

# **Submission on Electricity Distribution Ring Fencing Guidelines Review – AER Discussion Paper**

February 2012



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# 1. Adequacy of existing ring fencing guidelines

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## 1.1 Background

The following comments are provided by Ausgrid, operating as one of three New South Wales (NSW) based distribution network service providers (DNSPs). Ausgrid operates a distribution network that supplies electricity to customers in Sydney, Central Coast and Hunter regions. In March 2011, the NSW Government privatised NSW electricity retail businesses owned by Ausgrid and the other two NSW based DNSPs. This has resulted in the ownership separation of retail and distribution components of electricity supply in NSW.

A contestable market for the provision of connection services has operated in NSW for more than 10 years. The NSW framework provides for the Accreditation of Independent Service Providers (ASPs) to provide customer connection services previously only offered by DNSPs. The NSW DNSPs participate in this market to varying degrees whilst also undertaking monopoly network services (regulated services). Contestability arrangements in NSW also apply to some categories of meter provision, installation and data collection, street lighting and certain capital works requested by and funded by individuals (such as asset relocation).<sup>1</sup>

## 1.2 Ring fencing arrangements in New South Wales

NSW DNSPs are currently subject to the ring fencing rules set out in the Independent Pricing and Regulatory Tribunal (IPART) Guidelines<sup>2</sup>. Compliance with these guidelines is imposed by the NSW Government through a condition of each NSW DNSP's operating license and a requirement of the National Electricity Rules (NER).<sup>3</sup>

The ring fencing guidelines broadly seek to ensure;

1. there is a level playing field (i.e. competitive neutrality) between DNSP and Accredited Service Providers (ASPs) for contestable customer connection services;
2. NSW DNSPs do not misuse their monopoly position to create barriers to new entrants or adversely affect competition in the market for contestable connection services; and
3. there are no cross-subsidies between the contestable and non-contestable activities that may be undertaken by DNSPs.

In doing so, the NSW guidelines contribute to the achievement of the National Electricity Objective by facilitating competition (where competitive markets exist).

The NSW ring fencing guidelines are quite narrowly focused as they only operate between prescribed services (non-contestable) and contestable customer connection services.<sup>4</sup> These requirements relate to access to services and information, allocation of costs, communicating with customers and the functional separation of operational staff providing specified "regulatory" type services from staff providing contestable services.<sup>5</sup> The guidelines do not require accounting separation as this is already required under NSW DNSP licensing conditions.<sup>6</sup> Operational separation is also not expressly required as this too is a requirement of DNSP licensing conditions in NSW.<sup>7</sup> Ausgrid considers that current arrangements in NSW are also flexible enough to take into account DNSP circumstances or emerging trends, with

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<sup>1</sup> NSW Government, *Department of Water and Energy*, Code of Practice Contestable Works, p 4.

<sup>2</sup> NSW Distribution Ring Fencing Guidelines, 2003.

<sup>3</sup> Clause 6.17.1 of the NER provides that all DNSPs must comply with the Distribution Ring Fencing Guidelines prepared by the AER under clause 6.17.2. Under clause 11.14.5(c) of the NER IPART guidelines are taken to be guidelines made by the AER under the NER.

<sup>4</sup> Clause 6.2.3B (a) of Transitional Chapter 6 of the NER deems prescribed services as standard control services. Contestable services is defined in the *Electricity Supply (General) Regulation 2001 (NSW)* – see clause 3.

<sup>5</sup> NSW Distribution Ring Fencing Guidelines were made under clause 6.20 of the *National Electricity Code* by the Independent Pricing Regulatory Tribunal (IPART) in 2003. NSW's guidelines were developed taking into account DNSP's licence conditions, legal obligations and business structure.

<sup>6</sup> Distributor Network Service Provider License Conditions, clause 4.2 and 4.3.

<sup>7</sup> Ibid.

provisions allowing for DNSPs to apply for a waiver and the ability and for the regulator to add to the guidelines.<sup>8</sup>

Ring fencing arrangements in NSW are also supplemented by the Contestable Works Code of Practice (Code of Practice). The Code of Practice, which is aimed at promoting competition and customer choice in contestable works, outlines additional ring fencing measures. These include<sup>9</sup>:

- electricity distributors must not misuse their statutory rights or obligations, such as denying or delaying inspections or approvals, to obtain a competitive advantage; and
- electricity distributors must obtain the customer's written consent before information is shared with the distributor's internal contracting arm or any other contracting business

It is our opinion that to date, ring fencing in NSW has been successful in preventing behavior that may have inhibited the development of a competitive market for contestable connection services. This is evident by the significant amount of contestability carried out in the jurisdiction. For example, approximately, 20,000 connections or changes to services took place in 2009-10, most of which were carried out by third party ASPs.<sup>10</sup> Ausgrid's internally ring fenced business unit carried out less than 3 per cent of the total number of contestable connection services in Ausgrid's network in the past two financial years. However, despite the success of the NSW contestability regime Ausgrid believes that a review of existing guidelines is necessary to assess whether there is a continuing need for the current guidelines; and whether current arrangements are robust and flexible enough to meet future developments and challenges in the electricity services markets.

### **1.3 Relevance of jurisdictional guidelines in light of industry changes**

Each jurisdictional guideline was developed by taking into account such things as the legislative framework of the jurisdiction, accounting practices and the industry structure at the time. Since the development of the NSW guidelines in 2003, new legislative obligations have been introduced and there has been substantial progress moving towards a more national regulatory framework.<sup>11</sup>

Given these factors and in light of the limited review that has occurred since the development of each jurisdiction's guidelines, Ausgrid agrees that a review of existing jurisdictional guidelines is warranted to determine their continuing relevancy and adequacy. We understand the AER is also seeking to consider whether a national approach to distribution ring fencing is appropriate and/or desirable.

