

24 February 2012

Mr Chris Pattas
General Manager, Network Operations and Development
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Dear Mr Pattas,

Re: Electricity Distribution Ring-Fencing Guideline Review

The Energy Retailers Association of Australia (ERAA) welcomes the opportunity to comment on the Australian Energy regulator's (AER) discussion paper on the review of the Electricity Distribution Ring-Fencing Guidelines (Guidelines).

The ERAA is the peak body representing the core of Australia's energy retail organisations. Membership is comprised of businesses operating predominantly in the electricity and gas markets in every State and Territory throughout Australia. These businesses collectively provide electricity to over 98% of customers in the NEM and are the first point of contact for end use customers of both electricity and gas.

In this submission the ERAA has not provided detailed comment on the various questions raised in the Discussion Paper, as members of the ERAA will address these individually. The ERAA supports the AER developing Guidelines that are consistent with ensuring that structural separation of retail and network markets are maintained, to manage the ongoing integrity of the market, which includes the utilisation of monopoly assets by competitive retailers.

Market Power Issues

The commitment of Australian Governments to a National Energy Market (NEM) was born almost twenty years ago in 1991 and precedes their commitment to the National Competition Policy (NCP) in 1995. However NCP delivered later principles to guide future electricity reform.

Understanding this commitment is important to appreciate the position and concerns of the ERAA on potential competition policy issues that may arise in the emerging energy market where the importance of appropriate ring fencing measures are now even more important.

In July 1991, State and Territory Governments took the first step towards electricity market reform by agreeing to establish the National Grid Management Council (NGMC). The NGMC was tasked with promoting the "efficient, economic and environmentally sound development of the electricity industry" and asked to "encourage open access to the eastern and southern Australian grid and free trade in bulk electricity for private generating companies, public utilities and private and public electricity customers"¹.

After a series of subsequent commitments by the Council of Australian Governments (COAG), the NEM was launched in 1998.

In October 1992, COAG commissioned the independent Inquiry into a national competition policy, chaired by Professor Fred Hilmer. The Hilmer report was delivered in August 1993 and recommended a framework to

¹ Special Premier's Conference, Communiqué, Sydney 30 July 1991

implement NCP including the separation of markets dominated by government businesses (like electricity) into natural monopoly and contestable activities².

In April 1995 COAG committed Australian governments to the implementation of the principles of NCP recommended in the Hilmer Report³. Some of the NCP package agreed to by governments consists of the:

- *Conduct Code Agreement* – this is the basis of legislative reforms extending the Trade Practices Act 1974 to government businesses;
- *Competition Principles Agreement* – this set out (1) the key principles for competition reform (structural separation of natural monopoly and contestable activities, regulation of access to natural monopoly infrastructure, competitive neutrality between government and private businesses, review of laws and regulations to identify and deal with anti-competitive effects and application of NCP to local government) and (2) the public interest test to assess when to retain anti-competitive effects;

Separation of Contestable and Natural Monopoly Activities

Allowing distributors to offer new contestable services may be inconsistent with the objectives in *Competition Principles Agreement* to separate contestable and natural monopoly activities and assets of government businesses. While some distributors in the current market are privately owned, some remain government corporations and therefore the application of the *Competition Principles Agreement* remains relevant. More broadly the economic rationale guiding NCP to disaggregate public monopolies is equally applicable to private firms operating as a monopoly.

Under NCP existing state and local government electricity distribution entities were rationalised into a few government businesses, provided with exclusive franchise areas, corporatised or privatised, and separated from retail assets and functions. In some jurisdictions distributors were permitted to participate in the retail market under a separate licensing regime.

By establishing a fixed number of distributors with exclusive franchise areas, governments recognised that distributors exhibit the features of a natural monopoly because they can supply the market more efficiently as a result of their technology, incumbency and economic integration.

It was also recognised that the infrastructure required to manage the distribution of electricity represents the characteristics of a natural monopoly, primarily because it is not economically feasible to duplicate the infrastructure. To promote competition in downstream markets (retail), state or national access regimes were implemented to govern third party access to distribution infrastructure.

These structural separations and regulatory measures were applied to end the vertical integration of distribution businesses in the electricity market. Economic policy recognises that vertically integrated natural monopolies with significant market power tend to have higher production costs, may charge higher prices and may innovate more slowly than firms which are subject to competitive pressures⁴.

