

# Electricity distribution ring-fencing guidelines review

Response to the Australian Energy Regulator  
Position Paper

September 2012

**ActewAGL** 

*for you*

## Key points

ActewAGL Distribution considers that it would be premature for the AER to issue draft national ring-fencing guidelines in November 2012, for the following reasons:

- While the AER has shown that there are shortcomings in the current set of jurisdictional arrangements, it has not yet put forward a model for new national guidelines which would clearly deliver better outcomes and net benefits for consumers. The AER says “it may be preferable for the guidelines to operate in a more flexible way”. ActewAGL Distribution supports the AER’s intention to apply a flexible approach. However the AER also indicates that the flexible approach could involve applying the guidelines on a “case-by-case” basis and incorporating “waiver and variation provisions to allow for appropriate application of specific obligations”. ActewAGL Distribution believes that such an approach could involve significant uncertainty and costs for ring-fenced businesses and their customers, as well as significant administrative costs for the AER. These costs may more than offset the benefits of having national guidelines.
  - The AER should develop a clearer preferred position and allow sufficient time for consultation on likely costs, benefits and implementation issues for the preferred model and alternative national and jurisdictional approaches.
- In the position paper the AER refers to the need for ring-fencing guidelines to accommodate emerging market trends. ActewAGL Distribution agrees this should be a focus of any new or amended guidelines. However, the types of emerging markets that the AER refers to – for example advanced metering services – are currently the subject of major reviews which could result in significant changes to contestability frameworks. For example, in the *Power of Choice Draft Report* the Australian Energy Market Commission (AEMC) has outlined a new model for contestability of advanced metering services and is seeking stakeholder consultation on the model.<sup>1</sup> The AEMC has also made draft recommendations on other services, such as demand side participation (DSP) services and embedded generation services, which may be provided by distribution businesses in contestable markets.
  - Instead of trying to develop new guidelines at a time of considerable uncertainty and pending change, the AER should develop the guidelines sometime after the *Power of Choice* review is finalised, when there is

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<sup>1</sup> AEMC 2012, *Power of choice – draft report*, September, p. 56

greater certainty about the regulatory framework for distribution services and related services.

- There are likely to be advantages from delaying the process of developing new guidelines (as it can be better synchronised with other relevant policy processes such as the *Power of Choice* review) but few if any costs. The National Electricity Rules (Rules) allow the AER to develop ring-fencing guidelines, but do not require it to do so. The Rules also say that guidelines may vary across jurisdictions, and the current guidelines will remain in force unless the AER revokes, amends or replaces them.<sup>2</sup> The AER has not provided evidence of actual problems arising from the current ring-fencing arrangements which require changes to be made in the short term.

Consistent with the principles set out in the national *Competition Principles Agreement*, which underpinned the development of the current jurisdictional ring-fencing guidelines, the AER should clearly set out the options for achieving its ring-fencing objectives, carefully assess the costs and benefits of each, and choose the most cost effective option, through an open consultation process.

## Introduction

ActewAGL Distribution welcomes the opportunity to respond to the Australian Energy Regulator's (AER's) *Electricity distribution ring-fencing guidelines review – position paper* (the position paper), released on 4 September 2012.

ActewAGL Distribution, a partnership between ACTEW Distribution Ltd and Jemena Networks (ACT) Pty Ltd, owns and operates the electricity distribution network in the Australian Capital Territory (ACT). ActewAGL Distribution also owns the gas distribution networks in the ACT, Greater Queanbeyan and Shoalhaven.

ActewAGL Distribution and ActewAGL Retail together form the ActewAGL Joint Venture partnership. ActewAGL Retail is owned by ACTEW Retail Ltd and AGL ACT Retail Investments Pty Ltd. ActewAGL Retail purchases and retails electricity and gas services in the ACT and throughout the Capital Region (including Goulburn, Yass, Young, Nowra and Bega).

