energy networks association

AER RING-FENCING GUIDELINE

Response to Preliminary Positions Paper
30 May 2016

CONTENTS

EXECUTIVE SUMMARY

The Energy Networks Association (ENA) welcomes the opportunity to respond to the Australian Energy Regulator's (AER) Preliminary positions paper for an electricity ring-fencing guideline.

The ring-fencing guideline review process is significant part of broader steps to ensure regulatory frameworks evolve to reflect the changing landscape of Australian energy markets. ENA considers consumers will benefit from consistent national approaches where feasible to enhance competition and certainty for market participation decisions.

ENA strongly supports the AER's approach of adopting 'service-based' rather than 'asset-based' regulation as promoting the long-term interests of consumers by promoting a technology neutral approach to efficient delivery of regulated services.

The ENA supports the efficient delivery of network services and the important contribution networks make to enabling existing and emerging competitive energy service markets.

ENA members recognise that where the primary purpose of an investment is provision of a competitive customer-facing energy service, then distribution networks would not seek to include the relevant assets in their regulated asset base (RAB), but would rather seek to provide the service on a non-regulated basis through a business separate to the ring-fenced entity.

Ring-fencing guidelines should provide meaningful guidance to all market participants on how the regulator will apply its discretion and powers. Networks consider that the ring-fencing guideline itself - not just the waiver process - needs to provide sufficiently clear and certain guidance on expected AER approaches to a set of common circumstances likely to be encountered on a national basis.

The proposed scope of the AER's initial ring-fencing obligations is a matter of significant concern for the network sector. If the AER adopts a default approach that 'all contestable services are subject to ring-fencing, except where individual waivers apply', this is likely to be excessively onerous, time consuming and uncertain. It also fails the critical regulatory design principle of proportionality. For example, it would appear to impose higher practical obligations than any one of the jurisdictional ring-fencing guidelines or arrangements that it seeks to replace.

The approach proposed in the Preliminary positions paper does not recognise that many non-regulated services provided by the networks sector are designed to take advantage of shared resources (such as a depot location in a regional or remote community) and the ring-fencing obligations would in many cases be contrary to the efficient use of existing resources, potentially raising costs for customers of both regulated and unregulated services.

The ring-fencing guideline should provide sufficient flexibility to selectively apply the potential obligations on a 'menu' basis, so as to ensure a fit-for-purpose outcome, which lowers the potential for excessive costs or service prohibitions that would leave energy sector customers worse off. The energy networks industry considers a review of the scope of coverage of the guideline should be undertaken in response to the issues raises in this and network businesses' individual submissions.

However, if the AER does adopt an approach relying on ring-fencing except where a waiver is granted, the ENA is keen to work with the AER to develop its suggestion of setting out stylized or illustrative 'bulk waiver' case studies through the guideline process. This would provide greater market certainty, enabling network and other businesses to make efficient structural and market entry/exit decisions. It would be preferable that such clarity was provided as a component of the guideline itself. Such a process would also potentially avoid the AER being subject to multiple overlapping and similar individual waiver applications immediately following the finalisation of its guideline and provide for greater transparency and certainty for stakeholders.

ENA considers the draft guideline and the AER's illustrative case studies and waiver decisions need to fully take into account the range of existing mechanisms that already provide safeguards against discriminatory, unfair or anti-competitive conduct. It would be good regulatory practice to firstly assess how any perceived and documented weaknesses of these arrangements could be addressed in revised arrangements, for example, how cost allocation approaches might be further strengthened to provide greater regulatory, market or policymaker confidence. The ENA would welcome further discussions or a workshop approach with the AER, AEMC and stakeholders to advance this issue.

There are pragmatic alternatives to a 'one-size-fits-all' initial approach which are not fully addressed by the AER in its case studies. For example, one option is that networks should be able to own and operate assets that support the delivery of regulated network services subject to arm's length contractual arrangements with a retailer being in place in relation to the wholesale market energy transactions. Such pragmatic arrangements, already being trialled, can work in conjunction with the control measures

provided for in the Rules which can provide adequate additional safeguards. An example of these existing safeguards include cost separation via Cost Allocation Method approval processes, benefits sharing through the AER Shared Asset Guideline, the incentives provided by the Capital Expenditure Efficiency Sharing Scheme, annual planning reports, and regulatory investment test processes.

