

30 January 2025

Anthea Harris  
Chief Executive Officer  
Australian Energy Regulator

Submitted electronically via [AERringfencing@aer.gov.au](mailto:AERringfencing@aer.gov.au)

## **Subject: Review of Ring-fencing Guideline**

Dear Ms Harris,

Essential Energy welcomes the opportunity to provide feedback on the changes proposed in the draft of Version 4 of the Australian Energy Regulator's (AER) Ring-fencing guideline (electricity distribution) (the guideline) published on 9 December 2024. Essential Energy also appreciates the AER's willingness to consider stakeholder views on prospective changes to the guideline in the future as articulated in the draft explanatory statement.

### **PROPOSED UPDATES TO THE GUIDELINE**

Essential Energy supports the proposed changes to clause 5.3.4 in the guideline that remove the maximum duration of a waiver. This change will give the AER more flexibility to determine the appropriate term of a waiver and is a sensible change.

We also support the proposed requirement outlined in guideline clause 6.2.1(f) that annual compliance reports are accompanied by a cover letter, signed by the Distribution Network Service Provider's (DNSP's) most senior executive, attesting that the contents of the report are accurate, to the best of their knowledge. This aligns with Essential Energy's current practice.

### **OTHER PROSPECTIVE CHANGES TO THE GUIDELINE**

In the draft explanatory statement, the AER requested views from stakeholders on other prospective changes to the guideline. While the reference was in relation to "broadening the guideline", Essential Energy considers that it would assist the operation of the National Electricity Market (NEM) and be in the long-term interests of consumers and in line with the National Electricity Objectives (NEO) if the AER was to consider the function and operation of the guideline more broadly with respect to the national regulatory framework. To this end, Essential Energy submits that the AER should consider the following in its next review of the guideline:

- ▶ Leveling the playing field between Distribution Network Service Providers (DNSPs) and Transmission Network Service Providers (TNSPs) for the connection of grid-scale generation, load and storage
- ▶ Commit to reduce administrative burden and pressure on the Ring-fencing framework by taking a holistic approach to the framework for the regulation of services.
- ▶ Small administrative changes to the timing for publishing Ring-fencing registers

These recommendations are discussed in turn below.

## Leveling the playing field between Distribution and Transmission in Ring-fencing

Under the National Electricity Rules (NER) clause 6.17.2, the AER must consider the need, to the extent reasonably practicable, for consistency between the Ring-fencing guidelines that apply to DNSPs and TNSPs. In its March 2023 revision of the Electricity transmission Ring-fencing guideline, the AER did not extend most functional separation obligations to TNSPs as those imposed on DNSPs as the nature of TNSPs' customers are typically large corporate entities seeking to connect generation, storage and loads and the cost of further functional separation outweighs the value of mitigating potential harms to those customers.

Essential Energy largely agrees with the assessment of the AER that large, sophisticated commercial entities are less at risk of harms that full functional separation is seeking to remedy in the guideline with consumer-level protections. As the energy transition proceeds, there are large connection proponents seeking to connect both at the distribution level and the transmission level of the grid. Therefore, consideration needs to be given as to whether DNSPs, without the current level of functional separation, should be able to undertake contestable connections where such a connection is proportionate to a transmission level connection. A more equalised landscape could be facilitated by adjusting the regulatory constraints, specifically in relation to stricter functional separation requirements, that currently limit DNSPs' ability to compete with TNSPs for large connections in their own right.

Large-scale connections could be defined through a connection threshold level, by value of the connection or by size of generation or load. Typical connection proponents include:

- ▶ Grid scale generation
- ▶ High voltage (HV) batteries
- ▶ Renewable Energy Zones (REZs)
- ▶ Large data centres.

## Reducing the administrative burden of the Ring-fencing Guideline – a holistic approach

The Ring-fencing Guideline has a strong interrelationship between other elements of the regulatory framework including Service Classification, the treatment of shared assets and the Cost Allocation Methodology (CAM). The Ring-fencing Guideline could be streamlined and operate more effectively if each of the other elements were operating in harmony. Service classification affects the treatment of services deemed either non-contestable or contestable for ring-fencing purposes, while the Shared Asset Guideline explains how assets can be shared between regulated and unregulated services, once costs are allocated appropriately.<sup>1</sup>

The NER provide for a distinction between the services provided by a DNSP and the capital and operating inputs used to provide those services.<sup>2</sup> The AER provides further clarification stating that “*The NER only permits distribution services to be classified. Inputs to these services cannot be classified. Inputs include all of the capital and operating inputs that contribute to the provision of a service.*”<sup>3</sup> Capital inputs for distribution services are the distribution assets which reside in a DNSP's Regulated Asset Base (RAB).

Despite this, the Guideline has been used to defacto regulate the use of assets that could provide distribution services. The AER has achieved this to date by not assessing services which could be

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<sup>1</sup> [AER - Explanatory Statement - Distribution Service Classification Guideline - 28 September 2018.pdf](#), p.2. see also [AER Ring-fencing Guideline - 30 November 2016.pdf](#), p.10.

<sup>2</sup> NER Cl. 6.2.3A(b)(3)

<sup>3</sup> AER, Service Classification Guideline, August 2022, p.4.

provided by distribution assets as distribution services, and to further classify them as either direct or negotiated services.