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<sup>8</sup> See IPART (NSW), Distribution Ring Fencing Guidelines, Part 6.

<sup>9</sup> NSW Government, *Department of Water & Energy*, Code of Practice – Contestable works, April 2007.

<sup>10</sup> The number of new connections is based on service line connections not metering point connections. For example, a block of 100 units would be counted as a single connection rather than 100 connections.

<sup>11</sup> Introduction of the *Competition and Consumer Act 2010* (Cth) (CCA) and compliance with s 46. Other legislative obligations include the National Energy Customer Framework (NECF) and development of National Connection Charging Guidelines under Chapter 5A of the National Electricity Rules. Ausgrid also notes that work was commenced in December 2011, aimed at developing a national framework for smart meter consumer protection and pricing.

## 1.4 Ensuring guidelines are appropriately robust and flexible

### *Narrow versus broad scope*

Ausgrid agrees that ring fencing guidelines need to be robust but also flexible enough to accommodate changing market conditions and emerging trends. We note that this might be an issue for some jurisdictions given the current scope of their guidelines.<sup>12</sup> For instance:

- Victoria's guidelines have a relatively narrow scope, as they are limited to ring fencing DNSP standard control services from retail business operations.<sup>13</sup>
- NSW and Tasmania guidelines have a different scope, focusing on ring fencing contestable services.<sup>14</sup>
- South Australia's (SA) guidelines are even broader requiring ring fencing of retail services and generation (unless generation services are carried out for network support purposes), as well as any services which are subject to effective competition.<sup>15</sup>
- Queensland and ACT guidelines have arguably the broadest scope out of all the jurisdictions, as they require DNSP's to ring fence standard control services from any related business of the DNSP engaged in producing, purchasing or selling electricity.<sup>16</sup>

Ausgrid questions whether some jurisdictions guidelines may be too narrowly focussed, while others too broad. For instance, Ausgrid questions whether guidelines which focus on the issue of vertical integration are still relevant in light of the privatisation of retail businesses and whether they are flexible enough to adapt to market changes and emerging trends. Conversely, there is concern with the broad "catch all" scope of some jurisdictions, which has had the effect of proscribing activities aimed at managing their network or meeting their licence conditions. An example of this is the need for Ergon Energy to apply for a waiver to install photovoltaic devices to improve building efficiency.<sup>17</sup>

Ausgrid considers that the NSW and Tasmania guidelines focus on "contestability" is an appropriate scope, as it is limited to circumstances where a DNSP is participating in the contestable market as well as the non-contestable market and their position in the non-contestable market can provide an unfair advantage over others in the contestable market.

The SA guidelines are slightly broader than NSW and Tasmania in the sense that they are aimed at ring fencing activities "subject to effective competition," where effective competition is determined by the regulator from time to time. The SA approach to ring fencing might be considered the most appropriate out of all the jurisdictions, as it is targeted enough to address areas which might give rise to anti-competitive behaviour (i.e. limited to DNSP engaging in markets which are subject to effective competition) and are flexible enough to accommodate market developments by conferring a discretion on the regulator to determine what constitutes effective competition from time to time.

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<sup>12</sup> This is largely a result of the contextual basis in which jurisdictional guidelines were developed.

<sup>13</sup> Refer to Electricity Industry Guidelines, No 17, Electricity Ring Fencing Issue 1, October 2004.

<sup>14</sup> Refer to IPART (NSW), Distribution Ring Fencing Guidelines; and Office of the Tasmanian Energy Regulator, Guideline for Ring fencing in the Tasmanian Electricity Supply Industry, October 2004.

<sup>15</sup> Refer to Essential Services Commission of South Australia, 'Operational Ring Fencing Requirements for the SA Electricity Supply Industry', Electricity Industry Guideline No 9, June 2003. For the purposes of "related business" the Commission determines what services are subject to effective competition from time to time.

<sup>16</sup> Refer to definition for "related business" contained in ICRC, Ring Fencing Guidelines for Gas and Electricity Network Service Operations in the ACT, November 2002; and Queensland Competition Authority, Electricity Distribution Ring Fencing Guidelines, September 2000.

<sup>17</sup> Ergon example discussed in the AER 'Electricity Distribution Ring Fencing Guidelines Review,' Discussion Paper, p 18. This was also an issue considered when developing the South Australia guidelines. Refer to Essential Services Commission of South Australia, 'Operational Ring Fencing Requirements for the SA Electricity Supply Industry', Electricity Industry Guideline No 9, June 2003, p 10.

### ***Principles/objective based versus detailed requirements***

Ausgrid notes that a key challenge for the AER in resolving current scope issues, is striking an appropriate balance between limiting matters to those appropriately addressed by ring fencing (so that they do not hinder the ability of a DNSP to manage their network or stifle innovation) and ensuring that the guidelines are sufficiently broad enough to be able to apply to changing market circumstances and emerging industry trends.

Ausgrid notes that where guidelines seek to be broad and all encompassing, they tend to result in a “catch all” effect and subsequently prescribe activities which can go beyond the regulatory intent of ring fencing. For example when ring fencing arrangements preclude DNSP’s from operating a transmission network or small generators to support its distribution network or assist in meeting design, reliability and performance license conditions (license conditions).<sup>18</sup> On the other hand, when guidelines seek to target very specific problems there is a danger that they can become overly complicated and requirement focused. A consequence of which is that they tend to lose relevancy over time.

Given current issues regarding the scope of some guidelines and future challenges facing distributors, Ausgrid believes that it is important that the AER strikes an appropriate balance between targeting the potential for anti-competitive outcomes and providing flexibility to accommodate changing market conditions and emerging industry trends. We think that such a balance can be achieved by adopting high level principle and objective based guidelines as opposed guidelines which are specific and requirement based. This is because such an approach allows for guidelines to remain relevant in light of market developments as they are flexible enough to accommodate change. This issue will be explored further in section 2.