It is important that the purpose of the ring-fencing guideline is clear, and limited to addressing the specific types of anti-competitive behaviour (such as those identified in section 2.1). It should not be developed with a view to solving other perceived weaknesses in the regulatory framework. An excessive ring-fencing burden should not be established based on scepticism about existing incentives for operating expenditure or non-network solutions. Any such demonstrated biases should be addressed through reform of the directly applicable incentives, tests and regulatory processes (for example, the Demand Management Incentive Scheme guideline).

ENA recognises that even following consideration of existing mechanisms, the issue of potential information asymmetry or equitable access to information is a priority for market confidence. ENA proposes that following the AER guideline providing principles and avenues for potentially addressing this issue, under individual framework and approach processes networks would be provided with an opportunity to set out how required information safeguards would be addressed, based on the relevant circumstances of the individual network (including the extent and nature of its participation in the potentially competitive markets).

Finally, ENA notes that the Preliminary positions paper considers issues associated with ring-fencing arrangements for electricity distribution networks. ENA notes that both the NER Chapter 6A arrangements, and the nature of currently applicable guidelines, differ between the distribution and transmission sectors given the different nature of these services.

For these reasons ENA considers that a cautious approach is warranted in any future analysis of the extent of appropriate alignment. As an example, the framework and approach stage of transmission and distribution determination processes differ significantly in their scope, as do the categories of service classifications. This will place a premium on individual consideration of appropriate transmission arrangements in the future.

The balance of this submission therefore focuses largely on matters relevant to the distribution ring-fencing arrangements. The ENA welcomes, however, further discussion of the appropriate role for ring-fencing in a transmission context at the appropriate stage, noting that a national guideline is already in place.

CONTEXT FOR REVIEW

The ring-fencing guideline review occurs at a time of significant and fast-moving technology and market change in the energy sector.

These changes and recent AEMC metering rule changes have increased focus on the role of national ring-fencing arrangements, which previously were examined by the AER in 2011.

ENA members recognise that where the primary purpose of an investment is provision of a competitive customer-facing energy service, then distribution networks would not seek to include the relevant assets in RABs but would rather seek to provide the service on a non-regulated basis through a business separate to the ring-fenced entity.

It is important that the AER's ring-fencing guideline can be demonstrated to promote the National Electricity Objective by serving the long-term interests of electricity consumers.

This will require an assessment of the:

- effectiveness of the existing legislative and regulatory framework and broader competition law;
- extent to which the costs imposed by the AER's preferred ring-fencing requirements are greater that the corresponding benefits;
- potential for regulation to stifle participation, investment and innovation in potentially contestable markets;
- extent to which competition would be distorted in the absence of the regulatory obligation being imposed; and
- administrative costs of the regulatory obligation on the AER, the network companies and customers.

In ENA's view, consumers will benefit from consistent national approaches where feasible to enhance competition and certainty for market participation decisions of third parties, retailers and networks.

Network businesses have an important role to play in fostering new and emerging markets such as energy storage services. New markets do not form and develop in a vacuum – instead they can greatly benefit from the experience and skills that network businesses are well placed to provide. Network businesses are already seeing

evidence of this in regular discussions and engagements with emerging energy services businesses.

Allowing network businesses to participate in developing these emerging markets ultimately leads to outcomes that benefit consumers, both directly in terms of providing competitive solutions and indirectly by reducing the cost of traditional network options. Examples of this process at work include existing network load control arrangements around hot water services and air-conditioning, developed and implemented by networks over the past two decades, and still be evolved to lower required network investments.

The challenge is to strike an appropriate balance so that networks do not exercise undue power. To this end, some form of ring-fencing is appropriate. However, the default position of excluding all opportunities in these markets risks not meeting the National Electricity Objective.

This point has already been recognized by the COAG Energy Council work in its *Policy Advice - Electricity network economic regulation; scenario analysis*. This, and the accompanying expert report by Synergies Economic Consulting provided to the Network Policy Working Group emphasised the potential risks and costs to the NEO of weak incentives for networks to enter alternative markets due to regulatory impediments.[1] It also highlighted the potential for regulatory impediments to lead to a failure to adapt to market changes.