There is also another class of distribution services which are not classified or regulated due to being available on a contestable basis. The AER would call such a service by default an 'unregulated distribution service'. While the AER is under no obligation to list distribution services it does not classify, it will do so when it considers it "*will provide greater clarity to stakeholders*".<sup>4</sup>

By way of example, to date the AER has been unwilling to provide stakeholders with greater clarity through either the classification of services provided to the community from network-owned batteries or listing those services as unregulated distribution services. In its Preliminary Framework and Approach paper for NSW electricity distributors, the AER considered that it "*need not have a role in recognising a request for the leasing of excess battery as an unregulated distribution service*".<sup>5</sup> Instead, it has relied on the ring-fencing framework to regulate the assets, and the investment in them, by restricting services provided by these assets.<sup>6</sup> However, the guideline is not well suited for the regulation of assets, as its primary two purposes are to address the risk of:

1. "*a DNSP cross-subsidising other services with revenue earned from provision of distribution services*"; and,
2. "*a DNSP favouring its own negotiated services or other distribution services, or an affiliated entity's other electricity services, in contestable markets*".

It accomplishes these two purposes through enforcing legal, structural and functional separation between the DNSP and its affiliated entity, which may conduct business in contestable markets.<sup>7</sup>

There is a fundamental distinction between using regulated revenue to cross-subsidise the services of an affiliated entity and using distribution assets to provide unregulated distribution services. One is prohibited through the separations listed above and the other is prohibited through the classification of the service provided. It is therefore the role of Service Classification to regulate the services provided by assets included in a DNSPs' RAB, not the Guideline.

The NER sets out that assets used to provide both standard control services and distribution services which are not classified, are by definition; shared assets.<sup>8</sup> Clause 6.4.4(c)(1) also sets out that DNSPs "*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*". So together service classification and the shared asset principles – as managed through the operation of the Shared Asset Guideline (SAG) – should work together to provide appropriate incentives to increase asset utilisation for the benefit of all DNSP customers.

Essential Energy is concerned that the current version of the SAG is not working in the interests of consumers. Since its inception, the SAG has delivered very little in terms of cost reductions back to consumers.<sup>9</sup> An initial NEM-wide analysis, as collated from final determinations, reveals that since the SAG came into effect, the AER has applied \$84.14 million of cost reductions back to consumers (in

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<sup>4</sup> Ibid, p. 6.

<sup>5</sup> AER, Preliminary Framework and Approach paper for NSW Electricity Distributors, April 2022, p. 9.

<sup>6</sup> See for example: AER, Attachment 13, Classification of Services, Final Decision NSW Electricity Distributors, 2024-29, April 2024, pp, 13-16.

<sup>7</sup> AER Ring-fencing Guideline – Explanatory Statement, November 2016, p 1.

<sup>8</sup> NER Cl. 6.4.4

<sup>9</sup> For example, Endeavour Energy is forecast to deliver its first cost reduction back to customers during the 2024-29 regulatory period of \$2.1 million. see AER, Final Decision, Attachment 1 Annual Revenue Requirement, April 2024, p. 7.

\$FY24 terms), from \$841 million of reported unregulated revenue exceeding the materiality threshold. This does not include unregulated revenue generated beneath the materiality threshold. This return reflects less than 0.04 per cent of total revenue, as determined by the AER that has been shared with customers via the SAG, so is unlikely to provide significant benefit to customer bills.

The existing threshold mechanism acts both as a barrier to the provision of a cost reduction to customers and a disincentive for networks to increase asset utilisation for the purposes of attracting unregulated revenues above the threshold. Under the current Guideline, only 10 per cent of the value of unregulated revenue is to be shared with customers, once the materiality threshold has been reached.<sup>10</sup>

Essential Energy contends that if the SAG was operating effectively, it would provide appropriate incentives to use distribution assets for the purposes of attracting unregulated revenue and pass an appropriate share of those revenues back to customers. Essential Energy is aware that one of the concerns of the AER, and consumers, is the over-sizing of RAB assets. The incentive to oversize could be mitigated through a higher sharing ratio, where revenues in excess of the revenue required to own and maintain assets is – after having exceeded the materiality threshold – shared directly with customers.

Reforms to a DNSP's approved CAM could take into account uses for assets outside of the provision of standard control services. One such example is for the use of community batteries and renewable microgrids where the primary function of the assets is for standard control services, but with a potential to provide a range of market services which do not prejudice the provision of those standard control services. Essential Energy contends that an effective regulatory environment, with the interrelationships between the Service Classification, the SAG, Ring-fencing and CAM all working in the same direction could have the following benefits:

- ▶ Increased regulated asset utilisation
- ▶ Provision of an adequate return of value to customers through a share of unregulated revenues
- ▶ Removal of incentive to over-invest in assets
- ▶ Allow DNSPs to more fully participate in the energy transition – moving toward role of Distributed System Operator
- ▶ DNSPs undertake role of asset owner and manager for contestable service providers who can increase customer choice
- ▶ Reduce the burden of the guideline by allowing it to focus on the mitigation of the core harms of cross-subsidisation between the DNSP and its affiliate and discrimination in favour of its affiliated entity in contestable markets where those harms may affect small customers.
- ▶ Reduce the need for waivers, thereby reducing administrative burden for the AER and DNSPs with adequate reporting of unregulated activities can be undertaken through the annual Regulatory Information Orders process.

#### **Additional request for minor change to the timing for publishing the Ring-fencing Registers**

Essential Energy also requests that clauses 4.2.4(b) and 6.2.3(b) of the Guideline are amended such that DNSPs are given until 31 January each year to publish their updated Office, Staff and Stand-Alone Power Systems (SAPS) Registers (the Registers) for the previous quarter. The Registers require inputs from numerous staff, many of whom take leave over the holiday period making it difficult to meet the current

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<sup>10</sup> AER Shared Asset Guideline, November 2013, p.14.



deadline of 15 January. The requirement for the Registers to be updated by 15 April, 15 July and 15 October is manageable, and we are not requesting changes to those deadlines.

If you have any questions in relation to this submission, please contact me on [REDACTED] or via email at [REDACTED]

Yours sincerely,

[REDACTED]

Hilary Priest  
**Head of Regulatory Affairs**