### ***The role of waivers***

While it may be argued that waiver provisions in guidelines provide flexibility to mitigate problems with existing guidelines, Ausgrid believes that this is not a viable long term solution for resolving underlying problems with guidelines.<sup>19</sup> This is because applying for waivers can be time consuming and costly.<sup>20</sup> They generally require DNSP’s to prepare substantial business cases to demonstrate that compliance is too onerous and that the cost of compliance outweighs the market benefit of the restriction. Preparing such business cases diverts time and resources away from DNSP’s core activities and may often require expert advice or reports.

While Ausgrid believes that waivers are not sufficient or appropriate for addressing underlying problems with jurisdictional guidelines, we do consider they have an important role in accommodating individual DNSP circumstances.

## **1.5 The need for consistency and a more national approach**

Given the disaggregation of the energy supply chain and future challenges facing the electricity supply industry, we note that there is now greater scope to further harmonise jurisdictional guidelines or to adopt a national approach. However, before an assessment of the appropriateness and scope of a national approach can be undertaken, Ausgrid considers that clear objectives and principles for ring fencing must be determined first. We believe that this is particularly important given the contextual basis in which jurisdictional guidelines were

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<sup>18</sup> See ICRC Ring fencing guidelines for gas and electricity network service operations in the ACT clause 3.1(b) and definition of “related business.” See also Queensland Competition Authority, Electricity Distribution Ring Fencing Guidelines, clause 1(b) and definition of “related business.” Guidelines which do not prevent DNSP’s from engaging in generation activities are NSW, Tasmania, Victoria and South Australia guidelines.

<sup>19</sup> Ausgrid considers that the underlying problems with existing guidelines include issues with their scope and their ability to accommodate market changes and emerging industry trends.

<sup>20</sup> In order to be granted a waiver in most jurisdictions a DNSP must demonstrate that the costs of compliance outweigh the benefit of compliance.

developed and their differences in scope. Without first having clear direction on the purpose and objectives of ring fencing, addressing this issue now risks back solving and unintended consequences such as imposing onerous or duplicative requirements.

We note that moving towards a more national approach on ring fencing would provide clear benefits across jurisdictions in the sense of greater consistency and competitive neutrality. Further, there is potential that a national approach would also reduce overall administration costs.

Ausgrid notes that the desirability of a national regime for ring fencing will depend on the extent that jurisdictional legislative frameworks, market conditions and structure are similar; and whether it can accommodate jurisdictional differences. To the extent that they cannot, we would argue that a national guideline would not be desirable as it would potentially drive up DNSP compliance costs. This is because compliance obligations may be more onerous or prescriptive on DNSPs in some jurisdictions than others and it may result in duplicating existing state based obligations.<sup>21</sup>

Ausgrid strongly advocates that if a national guideline were to be developed, that it should be high level principle based as opposed to detailed requirements. We believe that adopting such an approach will provide guidelines with the flexibility to account for jurisdictional differences and remain relevant in light of market developments and emerging industry trends.

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<sup>21</sup> DNSPs may find obligations too onerous or prescriptive due to jurisdictional differences in market and business structures. Further, differences in legislative frameworks and licence conditions between jurisdictions may result in duplicative obligations.

## **2. Appropriate content of DNSP ring-fencing guidelines**

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The AER discussion paper provides a useful basis for initiating discussion on the aim, objectives and scope of a national ring fencing guideline, as well as providing some examples of potential problems the guidelines may seek to address. Ausgrid considers it is important that ring fencing guidelines contain the following:

1. A clearly defined purpose of the ring fencing guidelines and set of objectives the guidelines are seeking to accomplish in the context of the current national electricity market. This process would necessarily need to consider examples of problems ring fencing guidelines would aim to address.

We acknowledge the challenge in developing national guidelines is to strike an appropriately balance that provides:

- sufficient guidance to DNSPs on how DNSPs' compliance with the guidelines can be achieved; and
- sufficient flexibility to accommodate market changes, jurisdictional differences or DNSP circumstances.

This is a particularly important step if national guidelines were to be developed.

2. Determine appropriate forms of ring fencing to address the objectives (e.g. legal, accounting, operational)
3. Conduct a gap analysis to determine whether there are existing mechanisms that achieve ring fencing objectives. We note that undertaking this process will allow stakeholders to assist the AER in identifying any potential jurisdictional and/or national based mechanisms already in place. Further undertaking such an analysis will inform the AER as to the feasibility of implementing a national guideline, as well as the appropriate content of any such guideline.

This was the approach adopted by IPART when it developed the current NSW ring fencing guidelines. In its discussion paper at the time IPART drew on accepted definitions and purposes of ring fencing and analysed them in the context of the electricity market in NSW at that time.<sup>22</sup> Ausgrid believes that without approaching the review in this manner, there is a risk that the resulting national guidelines may have an inappropriate scope, duplicate existing obligations or will lose their robustness and relevancy over time. This could result in increased DNSP costs (i.e. compliance costs and loss of economies of scale) and in the worst case increased prices to customers and distorted market outcomes.

### **2.1 Purpose and objectives of national ring-fencing guidelines**

As outlined above, Ausgrid considers it is important from the outset for the purpose/overarching aim of ring fencing to be defined. This will ensure that the scope of guidelines is appropriate and will assist in avoiding situations where DNSPs need to seek waivers for activities undertaken to deliver outcomes under licence conditions or network requirements.

In the discussion paper, the AER outlines the purpose of ring fencing in the context of vertical integration. Ausgrid believes that this is too narrow in scope. We note that the Government's decision to privatise retail electricity businesses has resulted in very limited circumstances in which vertical integration now applies to DNSPs.<sup>23</sup>

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<sup>22</sup>IPART Discussion Paper DP 41, September 2001 at pp 3-8.