Internationally, regulatory bodies and policy makers are also examining many issues relevant to the AER guideline process. In a range of processes, the question of allowing for network businesses and existing utilities to play a facilitative market stimulating role is being actively considered.

As an example, in the New York *Reforming the Energy Vision* 'Order Adopting a Ratemaking and Utility Revenue Model Framework' the Public Service Commission of the State of New York highlights that the interests of markets can be served by having some types of competitive services provided by incumbent utilities, particularly where they facilitate the growth and operation of markets.[2] It has therefore rejected approaches that would narrowly seek to prohibit the participation of existing utility businesses in new and emerging market areas.

[1] COAG Energy Council Energy Working Group Network Strategy Working Group *Electricity network economic regulation; scenario analysis – Policy Advice* June 2015, p.6-8

[2] State of New York Public Service Commission, Case 14-M-0101, Order Adopting a Ratemaking and Utility Revenue Model Policy Framework, May 19, 2016, p.49

RELATIONSHIP BETWEEN PRICE CONTROL AND RING-FENCING

Key message

- The use of some key terms in the Preliminary Paper may be unintentionally confusing and may obscure areas of common ground.
- Ring-fencing obligations are intended to, and can only, apply to the regulated entity.

To enable clear understanding and policy making for all stakeholders involved in the ring-fencing guideline development process, it is important for there to be commonly agreed understanding on the relationship between regulatory price controls and ring fencing.

This understanding should be based, wherever possible, on the closest reference to the relevant NER provisions.

As an example, the *Preliminary positions* paper discusses ring fencing of 'all contestable services' as one potential option for consideration. However, under the NER it is actually the provision of regulated services, and in particular direct control services, that are subject to ring-fencing. That is, ring-fencing obligations are intended to apply, and may only apply, to the regulated entity delivering these services (i.e. the monopoly business subject to building block regulation).

This distinction is important to recognise because the scope of electricity distribution business is typically broader than the core monopoly activity. The AER may impose functional and accounting separation of direct control services from other activities. It may also impose a legal separation between a DNSPs provision of network and non-network services.

A lack of clarity around the use of some terms may prove an unintended obstacle to identifying common ground and understandings in the remainder of the guideline development program.

EXISTING MECHANISMS AND SAFEGUARDS

Key message

- The draft guideline and the AER's illustrative case studies, and waiver decisions, need to fully take into account the range of existing mechanisms that already provide safeguards against discriminatory, unfair or anti-competitive conduct

AER consideration of ring-fencing arrangements in the context of regulated services is reasonable and is clearly a NER requirement. Where DNSPs provide services in contestable markets for the purposes of earning unregulated revenues, it may be appropriate for some form of regulation to apply.

It is important to consider, however, that there is a range of existing mechanisms in place which impact on the nature and degree of ring-fencing likely to be required. That is, a range of existing regulatory and competition law mechanisms will already impact on the identified potential risks set out in the *Preliminary positions* paper. These alternative existing mechanisms will also have different costs to a potentially significant widening of existing ring-fencing obligations.

ENA considers that as a first step, a comprehensive ring-fencing assessment must evaluate the demonstrated and potential effectiveness of existing mechanisms to address any concerns with the way in which a distribution network could compete in certain markets. Ring-fencing approaches and obligations should only then be developed to supplement and build on existing protections to provide such confidence to the market as is required for the promotion of the NEO where the benefits of these additional measures can be shown to exceed the associated costs.

These existing mechanisms include:

- **Competition and Consumer Act 2010 (Cth) competition protections** – sections 46 and 50 – which prohibit variety of anti-competitive conduct that appears to be the target of some of the ring-fencing arrangements proposed and which are to be further strengthened following the Federal Government's response to the Harper review; and
- **Metering Contestability Rule Change information requirements** – new arrangements under the recent AEMC rule change on the distribution and use of metering data, which is relevant to the AER's consideration of the potential for unfair informational advantages for customer load profile data.