Despite these structural separations and regulatory arrangements, economic theory and public policy assumes that natural monopolies will always seek to vertically integrate or control a related market if possible. If the related market is perfectly competitive it is difficult for the monopolist to vertically integrate and raise profits because there is only one monopoly rent that can be earned in a supply chain or network⁵. However a natural monopolist may still want to vertically integrate into a related market for a range of reasons which include⁶:

² Australian Government, National Competition Policy Review, 1993

³ Council of Australian Governments, Communiqué, Canberra, 11 April 1995

⁴ New Zealand Treasury and Ministry of Commerce, Discussion Paper – Regulation of Access to Vertically Integrated Natural Monopolies, 1995, p4

⁵ Ibid, 73

⁶ Ibid

- Avoiding regulatory restrictions or to preserve cross subsidies.
- Taking advantage of vertical economies of scale and scope, reduce transaction costs or internalise network spill over effects.
- Price discriminating in a downstream market.

The electricity retail market cannot be regarded as a perfectly competitive market but NCP imposes structural and regulatory barriers to the capacity of distributors to vertically integrate in the retail market.

Competitive Neutrality

There are two issues of competitive neutrality applicable to this Discussion Paper.

The first relates to the principles of competitive neutrality between government and private sector businesses as set out in the *Competition Principles Agreement*.

Under the *Competition Principles Agreement* competitive neutrality means that government businesses should not enjoy a net competitive advantage by virtue of public ownership⁷. Net competitive advantage is largely considered to arise in relation to⁸:

- Exemptions from taxation liability.
- Access to capital at concessional rates.
- Exemption from aspects of business regulation.
- Pricing policies which do not take account of full production costs.

In general terms, distributors which remain in government ownership have been subjected to a range of measures to ensure their activities comply with the principle of competitive neutrality under NCP. These include:

- Structural separation of distribution and any residual retail functions to eliminate transfer pricing or ensure that any cross subsidisation is transparent.
- Corporatisation to ensure the application of taxes or tax equivalents and all regulatory requirements applying to the private sector.
- Restrictions on access to capital at concessional rates and structural reform to enable borrowings in the private market.
- Market pricing or independent price oversight.

This has been achieved through the various jurisdictional ring fencing arrangements noted in the Discussion paper. However, it is unclear whether these measures are sufficient to guard against vertical integration and net competitive advantages in the retail market.

The second issue relates to distributors, regardless of their public or private ownership, being able to offer contestable services in the current and emerging industry. The Victorian Government, as example, has mandated the deployment of AMI for all customers who consume less than 160MWh per annum and provided distributors with the exclusive role in AMI implementation and management. This has been supported by the MCE. This has occurred without any regulatory framework in place to return to the roles or principles that underpin competition in the NEM,⁹ through equitable and open access to AMI and SMIS controlled by distributors, fair and clear B2B rules to govern the relationship between retailers and distributors, and

⁷ National Competition Council, *Competitive Neutrality Reform*, 1997

⁸ *Ibid*, p7

⁹ Under Chapter 7 of the Rules, metering is contestable.



appropriate controls and protections for consumers for the use of metering and associated services. The issue is further exacerbated where distributors begin to encroach on the customer-retail relationship such as through the development of customer web portal trials. The blurring of responsibilities has clearly arisen even in the light of current ring fencing provisions.

Whilst it is the view of the ERAA that a distributor's relationship with the consumer ends at the meter, the ERAA is concerned that participants that exclusively control or uses AMI and SMIS will be in a position to collect extensive data about customer usage. That type of data is a major source of competitive advantage because it enables the holder of that data to target customers in a way that is not possible for others who do not have access to the same full data-set. Telstra's dominant market position was attributable for a long time partly to this information advantage. As a result of its full access to customer calling patterns, Telstra could target particular classes of customers with pricing options calculated to appeal to them. Telstra's Flex plans leveraged this advantage because only Telstra had all the information necessary to be able to create plans geared to different groups of customers with different particular calling patterns.

It is not clear that in this emerging industry of contestable services that current ring fencing arrangements adequately guard against transfer pricing or make any potential cross subsidies that may arise transparent. Where these arrangements are inadequate there is risk of vertical integration of monopoly businesses. As such should the AER proceed with seeking to develop a draft set of distribution ring fencing guidelines for public comment than these guidelines must be stringent enough to ensure that competitive neutrality is maintained.