<sup>23</sup> Aurora Energy in Tasmania and Ergon Energy in Queensland are the only DNSPs in the NEM to retain retail businesses and have vertical integration. All other jurisdictions have complete ownership separation, from retail businesses and DNSPs.



The NSW experience demonstrates that ring fencing requirements can be appropriate to address competitive outcomes other than those which arise from vertical integration. Consequently, Ausgrid believes a more appropriate focus for ring fencing guidelines is:

*where a DNSP is participating in a competitive market as well as the monopoly market and its position in the monopoly market can provide an unfair advantage over others in the competitive market, thereby adversely impacting upon competition.*

We propose that as part of the next stage of the consultation process undertaken by the AER, it would be useful to seek stakeholder feedback on the appropriateness of this overarching aim of ring fencing.

Once the purpose of the ring fencing guidelines is clearly articulated Ausgrid considers that the overarching aim of the guidelines should be supported by a set of objectives and underlying principles. Ausgrid strongly believes that these should be principles-based (i.e. high level) rather than detailed and/or prescriptive requirements (i.e. a specific rules approach). The key argument in favour of such an approach is that it is less intrusive than prescriptive approaches to ring fencing.

Further, a high level approach has the capacity to encompass all forms of anti-competitive behaviour, including those that have not been anticipated by regulators. A high level approach is also more flexible, meaning that DNSPs have the opportunity to be innovative in meeting their ring fencing obligations and will avoid the need to continually revise ring fencing guidelines as new market developments arise.<sup>24</sup>

We believe that adopting detailed requirements in the guidelines tends to give rise to the risk of unanticipated consequences. An example of this is the prescriptive nature of Queensland guidelines which prevents DNSP from carrying on any related business of producing, purchasing or selling electricity, even if the DNSP is seeking to carry out this activity for the purpose of supporting its network or to assist it in meeting license conditions. Further, we note that detailed requirements based guidelines tend to lose their relevance over time; are often narrow in scope; provide limited scope for innovation; and may be inappropriate in some cases due to individual DNSP circumstances.<sup>25</sup>

Ausgrid advocates that adopting high level principles will provide the flexibility to account for jurisdictional differences and to remain relevant in light of market developments. We consider the objectives outlined in the SA guideline to be a useful starting point for discussion. The SA objectives include:

- Avoid the anti-competitive effects of cross-subsidies or other discriminatory interactions between the contestable and non-contestable activities;
- Ensure that unfair advantage is not secured by using information acquired by a monopoly activity, for the benefit of contestable activity; and
- Avoid a perception of an uneven playing field that may deter potential market participants.

As part of the consultation process being undertaken by the AER, Ausgrid considers it would be useful for further stakeholder consideration and development of these objectives to be undertaken.

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<sup>24</sup> See IPART, *Ring Fencing of New South Wales Electricity Distribution Network Service Providers*, Discussion Paper and Draft Ring Fencing Guidelines, September 2000, p 13.

<sup>25</sup> *Ibid*, p 15.

To assist in the development of a defined set of objectives of the ring fencing guidelines, Ausgrid believes that it is necessary to consider the broad types of problems that the AER is seeking to address through ring fencing. Clear articulation of the problem(s) ring fencing seeks to address, will assist both stakeholders and the AER in assessing the adequacy of current arrangements and setting principle-based objectives.

To assist the AER we have provided some commentary on the examples provided in the AER's discussion paper in which this anti-competitive behavior may occur:

- Limiting access of competitors to the distribution network by delaying or degrading connections;
- Restricting the quantity and quality of the distribution service provided to competitors or improving the network performance for its affiliated interests,
- Sharing commercially sensitive information regarding competitors with its affiliated interests;
- The way it negotiates and processes connection arrangements with competitors as opposed to affiliated interests;
- Shifting costs between regulated and unregulated activities, and
- Developing/emerging markets.

### **Some of the problems ring fencing seeks to address**

The following section contains Ausgrid's analysis of some of the problems that ring fencing would seek to address, as identified in the AER's discussion paper. Our analysis includes:

- commentary on the scope of these potential problems;
- possible objectives to address the perceived risk, and
- approaches adopted in NSW (and in some cases other jurisdictions) to deal with that risk.

#### *1. DNSPs limiting access of competitors to the distribution network by delaying or degrading connections*

In NSW, the provision of customer connection services is contestable (has been for over 10 years) and customers can choose the Accredited Service Provider (ASP) to undertake this work. Whilst it is not currently common practice, DNSPs can operate in this competitive market. An overarching objective to address the risk would be to seek to ensure that discriminatory interactions of DNSPs between the contestable and non-contestable activities are avoided.

Due to the contestable nature of connection services in NSW, Ausgrid considers that it is not possible to provide a degraded connection. However, in principle it is possible to delay the provision of the necessary accompanying monopoly services (referred to as "prescribed distribution service" in the NSW Ring Fencing Guidelines).

In the NSW Distribution Ring Fencing Guidelines this has been addressed by clauses 2.1 and 2.2 which while specific are essentially objective based.

*2.1.1 A DNSP must provide a prescribed distribution service<sup>26</sup> to an independent accredited service provider on terms that are no less favourable than the terms on which it provides that service to the part of the DNSP's business providing contestable services.*

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<sup>26</sup> The term *prescribed distribution service* was defined in the IPART regulatory determination, current at the time the ring fencing guidelines were drafted. This term could be updated to reflect the terms used in the National Electricity Rules and used by the AER in its' regulatory determinations (i.e. *distribution service*).