The existing economic regulatory framework also contains a series of elements directed towards ensuring a level playing field for market participants:

- **Cost allocation rules -** Chapter 6 of the NER provides for cost allocation arrangements aimed at ensuring that costs are allocated appropriately between the various service classifications, to prevent any cross-subsidy of contestable and potentially contestable activities by regulated activities. These requirements are a form of ring-fencing because they separate – in an accounting sense – the monopoly activities from contestable activities.
- **Ex-ante cost reviews -** The AER's regulatory determination process provides assurance that the regulator has the opportunity to fully examine the costs incurred by network businesses in delivering regulated services.
- **Assessments of related party transactions -** The regulatory regime is effective in addressing concerns with regard to related party arrangements. The AER's *Expenditure Forecast Assessment Guidelines*, amongst other things, set out a rigorous approach to the assessment of related party costs, to ensure that costs arising under a related party transaction reflect arm's length commercial arrangements. These requirements therefore eliminate the potential for a distribution business to favour a related party in the procurement of services.
- **Chapter 5 connection requirements** – recently revised which set conditions on which networks must accept connections on a non-discriminatory basis.
- **Benefit sharing rules for shared use of common network -** The NER empower the AER to reduce the annual revenue requirement for a regulated business to reflect the costs of the regulated assets that are used in providing an unregulated service. The AER has established Shared Asset Guidelines to give effect to the NER requirement.

Given that the existing regulatory framework already provides for mechanisms which achieve a range of the ring-fencing objectives identified, the ENA considers that the AER needs to undertake a clear 'gap analysis' in order to identify which additional ring-fencing requirements may be required. This approach is consistent with best practice regulation (for example the *COAG Best Practice Regulation*

Guide 2007) and will assist in achieving a targeted and balanced set of measures that avoid obligations which are overly onerous or duplicate existing requirements.[3]

Similarly, if there are any identified deficiencies in any of the existing mechanisms that affect their ability to provide confidence, consideration should be given to whether a case exists for strengthening these arrangements, and balanced against an alternative approach justified by any perceived weaknesses in existing mechanisms.

RESPONSE TO PRELIMINARY POSITIONS

OBJECTIVES AND APPROACH

The ring-fencing objectives proposed by the AER are broadly adequate and specify the types of anti-competitive behaviour that the AER is seeking to address through its guideline. The ENA agrees that these types of behaviour are contrary to the long-term interests of electricity consumers.

ENA supports the AER's approach of adopting 'service-based' rather than 'asset based' regulation as promoting the NEO as an appropriately outcome focused and technology neutral approach.

ROLE OF THE GUIDELINE

Key message

- A guide that does not deliver clear, predictable guidance is not fit for purpose
- The waiver process should not be the mechanism for delivery of this certainty

The AER has identified the elements that the ring-fencing guideline will need to include as:

a. a statement of the objectives of ring-fencing,

b. a 'prime facie' identification of ring-fenced services,

c. a setting out of the ring-fencing obligations, and

d. guidance on waiver processes.

The guideline is also likely to contain transitional arrangements, and process and compliance requirements.

The ENA recognises that the key challenge in developing the ring-fencing guideline is striking the appropriate balance to ensure that the guideline is sufficiently flexible to accommodate changing market circumstances and providing upfront clarity for the DNSPs as to how compliance with the guideline can be achieved.

The ENA considers that the ring-fencing guideline (not the waiver process) needs to provide clear and certain guidance on expected AER approaches to a set of common circumstances likely to be encountered on a national basis and a consistent set of principles that will guide this application.

This objective is consistent with the intended purpose of guidelines under the NER framework of providing guidance on the way in which the AER will approach interpreting and applying rules, including the factors it will consider in exercising its regulatory discretion.

While it would be possible for the ring-fencing guideline to merely provide a procedural framework for applications for waiver and repeat the broad menu of possible forms of ring-fencing that may or may not be imposed in individual cases, such a guideline would fail to meet the core policy objective of a regulatory guideline to inform and guide market participants seeking to make commercial and investment decisions dynamically through time.

For this reason ENA considers it is important that the AER draft guideline focus as much as possible on upfront guidance on the nature of ring-fencing requirements likely to be in place across a suite of potential circumstances, and set out a provisional 'hierarchy' of individual ring-fencing obligations, together with analysis of when individual obligations are most likely to be required.

