNSPs have an incentive to find opportunities to use regulated assets for non-regulated purposes;
- Sets an appropriate materiality threshold that enables DNSPs to engage in unregulated activities on a small scale in order to promote innovation and investment to the benefit of customers; and
- Avoids imposing costly obligations on DNSPs and customers unless there is a discernible benefit.

United Energy looks forward to working with the AER on finalising the Ring Fencing Guideline in the coming months. The attachment includes a summary of United Energy's recommendations. If you have any queries regarding this submission, please contact me on 03 8846 9856.

Yours sincerely,

Verity Watson
Manager Regulatory Strategy

¹ COAG, *Best Practice Regulation: A guide for Ministerial Councils and National Standards Setting Bodies*, October 2007, page 4.

UNITED ENERGY'S SUBMISSION ON THE AER'S DRAFT RING FENCING GUIDELINE

1. Introduction

United Energy supports the introduction of Ring Fencing Guideline, which seeks to provide a level playing field in the wide range of energy services developing in response to technological change.

The AER's draft Ring Fencing Guideline imposes significant restrictions on the activities that DNSPs can undertake. The AER's intention is that this restriction will promote the achievement of the National Electricity Objective (NEO) by protecting electricity customers from the risk of cross-subsidisation and anti-competitive practices.

However, as explained below, the draft Ring Fencing Guideline adopts an overly narrow definition of the services that DNSPs are allowed to undertake. While this outcome appears to be an inadvertent drafting error regarding the definition of 'network services', it highlights the importance of targeted and proportionate regulation and the high costs to customers of excessive regulation.

The remainder of this submission is structured as follows:

- Section 2 address the AER's definition of non-network services;
- Section 3 discusses how cost sharing can be promoted through targeted and proportionate regulation, for the benefit of electricity consumers;
- Section 4 comments on the requirement that the DNSP must operate independent and separate offices for the purpose of conducting competitive market activities;
- Section 5 explains why the AER's proposed materiality threshold is inappropriately low;
- Section 6 comments on the importance of appropriate transitional arrangements; and
- Section 7 summarises United Energy's recommendations.

2. AER definition of network services

The draft Ring Fencing guideline prevents DNSPs from providing services other than 'network services'. The AER explains its approach as follows²:

"By restricting a DNSP to provide only network services, we address concerns about the potential for a DNSP to cross-subsidise its non-network services through its network services, to the long term detriment of customers. We consider that this restriction is required to address this risk and that separate accounting and cost allocation, without legal separation, would not be effective."

However, 'network services' is defined relatively narrowly in Chapter 10 of the Rules to mean:

² AER, Ring Fencing Guideline Explanatory Statement, August 2016, page 23.

“Transmission service or distribution service associated with the conveyance, and controlling the conveyance, of electricity through the network.”

Therefore, if a DNSP were restricted to only providing network services (as the AER suggests) the DNSP would be prevented from:

- earning revenue from shared assets, such as pole rental to providers of communications services;
- earning revenue from engineering consulting or specialist testing services;
- providing connection services, as these services are not strictly ‘network services’; and
- providing ancillary services that are not connected to the ‘conveyance of electricity’, but are essential aspects of the services that the customers expect DNSPs to provide.

It is evident from the AER’s explanatory statement that these outcomes are unintentional. We note, for example, that the AER’s explanatory statement makes the following comments in relation to Case Study 14³:

“A DNSP can rent out space in its underground ducts or on pole tops to third parties.”

United Energy also notes that the AER’s Case Studies and its explanatory statement tend to refer to ‘distribution services’ and ‘network services’ interchangeably – even though the scope of these services are materially different from one another. United Energy also notes that the AER’s draft Ring Fencing Guideline also raises the possibility of distributors being required to ring fence their electricity and gas networks, which would have significant cost implications.

Given the significant problems with the AER’s draft Ring Fencing Guideline, the AER should work closely with the network companies to ensure that the provisions are workable.