*2.1.2 A DNSP must not treat a customer more or less favorable than another because the customer engaged or elected not to engage the DNSP to provide it with contestable services*

*2.2 A DNSP must provide information relating to or deriving from the provision of prescribed distribution services to an independent accredited service provider on terms that are no less favorable than the terms on which that information is made available to that part of the DNSP's business that provides contestable services*

In the South Australian Ring Fencing Guideline this has been addressed by clauses 3.3:

*The Distribution Licensee must ensure that, in providing goods or services for which the Licenced Business is the monopoly supplier to a Related Business or a competitor of the Related Business, those goods and services are provided on a non-discriminatory, commercial basis.*

Ausgrid considers the broad approach adopted by the SA guideline is sufficient to ensure that discriminatory interactions of DNSPs between the contestable and non-contestable activities are avoided, whilst also being flexible enough to accommodate future competition in the provision of services.

*2. DNSPs restricting the quantity and quality of the distribution service provided to competitors or improving the network performance for its affiliated interests*

It is difficult to consider an example where the quantity or quality may be altered to disadvantage ASPs or advantage the DNSPs own affiliated interests. Notwithstanding this comment, the NSW Distribution Ring Fencing Guidelines provide a mechanism to avoid such behaviours or interactions of DNSPs in Clause 2.1.1. Similar to the concern of delayed or degraded connections outlined above, Clause 3.3 of the SA Ring Fencing Guidelines address this risk.

*3. DNSPs sharing commercially sensitive information regarding competitors with its affiliated interests*

Contractual confidentiality obligations as well as privacy militate against this type of discriminatory activity. We also note that clause 3.2 of the SA guideline and clause 5.3 of the NSW guideline also appropriately addresses this problem.

*4. The way DNSPs negotiate and process connection arrangements with competitors as opposed to affiliated interests*

The comments provided in response to items 1 and 2 above apply to this risk. In addition, the new National Energy Retail Laws and Rules to establish the National Energy Customer Framework (NECF) cover requirements in relation to the negotiation and processing of connection arrangements by DNSPs.

*5. Shifting costs between regulated and unregulated activities*

We believe that Part 3 of the NSW distribution ring fencing guidelines (cost allocation requirements) and clause 4.3 of the ministerially imposed licence conditions provide a mechanism to avoid such behaviour or interactions of DNSPs. Part 3 of the NSW guideline requires that DNSPs fully allocate prescribed distribution services on a causation basis; whereas clause 4.3 of Ausgrid's licence conditions requires it to keep separate accounting and business records for its distribution system operation functions.

## 6. *Emerging issues*

We note that the Australian Energy Market Commission (AEMC) is currently undertaking reviews of demand side participation and electric vehicles.<sup>27</sup> As part of these reviews the AEMC will be considering market and regulatory arrangements that impact on the electricity market supply chain, including the Rules, other national and jurisdictional regulations, commercial arrangements and market behaviours. Although the outcomes of these reviews will not be known for quite some time, there is a need to ensure that any changes to existing ring fencing arrangements are flexible enough to give effect to the outcomes of these reviews.

### 2.2 Determining the appropriate form of ring-fencing

When determining whether or not to impose ring fencing requirements it is important to remember that ring fencing is intrusive by its very nature. It constrains the commercial behaviour of DNSPs by requiring particular forms of conduct. By doing so, it can lead to inefficiencies and distorted market outcomes.

Therefore it is important when considering the need for ring fencing that the potential benefits from ring fencing are carefully weighed against their costs.<sup>28</sup> Ausgrid advocates that the AER consider the potential upfront costs and disruption to the business, as well as the ongoing intrusiveness of compliance requirements in determining the level of prescription of any national ring fencing requirements that may be adopted. We note that the typical ring fencing costs include<sup>29</sup>:

- *Initial set-up costs* – for example, business reorganization
- *Ongoing operational costs* – This includes compliance and monitoring costs, and losses of economies of scale and scope.
- *Limits on business choice* – This refers to costs incurred by restricting the electricity businesses' ability to select their own business structure

Ausgrid strongly advocates that if the costs associated with ring fencing are greater than the benefit of promoting or facilitating competition, then the restriction is not justified.

Further we note that there is a need to ensure that if any changes to the form of ring fencing are to be made, that the changes do not have the effect of stifling innovation or market competition. We believe that it is important to ensure that DNSPs are not unfairly disadvantaged in emerging or competitive markets by being subject to restrictions which do not apply to other external parties operating in the market.

To impose restrictions, purely on the grounds that a DNSP is operating in a market which is subject to competition is not consistent with the National Electricity Objectives (NEO) and in fact hinders the development of market competition by distorting market outcomes. We believe that restrictions should only be imposed in situations where DNSP's have the necessary market power to distort market outcomes. When DNSPs are placed in such a position in the market it is arguable that there are incentives for it to engage in anti-competitive behaviour in order to maximise its revenue. Accordingly, it is appropriate in these circumstances to restrict DNSP behaviour.

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<sup>27</sup> AEMC Reviews: *Power of Choice – Stage 3 DSM Review, Issues Paper*, 15 July 2011 and *Energy Market Arrangements for Electric and Gas Vehicles, Approach Paper*, 22 September 2011.

<sup>28</sup> Examples of the type of costs arising from ring fencing include: establishment, administrative and compliance costs, as well as potential losses of economies of scale/scope

<sup>29</sup> IPART, *Ring Fencing of New South Wales Electricity Distribution Network Service Providers*, Discussion Paper and Draft Ring Fencing Guidelines, p 4.

Key questions the AER may consider in deciding whether to impose ring fencing obligation are:

- does the restriction assist in preventing anti-competitive behaviour?
- does the restriction impose a significant cost burden on distributors?
- is the cost of imposing the restriction justified in terms of the benefits that will accrue to the customer in terms of increased competition?

### **2.3 The importance of undertaking a gap analysis**

An important step in the review process, once the problems and objectives have been clearly identified, is to conduct a gap analysis to determine whether mechanisms already exist nationally or jurisdictionally to achieve these objectives. This is an important consideration as while ring fencing can provide benefits in terms of removing potential barriers to competition it also imposes costs. It is important that the AER does not impose obligations which are overly onerous or duplicate existing requirements as this can increase DNSP compliance costs, may cause confusion and have other unintended consequences.