While the AER's proposed approach could result in the gradual establishment of a body of precedent over time and this *could* be argued to deliver a measure of certainty, the ENA considers this is not a substitute for robust upfront guidance because:

- network firms, existing and potential market participants could face significant delays given the likely lengthy nature of the waiver process, harming their capacity to plan and implement revisions to their commercial plans or structures;
- stakeholders may be unable to accurately assess to what extent individual AER waiver decisions on

[3] See for example *COAG Best Practice Regulation – A guide for Ministerial Councils and National Standard Setting Bodies*, October 2007, Principle 8, p.6

potentially critical issues of national precedent were driven by jurisdiction specific market circumstances;

- stakeholders would be in the position of effectively seeking guidance based solely AER assessments of past waivers, rather than a combination of past precedents and clear forward-looking guidance; and
- uncertainty over regulatory approaches produced by the above factors is likely to lead to inefficient deferral of market entry, exit or participation decisions.

These factors mean that ENA considers that the guideline document itself should be the mechanism for the provision of practical guidance to the market on AER approaches to the exercise of its discretion under Clause 6.17 of the NER.

EFFICIENT AND PROPORTIONATE RING-FENCING OBLIGATIONS

Key message

- Uncalibrated regulatory approaches are potentially costly, and not proportionate

Need for calibrated regulation

Recently Mr Euan Morton and Professor George Yarrow undertook an expert report for ENA on the implications of the changing energy market for the application of competition and economic regulation in Australia (see Attachment A).

This report recommends a flexible approach to regulation during a period of transition, and explicitly cautions against 'one size fits all' regulation, as potentially leading to outcomes that are not in the long-term interests of consumers.

Instead, the report advocates the potential adoption of what it terms 'calibrated' regulation, which takes into account the business models, and characteristics of the markets networks operate in.[4] ENA considers this central finding of reaching a calibrated form of regulation could usefully inform the development of the draft and final guideline.

The ENA is concerned that the AER's approach of a default application of ring-fencing to all contestable services, with the exception of individually waived services, may not be an efficient or proportional regulatory approach. The approach appears to presume the deficiency of existing safeguard measures, without consideration of their adequacy or how they might be strengthened, or their relative costs and benefits compared to the measures proposed.

In application, the proposed approach has the potential to be onerous, time consuming and uncertain, and to fail a proportionality principle. For example, on its face, it would appear to impose higher practical obligations than any one jurisdictional guideline or arrangement it seeks to replace in return for unclear benefits while providing no clear exemptions or materiality thresholds.

Menu of obligations approaches

The AER proposed approach does not recognise that many non-regulated services provided by the networks sector are designed to efficiently take advantage of shared resources. If the AER's proposed ring-fencing obligations were taken to be a fixed prescriptive minimum requirement, rather than a menu, this would be contrary to the goal of encouraging efficiency through shared use of resources for the benefit of end customers. Rather than adopting this 'blanket' approach there should be flexibility to apply obligations on a menu basis, with networks able to draw on upfront guidance from the AER and propose the flexible use of the variety of mechanisms available to reflect their particular market circumstances.

It is evident from clause 6.17 that the NER do not intend the AER to adopt a 'one-size fits all' approach to ring-fencing, in which blanket obligations are applied to all network companies, unless a waiver is in place. The scope of the NER, in effect, provides a non-exhaustive list of measures from which the AER should select targeted and proportionate responses to identified issues.

For example, the ENA considers that clause 6.17.2(b) is sufficiently flexible to allow the AER to adopt a range of measures, including:

- Allowing a regulated business to propose the application of a set of conduct or voluntary ring-fencing or other safeguard measures, such that the objectives sought by the AER are adequately satisfied;
- An enforceable undertaking from a regulated company that it will not engage in particular conduct; or
- A specific ring-fencing obligation on one or more network companies to address a particular concern; or

[4] Report by Euan Morton and Professor George Yarrow for ENA - *Applying the Hilmer Principles on economic regulation to changing energy markets*, April 2016, p.6-8

» A generic consistent ring-fencing obligation on all network companies.

This flexibility in the Rules should be used to ensure a practical and workable approach.

There are pragmatic alternatives to a 'one-size-fits-all' initial approach which illustrate the point that an approach of 'all ring-fencing obligations shall apply in all circumstances' is not an efficient default assumption.