3. Promoting cost sharing through targeted and proportionate regulation

United Energy notes that the regulatory and legislative frameworks already provide tools to address the risk of cross subsidy and discrimination, including:

- the Competition and Consumer Act 2010 (Cth), which prohibits anti-competitive practices;
- the Metering Contestability Rule Change information requirements, which is addressing issues regarding the use of metering data;
- Chapter 6 requirements relating to cost allocation and service classifications, which address cross subsidy issues;
- The AER’s RIN requirements and expenditure forecast assessment guidelines, which enable the AER to set efficient ex ante expenditure allowances and eliminate the potential benefit to DNSPs of cross-subsidising unregulated activities; and

³ Ibid, page 64.

- Chapter 6 requirements covering related party transactions, which ensure that regulated costs are not affected by related party transactions.

Given these provisions, the potential harm from cross-subsidy and discrimination – and the benefit of introducing Ring Fencing Guidelines – is likely to be small. On the other hand, the potential cost of regulation is likely to be significant. It is important, therefore, that the Ring Fencing Guideline is targeted and proportionate so that the costs of regulation do not outweigh the benefits.

One area of concern relates to the impact of the Ring Fencing Guideline on the opportunities for cost sharing between regulated and non-regulated services. United Energy notes that the Rules set out the following cost sharing principle⁴:

“The Distribution Network Service Provider should be encouraged to use assets that provide standard control services for the provision of other kinds of services where that use is efficient and does not materially prejudice the provision of those services.”

It is important that the AER’s Ring Fencing Guideline has regard to this principle by ensuring that an appropriate balance is struck between:

- taking action to minimise the potential harm from cross-subsidy and discrimination; and
- ensuring that DNSPs are encouraged to pursue cost sharing opportunities.

United Energy therefore proposes that the Ring Fencing Guideline should clarify that DNSPs are able to provide any energy related service that makes use of the regulated asset base. This clarification will provide certainty and predictability to DNSPs in accordance with the best practice principles adopted by the AER.

4. Independent and separate offices

The draft Ring Fencing Guideline requires that a DNSP must operate independent and separate offices for the purpose of conducting competitive market activities. In addition to preventing staff from mixing in the normal course of undertaking work activities, the DNSP must operate in a different building.

Evidently, the requirement for a separate office may impose significant costs on customers if accommodation has been sized to meet the needs of regulated and competitive market activities. A more cost effective approach is to establish regulations that require the DNSP to demonstrate that appropriate measures have been put in place to prevent inappropriate transfer of information between the regulated and competitive market activities. For example, separate working areas with restricted access may prove to be a lower cost, but equally effective method for meeting the ring fencing objectives.

⁴ National Electricity Rules, clause 6.4.4(c).

5. Materiality threshold

The AER's draft Ring Fencing Guideline allows DNSPs to undertake non-network services so long as the total costs of providing those services does not exceed a threshold of \$500,000 per annum. The AER's reasoning for this threshold is reproduced below⁵:

"On balance, we consider a materiality threshold is required to enable a DNSP to provide limited non-network services that are incidental to, but necessary to support the provision of, its network services. The threshold should allow a DNSP to do the minimum necessary to support its network services, without having a materiality adverse impact on competition in the market for non-network services.

The annual materiality threshold is \$500,000 of total costs incurred (comprising direct and non-direct costs), and would apply in any year when the non-network services provided by a DNSP exceed \$500,000 of total costs. In determining this level, we considered first materiality thresholds for distribution pass through events under the NER, currently set at one percent of annual average revenue. That threshold, if applied to legal separation, would create inconsistencies across DNSPs, and could result in materially adverse effects on the markets for contestable services. Instead, a threshold based on a fixed dollar value would achieve a more balanced outcome."

It is unclear what the AER is referring to when it says that some non-network services are necessary to support network services. United Energy would be very concerned if the Ring Fencing Guideline had the potential to restrict DNSPs from undertaking activities that are necessary for the provision of network services. It is not appropriate to rely on a materiality threshold to avoid unintended consequences from regulation that is drafted too broadly.

A similar observation applies to the waiver provisions. Such provisions are essentially a safety valve introduced by the regulator because it is likely that the provisions will be prove to be too onerous in some cases. United Energy supports regulation that is 'right-sized', which means it is targeted and proportionate, consistent with COAG's best practice principles. In addition, if waiver provisions are unavoidable, it is important that DNSPs have certainty that their application will be addressed within an appropriate timeframe. At present, the draft Ring Fencing Guideline does not provide this assurance.