In the examples provided in section 2.1, we have sought to outline existing arrangements that we consider achieve the aim of ring fencing guidelines and address the problems identified by the AER in its discussion paper. We note that in NSW there is a range of mechanisms in place that achieve the objectives and purpose of ring fencing. These include:

- Licence conditions (both the design, reliability and performance licence conditions and the ministerially imposed licence conditions)
- Contestability market arrangements (i.e. contestable works code of practice and Accredited Service Provider Scheme)
- National Energy Customer Framework
- Privacy laws
- Regulatory framework
- *Competition and Consumer Act 2010 (Cth) (CCA)* – sections 46 and 50.

We believe that it is likely that by undertaking a “gap analysis” of existing mechanisms that the AER may reach the conclusion that there is no need for more prescriptive ring fencing arrangements.

## **3. Dealing with emerging industry trends**

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Ausgrid notes that there is an emerging concern regarding the appropriateness of DNSP's engaging in the provision of unregulated services, outside the scope of current contestability arrangements. We note that the AER may have concerns regarding DNSP's involvement in these emerging markets, in particular, their possible impact upon competition. There are also concerns that DNSP engagement in the provision of these services encroaches on the retail sphere and is therefore not appropriate.

Ausgrid considers that careful consideration needs to be given to the basis of these concerns and whether there is in fact an anti-competitive issue. Going back to first principles, we consider that the question that needs to be addressed is whether the position of a DNSP in both the non-contestable and the emerging contestable market does in fact give the DNSP an unfair advantage in the contestable market. To the extent that a real potential for anti-competitive activity can be identified, then there may be a basis for action. Given the concerns regarding this emerging area, Ausgrid believes that it would be beneficial for stakeholders if there was further debate on this issue. This will help the AER to determine whether this issue is best addressed through ring fencing or whether it should be addressed through other existing or proposed mechanisms including the economic regulation framework.

#### **4. Application of ring fencing to 'shared network' assets**

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Ausgrid notes that the AER is concerned that shared network assets may be used by DNSPs to earn unregulated revenue whilst also recovering regulated revenue for the same assets. While Ausgrid appreciates the AER concerns, we believe that ring fencing is not an appropriate mechanism for addressing this issue. Ausgrid believes that this is an economic regulation issue and is appropriately handled in that context, as such should be excluded from the scope of both this review and ring fencing in general. We note that this issue is currently being considered as part of the AEMC's review of the AER's proposed rule change package to the economic framework of network service providers.<sup>30</sup> As such, we think that comments on this issue should be limited to this forum.

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<sup>30</sup> AER, *Rule Change proposal: Economic regulation of transmission and distribution network service providers – AER's proposed changes to the National Electricity Rules*, September 2011, pp 58-61.

**1. *Is ring-fencing an appropriate means of addressing the problems that vertical integration of DNSPs may give rise to? If not, what is an appropriate regulatory method?***

As we have set out in the main part of our submission, we consider that the AER has skipped an important step by starting the review without first analysing the basis and purpose of ring fencing in the current NEM. Whether the focus should be on vertical integration will be an outcome of the initial analysis. As noted in the main part of our submission, the current NSW Ring Fencing Guidelines are not focussed on addressing issues arising from vertical integration. It is possible that, after analysis, the AER will find that the needs of the current NEM have moved from a focus on vertical integration; or at the very least that ring fencing guidelines need to be structured so that they can respond to changing ownership structure. Ausgrid believes that there is a danger of unintended consequences arising from delving into specifics without first conducting some initial analysis of the issues ring fencing seeks to address.

Ausgrid advocates that further discussion and guidance should be given on the problems that the AER is seeking to address. In particular, Ausgrid believes that further discussion is required on:

- the issue of contestability
- the emergence of new contestable services currently not dealt with within the scope of contestable arrangements in jurisdictions; and
- the issue of DNSP's engaging in the provision of unregulated services

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**2. *Is a national set of Distribution Ring-Fencing Guidelines desirable under the current regulatory framework? Are the current guidelines and provisions of the CCA sufficient to deal with the issues that vertical integration poses?***

As stated in our submission, while this is an important consideration it is an issue that should be discussed further along in the review process. As outlined in Section 2, Ausgrid's considers that the initial focus of the review should be on:

- 1) Clearly defining the purpose of the ring fencing guidelines and the set of objectives the guidelines are seeking to accomplish in the context of the current national electricity market.
- 2) Determining appropriate forms of ring fencing to address the objectives (e.g legal, accounting, operational)
- 3) Conduct a gap analysis to determine whether there are existing mechanisms that achieve ring fencing objectives.

Existing guidelines are contextually based, meaning that they have slightly different focuses and objectives due to market structure and issues prevalent at their development. Ausgrid notes that the extent to which a national guideline will be considered desirable will depend on the extent that jurisdictional legislative frameworks, market conditions and structure are similar. Conversely, whether a national guideline is desirable depends on its flexibility to take into account a jurisdiction's circumstances. To impose a national guideline which does not have the ability to take into account individual jurisdictional circumstances risks driving up DNSP's compliance costs by imposing obligations which are either too onerous or are duplicative.

It is not possible at this stage to form a view on whether the merger approval provisions of the CCA are sufficient to address issues which might arise from acquisitions within the NEM. As we have previously stated there needs to be a careful analysis of whether DNSPs are actually in a position to impact on the competition within markets for contestable services, noting that there may be more than one market under consideration. In the past the focus has been on the market for retail energy services whereas there are now developing markets for energy management and demand side participation services.