ActewAGL Distribution's current ring-fencing obligations are set out in the *Ring Fencing Guidelines for Electricity and Gas Network Service Operators in the ACT*. The guidelines were published by the Independent Competition and Regulatory Commission (ICRC) in 2002. Details on the current ACT guidelines were provided in our February 2012

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<sup>2</sup> NER 6.17.2 and 11.14.5

response to the AER's initial discussion paper for the ring-fencing review. The current ACT guidelines are comprehensive, covering both electricity and gas and incorporating each of the potential guideline elements listed by the AER in the initial discussion paper.<sup>3</sup> In developing the ACT guidelines the ICRC aimed to “achieve an appropriate balance between the costs (both to utilities and the Commission) and benefits of ring-fencing” and “not be unnecessarily prescriptive or intrusive”.<sup>4</sup>

## Context for the AER's review

The AER's review and possible amendment of ring-fencing guidelines should be informed by an understanding of the current policy and market context, as well as the background to the development of the current guidelines.

### Background

Most of the current jurisdictional ring-fencing guidelines were established around 10 years ago, in accordance with the requirements of the National Electricity Code. In the position paper the AER says that the current guidelines, developed by jurisdictional regulators, “appear to have been informed by national competition principles”.<sup>5</sup> ActewAGL Distribution considers that the principles set out in the *Competition Principles Agreement*, signed by Australian governments in 1995 to implement the Hilmer recommendations, were fundamental to the development of the current guidelines and should also be a central consideration in the AER's current review.

The *Competition Principles Agreement* explicitly refers to the need to balance the costs and benefits of a particular policy or course of action and assess the most cost effective means of achieving a policy objective. Carefully assessing the costs and benefits, and choosing the most cost effective option, should also be fundamental principles for the AER's review of ring-fencing guidelines. As noted in our response to the AER's initial consultation paper, in determining which ring-fencing obligations or requirements to apply the AER should ask:

- What issue or problem is the requirement trying to address?
- What are the likely costs and benefits?

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<sup>3</sup> The AER notes that the ACT guidelines do not contain waiver provisions. However the ACT guidelines do include provision for variations, at the request of the regulated business or initiated by the ICRC.

<sup>4</sup> ICRC 2002, *Ring Fencing Guidelines for Electricity and Gas Network Service Operators in the ACT*, p. 4

<sup>5</sup> AER 2012, *Electricity distribution ring-fencing guidelines review – position paper* (position paper), September, p. 1

- Is there are better way of addressing the issue or problem?

The fundamental principles underpinning the development of the national energy market should also inform the AER's approach to the review of ring-fencing guidelines. The *Australian Energy Market Agreement*, signed by Australian governments in 2003, says that one of the objectives in establishing the national energy regulatory framework is to:

*“streamline and improve the quality of economic regulation across energy markets to lower the cost and complexity of regulation...”*<sup>6</sup>

In line with this objective, the AER should adopt ring-fencing arrangements which, as far as possible, streamline and simplify the requirements and obligations on distribution businesses. They should not involve additional complexity and regulatory burden, or be overly prescriptive.

#### **The changing market and regulatory framework**

In the position paper the AER concludes that “changes to the electricity industry, in particular around the development of advanced meter services, means that most of the existing jurisdictional guidelines may not provide an effective ring-fencing regime”.

ActewAGL Distribution considers that market developments, and related policy and regulatory developments, have implications for both the nature and timing of any changes to ring-fencing arrangements.

Most of the original guidelines were primarily aimed at addressing potential competition issues arising from the involvement of monopoly network businesses in competitive, or potentially competitive, retail markets. However ring-fencing arrangements are now potentially relevant to a far wider range of activities and circumstances. For example, ring-fencing of distribution and generation activities has been identified as a potential issue in the Australian Energy Market Commission's (AEMC's) current *Power of Choice* review. The AEMC considers that there are likely to be significant benefits from allowing distribution businesses to export power from distributed generation assets into the wholesale market. However:

*“These benefits may not be realised if ring-fencing arrangement place stringent restriction on the ability of DNSPs to provide generation services.”*<sup>7</sup>

The role of distribution businesses in providing other competitive services such as advanced metering services and demand management services is also being addressed in the *Power of Choice* review, and the AEMC has noted the importance of effective ring-fencing arrangements in this context.