For example, another option in relation to energy storage in addition to the measures discussed above is that networks should be able to own and operate storage assets that support the delivery of regulated network services subject to arm's length contractual arrangements with a retailer being in place in relation to the wholesale market energy transactions.[5]

Such pragmatic arrangements can work in conjunction with the control measures provided for in the Rules that provide adequate additional safeguards (e.g. cost separation via CAM, benefits sharing, capex efficiency measures, transparency of planning reports etc.) without all of the obligations contemplated in the AER *Preliminary positions* paper being required.

Avoiding unnecessary costs and unintended outcomes for consumers

Due to the wide nature of the potential obligations contemplated in the *Preliminary positions* paper and the uncertain nature of waivers contemplated by the AER, it is difficult to identify the nature of costs that would flow from implementing the AER's preferred option. Examples of such costs may include:

» duplication of part or whole of IT infrastructure

» loss of synergies from loss of staff sharing opportunities

» costs to establish and maintain physically separate locations where required

» costs arising from changes to operational management processes and systems

[5] The AEMC indicated in its recent energy storage review that network businesses should be free to use energy storage on the grid as a substitute for traditional network, where efficient to do so, so long as it does not significantly displace competitive energy services. It would be appropriate for the storage to be financed from regulated expenditure to the extent that it is providing network services and any use for energy trading (or other competitive energy services) should be separated from the regulated network business through mechanisms such as auctioning, or transfer to a retailer as proposed in the ElectraNet storage trial.

ENA is keen to discuss with the AER in detail a range of practical working examples, or potential circumstances that might arise as a result of a overly narrow interpretation of the AER's Preliminary positions, to more fully understand the AER's potential approach.

These are intended to serve as potential case studies to enable fuller shared understanding of any underlying policy concerns and the scope of guideline obligations which the AER might contemplate as it considers implementation of its approach. These examples are:

» *Inter-network competition* – treatment of the market entry of a network into the monopoly service area of an incumbent network, for the purpose of offering competitive services.

» *Regional depot treatment* – shared staff from regulated and non-regulated staff are co-located at a regional or remote depot, where duplication of staff and separate physical locations would render an existing competitive service uneconomic. Past economic regulators, such as the Essential Services Commission of South Australia, have explicitly recognised the strong economic benefits of such sharing.[6]

» *Shared non-market facing staff* - In some cases networks currently share staff for back office (non-market facing) functions, e.g. payroll and human relations. There appears to be little benefit in requiring the potential duplication or inefficient use of these staff resources where any potential impacts on competition are absent.

» *Demonstration project* – the regulated firm seeks to deploy a new technology as a demonstration project, for example to improve its capacity to rapidly and efficiently integrate distributed energy resource technologies into existing grid operations.

» *Partnership project* – a network service provider seeks to own and operate a distributed energy resource, in an arms length partnership with an independent party (for example, a large energy retailing firm) in relation to customer-facing energy market transactions meaning that the network has no impact on wholesale energy markets.

» *Transmission and distribution network staff sharing* – sharing of staff between two related regulated firms that are each subject to separate ring-fencing arrangements.

[6] ESCOSA *Operational Ring-fencing Requirements for the SA Electricity Supply Industry: Final Determination*, 2003, p.13

» *National Broadband Network support services* – this is an unregulated service, in terms of the AER's framework, but a number of networks are subject to regulatory obligations to only charge incremental costs of service pole attachments. Ring-fencing of this unregulated service would deliver no customer benefits, and fail to account for the fact that any material benefits that do arise are shared with existing network customers via the Shared Asset Guideline.

These types of circumstances may also be matters that the AER would wish to take forward as part of fuller guidance on the coverage of the draft guideline, and as part of any upfront waiver identification process.

WAIVER PROCESS

Key message

- Network businesses and the market will be best served by greater upfront certainty on the likely mix of ring-fencing requirements to be applied in some common, foreseeable case studies

The industry is keen to work with the AER to develop the AER's suggestion of setting out stylized or illustrative 'bulk waiver' case studies through the guideline process to provide the greater certainty that will enable businesses to make efficient structural and market entry/exit decisions.

This would help early identification of those areas where it is agreed that no ring-fencing is required, and allow this to be efficiently progressed.