Further, we note that the AER's discussion paper focuses on section 50 of the CCA and appears to overlook section 46, which we think is a key provision in the context of ring fencing. Section 46 contains a general prohibition on misuse of market power. We note that determining whether a corporation has misused their market power in contravention of section 46 involves a two stage process. Firstly, it is necessary to identify the relevant markets in which the corporation operates. Once the relevant markets have been identified, it is then necessary to assess the degree of power the corporation has in those markets. This, in turn, requires a consideration of the extent to which the corporation's pricing and other decisions are constrained by its competitors, suppliers and customers. We think that it is important to note that the CCA does not prohibit a corporation from having substantial market power. Rather, s 46 only prohibits a corporation which has such power from taking advantage of that power for a proscribed anti-competitive purpose.

Ausgrid believes that the CCA and its strong enforcement regime provide consistent protections against DNSP misusing their position to gain an unfair advantage over other competitors. We suspect that once the AER has carried out its gap analysis it will be apparent that there is no need for more prescriptive ring fencing guidelines given existing mechanisms in place.

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***3. Are the current enforcement mechanisms sufficient to ensure effective compliance by DNSPs with their ring-fencing obligations?***

Ausgrid is not aware of any inadequacies in enforcement of the current NSW guidelines. Ausgrid is required to comply with the guidelines by way of a licence condition as well as 6.17.1 of the Chapter 6 Transitional Rules. These guidelines are subject to compliance reporting in the same way as other obligations under our DNSP Licence and the National Electricity Rules. A failure to comply with the guideline would be subject to the same compliance and enforcement regime as other rule obligations, which Ausgrid submits is appropriate. No further or special enforcement mechanisms are required.

***4. Are the existing jurisdictional guidelines still appropriate in light of recent developments in the industry structure and the regulatory framework governing DNSPs? If not, why?***

Ausgrid believes that the answer to this question depends on the outcome of an analysis of the purpose and scope of ring fencing in the current NEM. We believe that it is difficult to assess the relevancy or adequacy of existing guidelines without first being given guidance on this issue. However, we note that the privatisation of most retail businesses in jurisdictions has meant that the problem of vertical integration is not a current issue in the NEM. As such, guidelines which have vertical integration as a key focus may need to be recast so that they can respond to future changes in ownership, should a view be formed that the CCA does not provide sufficient protection against anti-competitive outcomes.

To date, it is our opinion that ring fencing in NSW has largely been successful in preventing anti-competitive behavior within the market for contestable customer connection services and fostering a full competitive market for these services. Ausgrid believe that a review of existing guidelines is important to determine whether current arrangements are robust and flexible enough to meet future developments and challenges in the electricity market. However, we believe that to be able to test the adequacy of current ring fencing arrangements requires clarity on objective and focus of ring fencing.



**5. Are there matters that the Transmission Ring-Fencing Guidelines deal with that a national set of Distribution Ring-Fencing Guidelines should not?**

Ausgrid believes that this question would be best answered through the fundamental review process, which we have advocated in this submission. We strongly advocate that key issues regarding the scope, aim and objectives of ring fencing be established first before seeking to address this issue.

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**6. What matters should distribution ring-fencing guidelines address and what is the appropriate way to deal with such matters?**

We have largely addressed this issue elsewhere in our submission. Ausgrid believes that further guidance from the AER is required to be able to provide comments on this issue. In particular, we think that guidance from the outset should be given on the following:

- 1) Clearly defining the purpose of the ring fencing guidelines and the set of objectives the guidelines are seeking to accomplish in the context of the current national electricity market.
- 2) Determining appropriate forms of ring fencing to address the objectives (e.g. legal, accounting, operational)
- 3) Conduct a gap analysis to determine whether there are existing mechanisms that achieve ring fencing objectives.

If these issues are not addressed from the start, we believe that there is a danger that the review will result in back solving and have unintended consequences. In particular, Ausgrid is concerned that the AER's approach is likely to give rise to confusion and scope creep. An unintended consequence of which would be the development of overly prescriptive guidelines that impose unnecessary regulatory burden and distort market outcomes.

See also comments provided in relation to questions 1 and 2.

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**7. Are there any problems with the content of the current jurisdictional guidelines? In what ways could they be improved?**

Refer to comments provided in 1.3 of Ausgrid's submission.

As noted in section 1.3 of our submission, it appears that some jurisdictions are experiencing issues with the scope of their guidelines. Ausgrid notes that some guidelines were focused too narrowly on the issue of vertical integration. Consequently, there are doubts as to whether these guidelines are still relevant or can respond appropriately to the current industry structure and emerging industry trends. Other jurisdictions on the other hand, are struggling with the broad "catch all" scope of their guidelines. This is giving rise to issues where activities which are carried out for network support or to meet license conditions are being captured under the scope of the guidelines. This goes beyond the regulatory intent of guidelines, resulting in possible network inefficiencies and ultimately higher electricity prices to consumers due to networks being constrained from pursuing least cost options.

As outlined in our submission and in answer to question 12, Ausgrid believes that the issue of scope creep could be solved by excluding activities carried out for network support or license conditions purposes. This is because these activities are not carried out with the intent of earning revenue and are unlikely to diminish market competition. We think that excluding these activities from ring fencing guidelines is important in promoting the NEO, in the sense that they are aimed at improving the reliability and supply of electricity in the most efficient manner.

See also comments provided in relation to question 1, 2, 6, 8, 12 and 13.

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**8. Should the AER work to develop a set of national guidelines that apply consistently across all participating jurisdictions?**

Ausgrid believes that this question cannot be addressed without analysis of what inconsistencies exist between jurisdictions and the reasons for these inconsistencies.