In relation to the threshold, United Energy considers 1% of the maximum allowed revenue is substantially more appropriate than the AER's threshold of \$500,000, which is arbitrary and highly restrictive. In addition, the threshold should be defined so that it excludes any regulatory allowances, such as those relating to the demand management incentives scheme and innovation allowance mechanism. Otherwise, the purpose of the threshold will be undermined.

United Energy considers that the threshold should balance the objectives of:

- reducing the risk of harm as a result of cross subsidies or discriminatory practices; and
- encouraging DNSP participation, innovation and investment in non-regulated activities in an environment characterised by rapid technological change.

⁵ AER, Ring Fencing Guideline Explanatory Statement, August 2016, page 24.

The NEO is concerned with promoting efficiency for the long term benefit of customers. Efficiency is a dynamic concept in the sense that efficient outcomes are only achieved over time if there is an appropriate level of investment and innovation. The AER's threshold of \$500,000 essentially excludes DNSPs from participating in non-regulated activities because of the potential (not actual) harm arising from cross subsidies and anti-competitive practices. Such an approach to regulation is at odds with the principles adopted by COAG⁶:

"Many existing and proposed regulations and requirements restrict competition, including by imposing barriers to entry, exit, or innovation, and can have the effect of restricting consumer choice, raising prices and reducing overall economic efficiency and productivity.

As far as possible, restrictions on competition should be avoided or minimised. Regulation should only restrict competition where this is necessary to achieve the objective, and the benefits of restricting competition outweigh the costs."

A materiality threshold of 1% of the maximum allowed revenue is already a feature of the regulatory framework applying to DNSPs. United Energy considers that a threshold of this level would provide an appropriate balance between the need to protect customers from anti-competitive practices, and promote competition, innovation and investment which are essential pre-conditions for achieving the NEO.

6. Transitional arrangements

The AER recognises that its Ring Fencing Guideline will create costs for DNSPs in amending corporate processes and structures to comply with the new arrangements. While the AER proposes a transition period of up to 12 months for ring-fencing obligations relating to legal and functional separation, the AER proposes to enforce from 1 December 2016 the obligations relating to separate financial accounts, customer information protection and non-discrimination.

United Energy considers the timeframe proposed by the AER to be inadequate. United Energy will need time to determine the operational impact of the final Guideline and to make the necessary internal changes, and conduct training. A more realistic timeframe for enforcement of the obligations relating to separate financial accounts, customer information protection and non-discrimination is 1 December 2017, and 18 months for legal and functional separation.

A further transitional issue arises if a distribution determination results in a change to the classification of distribution services that affects the DNSP's obligations under the Ring Fencing Guideline. United Energy considers that DNSP should also be afforded a 12 month period after the commencement of the relevant distribution determination to comply with the Ring Fencing requirements.

7. Summary of United Energy's recommendations

United Energy's recommendations are summarised below:

A. The AER should work closely with the network companies to ensure that the provisions are workable.

⁶ COAG, *Best Practice Regulation: A guide for Ministerial Councils and National Standards Setting Bodies*, October 2007, page 6.

- B. The requirement to have separate buildings for the provision of ring-fenced services should be removed. Instead, DNSPs should be required to demonstrate that measures are in place to prevent the inappropriate transfer of information and mixing of staff between regulated and competitive market activities.
- C. The Ring Fencing Guideline should clarify that DNSPs are able to provide any energy related service that makes use of the regulated asset base.
- D. DNSPs should be allowed to participate in the provision of services that would otherwise be required to be provided by a separate legal and functionally separate company, providing that the costs of the services provided do not exceed 1% of the maximum allowed revenue. The threshold should be defined to exclude any regulatory allowances, such as those relating to the demand management incentive scheme and innovation allowance mechanism.
- E. The transitional arrangements should be extended so that customer information protection and non-discrimination is introduced on 1 December 2017, and 18 months is provided for legal and functional separation from the commencement of the new Rule.
- F. A 12 month transition should be provided to address any change in the Ring Fencing obligations resulting from a regulatory determination.