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<sup>6</sup> AEMA 2.1(b)(ii)

<sup>7</sup> AEMC 2012, *Power of Choice, Draft Report*, p. 144

In the *Power of Choice Draft Report* the AEMC proposes some major changes with far-reaching implications for the provision of distribution services, retail services and other related energy services. For example, the AEMC is proposing a new model for contestability of metering services. The AEMC intends to finalise its report to the Standing Council on Energy and Resources (SCER) in November 2012. Any Rule changes required to implement the recommendations accepted by SCER would then be developed and assessed during 2013 and 2014.

Against this backdrop of pending significant changes in the regulatory framework, ActewAGL Distribution believes the AER should defer its consideration of new national ring-fencing guidelines until after the *Power of Choice* review and any subsequent Rule changes are made, when there should be greater certainty about the future framework for distribution services and related services.

## The AER's case for national guidelines

The AER's case for replacing the current jurisdictional ring-fencing guidelines with new national guidelines is underpinned by its assessment that:

- The existing jurisdictional guidelines “are not adequate for either the current environment or into the future”<sup>8</sup>; and,
- The shortcomings should be addressed through new national guidelines rather than amendments to the existing guidelines because “there are significant administrative efficiencies to it (the AER), market participants and all DNSPs in running a single review process for a NEM wide distribution ring-fencing guidelines, rather than six separate state based processes”.<sup>9</sup>

ActewAGL Distribution agrees with the AER's assessment that there are shortcomings in current jurisdictional guidelines, in particular inconsistent definitions and uncertainty about application to emerging markets. Addressing these shortcomings should be the focus of any new or amended guidelines.

However, we believe that the AER has overstated the shortcomings in the existing guidelines, as a result of the assessment criteria it has chosen. The AER's first criterion for assessing the jurisdictional guidelines is:

*“Do the guidelines include the ring-fencing components listed in clause 6.17.2(b) of the NER?”*

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<sup>8</sup> AER 2012, Position Paper, p. 8

<sup>9</sup> AER 2012, op cit, p. 10

A simple checklist of what elements are included in each jurisdiction does not provide a sound basis for assessing the adequacy of the guidelines. A “no” response to the question above should not be interpreted as a shortcoming of jurisdictional guidelines. Clause 6.17.2(b) of the Rules lists the components that “may” be included in guidelines. There is no presumption in the Rules that all are appropriate or necessary. For example, effective application of two of the elements – accounting separation and restrictions on flows of information – could remove the need for other separations such as legal separation. The AER’s comparison of the components of guidelines across jurisdictions (provided in appendix B of the position paper) illustrates that a range of approaches, involving different combinations of separation requirements, have been determined to be appropriate by jurisdictional regulators. Each of the possible elements can also be applied to varying degrees – for example physical separation can involve location in different parts of the same building, or the significantly more costly requirement to locate in separate buildings.

ActewAGL Distribution also believes that the AER has not clearly established the case that developing a new set of national guidelines is a better option than amending the existing guidelines. The benefits and costs of the preferred option of new national guidelines depend on their design, and the AER has not provided adequate guidance on this (discussed further below). In addition, the AER may be overstating the likely costs of the option of amending the existing guidelines. The main problems that the AER has identified with the current arrangements are:

- inadequate scope to deal with emerging markets;
- problems of inconsistent coverage and definitions; and,
- the absence of waiver provisions in some guidelines

Directly addressing these shortcomings – for example by clarifying definitions and making terminology consistent – may be a lower cost and more effective option than the AER’s approach of developing new national guidelines from scratch and then possibly applying them on a “case-by-case” basis.

