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Mark Feather
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Submitted electronically: AERringfencing@aer.gov.au

Dear Mr Feather,

Issues paper: Ring-Fencing Guideline Review (Electricity transmission)

The AEC is the peak industry body for electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. Our members collectively generate the overwhelming majority of electricity in Australia, sell gas and electricity to millions of homes and businesses, and are major investors in renewable energy generation. The AEC supports reaching net-zero by 2050 as well as a 55 percent emissions reduction target by 2035 and is part of the Australian Climate Roundtable promoting climate ambition.

Ring-fencing has an important function and should firstly ensure competitively neutral outcomes, both during and after this important period of evolving markets and change. Transmission Network Service Providers (TNSPs) that participate in the market for contestable energy services represent a conflict of interest. This is because the TNSP has an incentive to cross subsidise the contestable services that they provide by using regulated revenues, and a clear incentive to discriminate in favour of ring-fenced affiliates. To mitigate these harms, the Ring-Fencing Guideline (Guideline) imposes functional, accounting, and legal separation obligations on TNSPs. Historically, mitigating the risks from TNSP discrimination and cross-subsidisation has rated mention in most of the AER's ring fencing guideline reviews. In practice little has been done to mitigate these two potential harms. Our observation generally is that more has been done to loosen rather than tighten the Guidelines to date.

With the market for contestable energy services forecast to grow exponentially in the future, our expectation is that TNSPs will use any competitive advantage available to them to maximise their market share. Therefore, to guarantee competitive neutrality in these markets, the AER will need to ensure the Guideline is robust and 'fit for purpose.' This means that positive assurances for compliance in of themselves will not, in the AEC's view, provide a plausible nor demonstrable enforceable compliance regime. The regulator and broader stakeholders will need to be satisfied that no violations have occurred if we are to rebuild any confidence in the effectiveness of ring-fencing arrangements.

Non-discrimination is also essential to ensure that all relevant competitive service providers can compete for the provision of these services on the same terms, and that the competitive tendering will ensure the discovery of the best price. Success will reveal itself through healthy competition between all service providers, leading to innovation and greater efficiency. Of course, failure will also reveal itself (as now) through lacklustre competition, the absence of depth in the market for non-network alternatives and a consolidation of the uneasily close commercial relationships between regulated network providers and their ring-fenced affiliates. This failure will also result in

long term consumer costs above what they could have been, and efficiency lower than it could have been. These latter two are contrary to the National Objectives.

We also observe that nothing in any Ring-Fencing Guideline prevents the procurement of transmission services, and the TNSP does not have to create a ring-fenced affiliate in order to procure either transmission services or competitive services. We also argue that there is no apparent synergy or scale benefit accruing to consumers from TNSPs creating “economies of scope” through ring-fenced affiliates. Therefore, we support the AER strengthening the current guideline because with the market for contestable energy services being in their early stages of development. An incorrect decision by the AER at this time could have serious consequences for longer term depth and competition in these markets.

Remove the 5% revenue cap.

The AEC supports abolishing the revenue cap that allows TNSPs to provide both generation and retail services at up to 5% of their regulated revenues. An estimated increase of roughly \$12.5 billion dollars of transmission investment projected to be installed by 2050 almost doubles the combined value of the TNSPs’ current Regulatory Asset Bases (RAB’s). Furthermore, the allowed rate of return for debt and equity is increasing in line with interest rates.

The combination of these two factors will significantly increase revenues, and therefore the nominal value of the current 5% threshold will be much larger. This will enable TNSPs to expand their retail and generation activities. This expansion is inconsistent with all recommendations and policies since the Hilmer Report of 1993, which have generally sought to keep separate the contestable services and the natural monopoly elements of the electricity supply chain.

If circumstances arise that require a TNSP to invest in either generation, distribution, or retail where it is economically more efficient and no other alternative is apparent, then TNSP’s may still apply to the AER for a waiver for permission to undertake these activities. While we acknowledge that the amended Guideline will exclude waivers for some core ring fencing obligations, we expect that the AER would consider a waiver application in these circumstances, though the AER should be rightly sceptical that a waiver is genuinely required.

TNSPs not be permitted to participate in contestable energy markets

TNSPs should not have the right to participate in the contestable energy services markets including those that provide the new and emerging services like consulting services, laboratory services, demand response services and services that may not fit discreetly into the definition of generation.

This is because the accounting and transactional separation obligations in the Guideline that require TNSPs to have separate accounts for their different service categories and allocate their shared and direct costs appropriately do not guarantee that cross subsidy will not occur; they simply require cost assignment. While TNSPs have Cost Allocation Manuals (CAM) that requires they implement a cost allocation between their different service categories, CAM’s provide TNSPs with too much flexibility on how to allocate direct and shared costs between these services to prevent cross subsidy.