IMPLEMENTATION AND TRANSITION

AER approaches, including the guideline and waiver process need to account for circumstances in which service classification decisions may change in a final determination. In these circumstances, under the current approach, DNSPs could find themselves nominally in breach of ring-fencing obligations that they did not have a capacity to implement, due to a departure in the previous service classification approaches set out in the framework and approach stage by the AER.

There is also a strong need for the AER to consider appropriately phased transition arrangements for any circumstances in which existing compliant network business activities may require restructuring to comply with revised AER approaches. This need reinforces the priority networks attach to obtaining clear upfront guidance through a combination of the AER guideline and any upfront bulk waivers.

This transition process would also, likely need to take into account that changes to business operations and structures may have greater costs if pursued over a short period (such as a year) than longer and more realistic multi-year phase in arrangements.

ANSWERS TO AER QUESTIONS

Question 1: What aspects of current jurisdictional ring-fencing arrangements have or have not worked well?

Some of the jurisdictional guidelines have provided quite clear and specific guidance upfront (for example on exemptions for generation owned for network support). This has provided a level of efficient definition and confidence around the bounds and scope of regulatory obligations in a way that can be superior to more costly permissions and waiver based processes.

Question 2: Do you consider these objectives discussed in section 2.1 adequately reflect the harm ring-fencing is seeking to avoid and the benefits of an even playing field?

These objectives are broadly adequate and specify the types of anti-competitive behaviour that the AER is seeking to address through its guideline. The ENA agrees that these types of behaviour are in contrary to the long-term interests of consumers.

However, the actual ring-fencing requirements imposed by the AER need to be targeted to address the identified concerns in relation to competition and represent proportionate measures having regard to the costs and benefits of different approaches.

Prior to imposing any ring-fencing obligations, the AER needs to conduct a gap analysis to determine whether the range of existing mechanisms already achieve the objectives discussed in section 2.1. The ENA considers that the existing chapter 6 provides for a comprehensive suite of arrangements to address many of the regulatory or competition issues that may arise when a regulated monopoly also engages in the provision of services in contestable markets.

Question 3: Do you agree with the service classification approach to ring-fencing which is discussed in section 3.3? Is there a better alternative?

The approach of ring-fencing decisions being linked to distribution framework and approach processes may be workable and sound, however, the guideline and the AER's approaches need to account for circumstances in which service classification decisions may change in a final determination. In these circumstances, under the current approach, NSPs could find themselves nominally in breach of ring-fencing obligations that they did not have a capacity to implement, due to a departure in the previous service classification approaches set out in the framework and approach stage by the AER.

The ENA considers that one option which is worth further consideration would be to include a trigger to determine which services may be ring-fenced, e.g. a materiality threshold as a specified percentage of the annual revenue requirement.

Under this approach, ring-fencing would not apply in the circumstances where the materiality threshold has not been reached. The specific design of this option will need to be considered in detail to ensure that this approach is workable in practice. Consistently with the AER's position, the materiality test can be applied on a per service basis.

For example, the specific service may be immaterial in terms of the revenue it earns, but complying with ring-fencing obligations or obtaining a waiver could be administratively complex and time-consuming.

Question 4: Does the proposed approach to ring-fencing adequately deal with the prospects for development of the contestable market for DER?

The AER's approach has the potential to restrict DNSPs from using DER devices for the provision of unregulated services where that use is efficient. This approach may lead to inefficient use of regulated infrastructure and the forgoing of significant customer benefit.

Limiting DNSPs to three options as described by the AER may result in:

1. Customers bearing the cost of a solution that is not truly 'a least cost' option
2. Compromising DNSPs' ability to flexibly manage their networks, to the harm of consumers;
3. Additional costs and administrative burden on the DNSPs, with impacts on customer costs;
4. DNSPs will withdraw from the provision of unregulated services when they are viable, and being replaced by higher cost providers.

Question 5: Are there other ring-fencing obligations we should impose on NSPs that provide services into contestable markets?

The ENA considers that the existing Chapter 6 provides for a comprehensive suite of arrangements to address many of the competition and regulatory issues that may arise when a regulated monopoly also engages in the provision of services in contestable markets.

The ENA recognises that forms of ring-fencing such as legal separation, limitations on the flow of information; and physical, staffing and functional separation are not addressed through Chapter 6.