Our initial view is that there is greater scope to harmonise guidelines or develop a national set of guidelines given that DNSP's are no longer vertically integrated and are likely to face similar future challenges.<sup>31</sup> Ausgrid notes that the extent to which a national guideline will be considered desirable will depend on the extent that jurisdictional legislative frameworks, market conditions and structure are similar. To the extent that a national guideline cannot accommodate jurisdictional differences, we would argue that a national guideline would not be desirable as it would potentially drive up DNSP compliance costs. This is because compliance with obligations may be more onerous or prescriptive on DNSPs in some jurisdictions than others and it may result in duplicating existing obligations.<sup>32</sup>

Ausgrid strongly advocates that if a national guideline is to be developed it should be high level principle based as opposed to a set of detailed requirements. We believe that adopting such an approach will provide guidelines with the flexibility to account for jurisdictional differences and remain relevant in light of market developments and emerging industry trends.

See also comments provided in response to question 2.

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**9. If not, how should the inconsistencies across jurisdictional guidelines be dealt with?**

Refer to comments in question 2 and 8.

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**10. Does the current structure of the NEM mean that distribution ring-fencing guidelines are no longer necessary?**

Ausgrid believes that to be able to answer this question requires consideration first of the purpose and objectives of ring fencing, the problems that it is seeking to address and whether or not there are mechanisms in place in jurisdictions to achieve this.

See also comments provided in relation to questions 1, 2, 4 and 6.

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**11. How should distribution ring fencing guidelines be modified to account for changes in the electricity supply industry?**

Ausgrid believes that this issue should be addressed further in the review once the fundamental issues of scope and objectives have been resolved and a gap analysis of existing mechanisms has been undertaken.

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<sup>31</sup> See Draft Energy White Paper, 'Strengthening the foundations for Australia's energy future', December 2011.

<sup>32</sup> DNSPs may find obligations too onerous or prescriptive due to jurisdictional differences in market and business structures. Further, differences in legislative frameworks and licence conditions between jurisdictions may result in duplicative obligations.

Our initial view on this issue is that if guidelines are based on high level principles as opposed to being detailed, they should be flexible enough to adapt to market developments and accommodate jurisdictional differences. Periodic review of guidelines may also assist in ensuring their continuing relevancy in light of changes to the electricity supply industry and emerging industry trends. This would also compliment the adoption of a principle based approach. Ausgrid also considers that principles allowing the regulator to amend guidelines from time to time would also be an appropriate mechanism to ensure that they accounted for changes in the electricity supply industry, so long as any such amendments were subject to proper stakeholder consultation.

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***12. How should the generation of electricity by DNSPs to offset energy consumption be dealt with in any ring fencing guidelines? Should there be an exception to allow such consumption, should it be capped, or should it be prohibited?***

Ausgrid believes that this question and other specific issues which have arisen with existing guidelines should be addressed by applying a proper analysis of the purpose and objectives of ring fencing and the problems which it is seeking to address. Going back to our earlier comment, consideration needs to be given to whether a DNSP is participating in a competitive market as well as the monopoly market and its position in the monopoly market can provide an unfair advantage over others in the competitive market, thereby adversely impacting upon competition.

It is our belief that ring fencing, in the context of electricity supply, is aimed at facilitating competition in markets by removing the scope for anti-competitive behaviour from participants who may have an unfair advantage in that market.. Promoting competition in the NEM or its component markets is important as it promotes DNSPs to behave efficiently and to deliver services in a cost effective manner. The flow on effect of this is reliable supply of services to customers at lower costs. Ring fencing achieves this purpose by preventing distributors from engaging in anti-competitive behaviour aimed at placing them at a competitive advantage over competitors by virtue of their position in the market as a provider of monopoly services.

If this is broadly the overarching aim and objective of ring fencing than we find it difficult to understand how activities undertaken by a distributor to support or flexibly manage their network should be captured by the scope of ring fencing. Ring fencing should be aimed at separating services in which a competitive market exists from monopoly services (regulated services). Further in determining whether an activity or service should be ring fenced it is also necessary to consider the context in which the service or activity is being provided. To the extent that it is being provided for network purposes as opposed to providing a service or product to a customer aimed at earning revenue, than we believe that the activity/service should not be ring fenced. To do so encroaches on a DNSPs ability to flexibly manage its network and is not in the long term interest of consumers as it distorts market outcomes. A possible flow on effect of this is increased electricity prices.

Ausgrid believes that prescribing network support activities goes beyond the original regulatory intent of ring fencing, and as such should be excluded from guidelines.

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***13. Do the current jurisdictional ring fencing guidelines inhibit effective innovation in the market for new contestable services? If so, how could a revised set of ring fencing guidelines address this?***

Ausgrid believes that its current guideline, in conjunction with the contestable works code of practice and the Accredited Service Provider regime, has been effective in facilitating contestability in NSW. We believe that our guidelines have been able to achieve this outcome due to the fact that the guideline and code of practice are high level and principle based.

Ausgrid notes that contestability arrangements in other jurisdictions are not as developed as NSW. As such, their guidelines may need to be amended to complement the development of contestability in their markets. We note that this is generally achieved by having guidelines which are high level and principle based as opposed to being detailed. We note that a key problem with adopting detailed requirement based guidelines is that they can become prescriptive and tend to lose relevance over time.<sup>33</sup>

Ausgrid believes that when guidelines start venturing into the realm of requirements there is a danger in them becoming overly prescriptive. An unintended consequence is when they prescribe behaviour which falls outside the regulatory intent of guidelines. Prescribing behaviour which is aimed at supporting the network or meeting licence conditions constrains a DSNP's ability to flexibly manage its network. It can also be argued that imposing such constraints create a disincentive for DNSPs to explore new innovative and cost effective ways for managing their network. The time and cost involved in applying for a waiver might be perceived as too time consuming and costly and might erode the cost savings that would have accrued from carrying out the activity. This can lead to increased prices to consumers as a result of DNSPs being hindered from pursuing more cost effective options.

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<sup>33</sup> This is because when guidelines are too detailed and requirement based they become rigid and are unable to adopt to changing circumstances.