This flexibility means that the TNSPs ring fenced affiliate could in theory provide the contestable service at a discounted price by using part of the benefit available to the TNSP to do so. This would have the potential to crowd out more efficient service providers from the non-network services market in the short-term, which diminishes productive efficiency, and would have a chilling effect on competition and technological development in the BTM market in the long-term, which diminishes dynamic efficiency. The AER should not be contemplating TNSP activities that diminish the efficiency criteria of the National Objectives.

The AEC therefore contends that the only way that TNSPs should engage in these markets is as subjected to full legal separation from ring fenced affiliates. Our minimum expectation is that TNSPs will comply with the AER's updated non-discrimination provisions that prevent TNSPs from discriminating in favour of their own ring-fenced affiliates.

TNSPs should not be permitted to own battery storage nor lease the spare capacity

TNSPs should not be permitted to directly own battery storage because of the risk of cross subsidisation. We acknowledge that for electricity distribution, the AER has decided to allow DNSPs to lease spare battery capacity or to provide non network services in the contestable services energy market subject to the appropriate regulatory oversight. To facilitate this process, the AER has established a streamlined waiver process which includes DNSPs addressing the cross-subsidisation risk. The AER's assertion in this process is that the risk of cross subsidisation can only be averted by allocating the cost of the portion of the battery that provides standard control services into the RAB.

The AEC does not support the AER's view. When they are operating, battery storage facilities can provide regulated and non-regulated services simultaneously and are able to switch between regulated and non-regulated services within milliseconds. In addition, over time they can change the mix of services they supply, especially if the demand for certain services change. This makes it almost impossible to allocate the direct and shared costs of a battery storage facility between the categories of electricity services they supply to prevent any cross subsidy. This error should not be replicated in transmission.

Waivers to be restricted

The AER must maintain the separation of the contestable services from the natural monopoly elements of the electricity supply chain to the extent possible. In our view, this outcome would be consistent with the recommendations in the Hilmer Report 1993. We acknowledge that there are circumstances where TNSPs may be required to apply for a waiver and that the AER may grant one where the benefits exceed the costs. However, we do not support the expedited waiver provisions developed by the AER in distribution that allows DNSPs to directly own generation in Stand Alone Power Systems (SAPS), or to own a battery storage facility that provides both regulated and non-regulated services. In our view, and in practice given the lack of depth still in each of these markets, these amendments crowd out potential suppliers from these markets. Correcting the absence of a flourishing market for non-network services will not be achieved by compounding the chilling effect that arises from the diminishing separation between services that should be provided by competitive markets from those of natural monopolies.

The AER's preliminary views on waivers includes consideration of the following:

1. Accounting requirements:

We support the removal of the ability of TNSPs to apply for a waiver from accounting requirements. As we have argued above, the scope of services that the TNSPs will provide going forward is likely to increase. This makes it more important for there to be transparency of the costs allocated between transmission and non-transition services in the future. between the important for transparency

2. Obligation not to discriminate:

We support the AER's view to broaden the obligation for TNSPs to not discriminate in favour of themselves or an affiliate in providing contestable services, especially because they provide prescribed transmission services.

3. Functional separation:

We do not support waivers in relation to the functional separation of accommodation or employees. In this regard:

- I. **Office separation:** The separation of offices between regulated network staff and a ring-fenced affiliate ensures that commercial information is not shared between employees. Where these employees are in the same offices it is very difficult to prevent this. We therefore consider that complete separation must be mandatory, and waivers should not be permitted in this regard.
- II. **Staff:** TNSPs have confidential information available to them, and staff sharing can lead to a competitive advantage for a ring-fenced affiliate. We do not agree with the AER that waivers should be permitted in this regard.

4. Information access & disclosure:

We do not support waivers in relation to information access and disclosure by TNSPs. TNSPs must keep private electricity information confidential and only disclose it in limited circumstances. Where this information is disclosed to a ring-fenced affiliate it must also be made clearly available to all other potential competitors.

5. Requirements third party service providers to comply

We do not support waivers in relation to this party contractor providing prescribed services. Discrimination and information leaks can still be a function of third parties.

Strengthen the compliance regime

The AEC supports the AER's proposal to move away from the existing approach to compliance with the guideline which simply reports on measures to ensure compliance. The compliance regime should be expanded from the current approach and further require TNSPs to:

- report on breaches.
- move towards a regime that ensures compliance.
- report on any services that have been offered in these markets not permitted in the guideline; and
- report on the purpose of all transactions between TNSPs and any ring-fenced affiliates.

In addition to this, the Guideline should require the obligations to be independently verified annually and a report submitted to the AER within 4 months of the end of the financial year. And as with distribution compliance enforcement, we expect that the AER would have the power to apply any breaches of the Guideline to a court.

Any questions about this submission should be addressed to David Markham by email to david.markham@energycouncil.com.au or by telephone on (03) 9205 3107.

Yours sincerely,

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