The most likely rationale for imposing a ring-fencing obligation is to prevent a DNSP from obtaining a competitive advantage by making use of information obtained through its monopoly activities. The ENA is not aware of any specific examples where a DNSP would be likely to obtain such a competitive advantage, but considers that the ring-fencing process should enable networks to address such potential issues to the satisfaction of market participants and the AER.

The ENA notes that potential other less intrusive alternatives to prescriptive and wide ring-fencing obligations could include, for example, voluntary undertakings, commitments to equivalence or non-discrimination etc.

Under the NEL, the AER may accept an enforceable undertaking from a DNSP that it will not engage in particular conduct (i.e. section 59A).

Question 6: What costs would be incurred in meeting these obligations?

The costs of ring-fencing arise from imposing additional compliance and administration requirements (and establishment costs in some instances) on distribution businesses and the potential of these requirements to reduce economic efficiencies and economies of scale. In a case in which these costs are not justified by the offsetting benefits, ring-fencing has the potential to leave electricity consumers worse off.

Examples of this can include:

- duplication of IT infrastructure
- physical location separation costs
- loss of synergies from loss of staff sharing opportunities

Question 7: Should asset sharing be restricted between regulated services and contestable service provision?

The NSPs should be encouraged to use regulated assets for the provision of unregulated services where that use is efficient. This is consistent with the *National Electricity Objective*.

There are a number of areas that need to be clarified including the proposed interaction with the Shared Asset Guideline, and the policy intent of other schemes and mechanisms to promote efficient dual use of regulated assets with savings rebated to users, and actively promote demand management and other non-network investments

Question 8: Do the factors set out above reflect the issues we should consider in deciding whether to grant a ring-fencing waiver?

While the ENA considers that relying on waiver is not the most appropriate and proportionate response to the AER's concerns, these factors appear reasonable for consideration of whether onerous ring fencing would be appropriate.

In addition to the factors listed by the AER, it is important to undertake cost-benefit assessment of ring-fencing requirements, including the following elements:

1. The potential for the regulatory obligation to stifle participation, investment and innovation in potentially competitive markets,
2. The extent to which competition would be distorted in the absence of the regulatory obligation being imposed, and
3. The administrative costs of the regulatory obligation on the AER, the network companies and customers.

Question 9: 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 regulated business should bear the costs of ring-fencing, as to be clear it is the 'ring-fenced entity'.

Ring-fencing exists for the benefit of customers of regulated services by reducing the costs needed to be recovered through regulated services – as reflected in the AER's Shared Asset Guidelines. Therefore, these customers should bear the cost of compliance with ring-fencing obligations.

The benefits these customers receive should outweigh these compliance costs in the case where ring-fencing obligations are proportionate and have been developed using an appropriate cost-benefit analysis.

Consumers will bear the broader economic costs of ring-fencing rules in the sense of the legally separated entities participating in the market may have higher stand alone costs than otherwise.

Question 10: How else could the AER minimise the administrative cost of ring-fencing while maintaining the integrity of its approach?

The draft guideline and the AER's illustrative case studies, and waiver decisions need to fully take into account the range of existing mechanisms that already provide safeguards against discriminatory, unfair or anti-competitive conduct (such as AER approval of cost allocation approaches and connection arrangements, Chapter 5 connection obligations, and the shared asset guideline).

The ring-fencing obligations listed by the AER should be taken as a maximum 'menu' from which required measures may be employed, not assumed to be required in each market circumstance.

Industry is keen to work with the AER to develop its suggestion of setting out stylized or illustrative 'bulk waiver; case studies through the guideline process (or immediately after) to provide this greater certainty that will enable businesses to make efficient structural and market entry/exit decisions.

Question 11: Is it reasonable for the AER to consider these transitional arrangements to the new ring-fencing guideline?

Yes.

It is important that the guideline provides certainly in relation to how the existing partnering arrangements around energy storage between some DNSPs and retailers be treated.

Question 12: How can we ensure ring-fencing compliance is robust and effective without imposing excessive costs that may ultimately be borne by consumers?

DNSPs already provide the AER with information in relation to their unregulated revenues as part of regulatory financial statements.

The current enforcement mechanisms are effective. A failure to comply with the guideline is subject to the same enforcement regimes as other obligations under the NER.