National Electricity Retail Law (NERL)

The new NERL and National Electricity Retail Regulations and Rules confirm the objectives of NCP and energy reform, provide the legal structure for the National Energy Customer Framework (NECF) and regulate the:

- Relationship between retailers and customers. This includes customer service, hardship policies for vulnerable customers, energy affordability, customer education, retail pricing information and comparisons for customers, and retailer of last resort policies. In keeping with the importance of the retailer-customer relationship, retailers are required to report on customer payment difficulties, disconnections, concessions, prepayment meters, complaints, customer service and the like.
- Relationship between distributors and customers. The extent of this is consistent with the limited relationship that distributors have with customers. It includes regulating distributor performance against service standards and delivering specified safety outcomes.

Risks to the NERL can be created when distributors provide direct information to customers about smart metering and/or specific products related to energy use such as direct load control, in-home displays, smart appliances and home area networks. This is because these functions are not consistent with the role of distributors recognised in the NERL and because they are regulated businesses.

Accordingly there is increased risk that they will subsidise their activities in the retail market with regulated revenue (irrespective of current ring fencing provisions). The ERAA notes that the AER *"has advised that distributors' using regulated revenue to fund unregulated activities is unlawful"*¹⁰. While current jurisdictional ring fencing measures is one way to minimise this risk, it is the opinion of the ERAA that these are not sufficient to eliminate it all together and recommend that the AER considers that in developing its draft set of Guidelines that it ensures that when a distributor does engage in activities considered to be contestable services, that the distributor is subject to the appropriate regulatory conditions imposed on retailers and it is done so with organisational ring fencing.

¹⁰ Accenture Final Report: Department of Primary Industries IHD Inclusion into ESC scheme, December 2011, page 85

Enforcement

Whilst the discussion paper seeks input to whether current enforcement provisions are sufficient, the ERAA recommends that the AER seek further input as to an appropriate national framework that ensures compliance is monitored and maintained. Without a robust compliance and monitoring framework any potential enforcement provisions are diluted thereby diminishing the effectiveness of ring-fencing provisions.

Comments on some of the questions raised in the Discussion Paper

Question in Approach Paper	ERAA Comments
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?	Yes, conditional that it accounts for the points raised above.
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?	Yes especially with the recent introduction of smart technologies which can be delivered by multiple parties and utilises metering data that is supplied by distributors.
Are the current enforcement mechanisms sufficient to ensure effective compliance by DNSPs with their ring-fencing obligations?	Yes, conditional on an appropriate ring-fencing arrangement that accounts for concerns raised above.
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?	No, as highlighted above in the development of contestable services in emerging markets.
What matters should distribution ring-fencing guidelines address and what is the appropriate way to deal with such matters?	This is highlighted in the above comments.
Are there any problems with the content of the current jurisdictional guidelines? In what ways could they be improved?	They should be more prescriptive as to services that should be ring fenced from distributors (or provide a set of principles that classifies what is contestable and not). Where a service is contestable then the distributor must adhere to the conditions sets out in the ring fencing guidelines, subject to an effective compliance regime, which ensures competitive neutrality and removes any opportunities available from the monopolistic nature of distributors.
Should the AER work to develop a set of national guidelines that apply consistently across all participating jurisdictions?	Yes, conditional that the ESCV revoke the current Guidelines that are in place, or an alternative arrangement that provides the AER with the power to do so..
Does the current structure of the NEM mean that distribution ring-fencing guidelines are no longer necessary?	No. Unless distributors are completely prohibited from offering contestable services then ring fencing is appropriate.
How should distribution ring fencing guidelines be modified to account for changes in the electricity supply industry?	They should be more prescriptive as to services that should be ring fenced from distributors (or provide a set of principles that classifies what is contestable and not). Where a service is contestable then the

	distributor must adhere to the conditions sets out in the ring fencing guidelines, subject to an effective compliance regime, which ensures competitive neutrality and removes any opportunities available from the monopolistic nature of distributors.
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?	The generation of electricity by DNSPs to offset energy consumption should be allowed under the guidelines as long as it is restricted to the office buildings or depots that a DNSP owns and operates.
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?	Innovation is stifled when industry participants perceive that competition issues cannot be properly addressed through ring fencing guidelines.

The ERAA appreciates the opportunity to comment on the Discussion Paper and supports a decision to proceed to develop a draft set of Guidelines for public comment. Should you wish to discuss the details of this submission further please contact me on (02) 9241 6556 and I will be happy to facilitate such discussions with my member companies.

Yours sincerely



Cameron O'Reilly
 Chief Executive Officer
 Energy Retailers Association of Australia