## The AER’s preferred approach to national guidelines

The AER’s preliminary view is that the distribution ring-fencing guidelines should allow for the following obligations to be imposed:

- Legal separation
- Accounting separation

- Allocation of costs
- Limitations on the flow of information
- Physical, staffing and functional separation
- Non-discrimination
- Waivers
- Compliance and reporting<sup>10</sup>

The nature and extent of separations required and the degree of prescription under each of these categories can vary widely. In the position paper the AER provides limited guidance on whether and to what extent it may apply each of the obligations. It describes two broad approaches that could be taken:

1. A “more prescriptive approach” where guidelines would “set out the particular ring-fencing obligation (functional separation, structural separation, legal separation etc) that would apply. For example, to establish or maintain effective separation of distribution and retail activities, a relatively strong form of separation may be mandated, such as legal or structural separation”.<sup>11</sup>
2. A “more flexible approach” with the guidelines “applying any of the possible ring-fencing obligations, on a case-by-case basis. In addition, to provide further flexibility, the guidelines would incorporate waiver and variation provisions to allow for appropriate application of specific obligations.”

The AER says it “may be preferable for the guidelines to operate in a more flexible way”.<sup>12</sup>

ActewAGL Distribution strongly supports the adoption of a more flexible, principles-based approach, and opposes a more prescriptive approach involving potentially inefficient forms of separation. A more prescriptive approach would involve significant costs for distribution businesses and their customers and not would be appropriate for addressing the matters arising from the involvement of distribution businesses in new and emerging energy markets. For example, investment in advanced metering infrastructure is likely to be stifled, rather than enhanced (which is a primary driver for the AEMC’s *Power of Choice* recommendations), if distribution businesses intending to participate in the market for these services are subject to intrusive requirements to structure their business in a certain way. Similarly, as noted by the AEMC in relation to the benefits of distributed generation:

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<sup>10</sup> AER 2012, *Electricity distribution ring-fencing guidelines review – position paper*, pp. 11-12

<sup>11</sup> AER 2012, *op cit*, pp. 10-11

<sup>12</sup> AER 2012, *op cit*, p. 11



*“These benefits may not be realised if ring-fencing arrangements place stringent restriction on the ability of DNSPs to provide generation services.”<sup>13</sup>*

While ActewAGL Distribution agrees with the AER’s preference for a flexible approach, it also needs to be light-handed. We are concerned that the AER has not developed a model which shows how this would be applied in practice. The AER indicates that the flexible approach could involve applying the guidelines on a “case-by-case” basis and incorporating “waiver and variation provisions to allow for appropriate application of specific obligations”. ActewAGL Distribution believes that such an approach could involve significant uncertainty and costs for ring-fenced businesses and their customers, as well as significant administrative costs for the AER. These costs are likely to more than offset the benefits of having national guidelines.

ActewAGL Distribution seeks further details and consultation on the AER’s preferred approach before the AER issues any new draft guidelines or amends existing guidelines.

## Concluding comments

While ActewAGL Distribution agrees in broad terms with the AER’s preference for a more flexible and less prescriptive approach, we believe that further analysis and consultation is required to ensure that the practical implications and likely costs and benefits of moving from jurisdictional to national guidelines are fully understood. The AER should only adopt new ring-fencing arrangements where it is clear that they will result in better outcomes than the current arrangements.

ActewAGL Distribution strongly favours a flexible, simple and light-handed approach to ring-fencing, in line with the fundamental principles which underpin the national competition policy reforms and the national energy market reforms. The approach should draw on the strengths of the existing guidelines, address any shortcomings such as unclear scope or inconsistent terminology as directly as possible, and not introduce costly and unnecessary new restrictions on the structure and operations of ring-fenced businesses. The current ACT guidelines should only be amended or replaced by a clearly superior approach, taking account of all costs and benefits.

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<sup>13</sup> AEMC 2012, *Power of Choice, Draft Report*, p. 144