

30 May 2016



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Mr Chris Pattas  
General Manager, Networks  
Australian Energy Regulator  
GPO Box 520  
Melbourne Vic 3001

Dear Mr Pattas,

Energex Limited (Energex) welcomes the opportunity to provide a submission in response to the Australian Energy Regulator's (AER's) Ring-fencing Preliminary Positions Paper (Preliminary Positions Paper).

Energex agrees that the development of a nationally consistent distribution ring-fencing guideline is timely given the rapidly evolving national energy market, including the emergence of new products and services underpinned by technological innovations and the entry of new market participants. However, while the intent of the Preliminary Positions Paper is supported, Energex has significant concerns with the positions proposed.

In Energex's view, the ring-fencing arrangements contained in the current Queensland jurisdictional guidelines form a sound and demonstrably effective basis for a national approach, while acknowledging that a wider application of these guidelines, beyond generating and selling electricity, is warranted. However, the preliminary positions proposed by the AER will impose significantly more onerous ring-fencing requirements on distribution businesses than exist under current arrangements.

Energex considers that ring-fencing arrangements must be applied in a way that will (or is likely to) contribute to the achievement of the National Electricity Objective (NEO). However, the Preliminary Position Papers does not clearly articulate how ring-fencing will contribute to the achievement of the NEO, nor does it explore the expected costs and benefits of ring-fencing. As such further work is therefore required to demonstrate that the existing ring-fencing arrangements and regulatory mechanisms are deficient and that increasing regulation through more stringent requirements will enhance the overall energy market to the benefit of customers.

Further, the positions proposed could potentially have the impact of limiting competition. From a principles perspective, it would appear counter-intuitive to introduce regulation which could be seen to limit competition per se as a means of improving efficiency. Of particular concern is the proposed default approach, whereby all other network services and non-network services are subject to ring-fencing, with potentially onerous obligations imposed. Energex strongly believes therefore that further consideration of the scope of ring-fenced services and the obligations to apply to those services, as well as the waiver process and transitional arrangements, is required.

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Energex values the opportunity to continue to work with the AER and other stakeholders in developing a guideline that is effective in achieving the ring-fencing objectives without imposing unnecessary compliance costs on the industry and ultimately customers.

Please find attached Energex's submission to the Preliminary Positions Paper, including responses to the AER's questions. If you have any queries in relation to this submission, please do not hesitate to contact Leigh Henderson, Acting Network Regulation Manager on (07) 3664 4118.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Jennifer Hocking', with a large, stylized initial 'J'.

Jennifer Hocking  
Acting Executive General Manager,  
Strategy, Regulation & Governance

# Energex

Submission on AER Ring-Fencing  
Preliminary Positions Paper

30 May 2016



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Energex Limited (Energex) is a Queensland Government Owned Corporation that builds, owns, operates and maintains the electricity distribution network in the growing region of South East Queensland, including the poles and wires and underground cables used to connect houses and businesses to the electricity network. We provide distribution services to almost 1.4 million domestic and business connections, delivering electricity to a population base of around 3.2 million people.

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# 1 Introduction

Energex Limited (Energex) welcomes the opportunity to provide a submission in response to the Australian Energy Regulator's (AER's) Ring-fencing Preliminary Positions Paper (Preliminary Positions Paper).

Energex notes it is already subject to stringent ring-fencing requirements under the Queensland Competition Authority (QCA) Guidelines and has taken its obligations seriously by implementing a compliance framework that is audited annually and reported to the AER. Energex also notes that to its knowledge, no formal complaints have ever been made in regard to the adequacy of the current framework in achieving the ring-fencing objectives.

Notwithstanding this, Energex agrees that the development of a nationally consistent distribution ring-fencing guideline is timely given the rapidly evolving national energy market, including the emergence of new products and services underpinned by technological innovations and the entry of new market participants.

Accordingly, Energex is of the view that the ring-fencing arrangements contained in the current Queensland jurisdictional guidelines form a sound and demonstrably effective basis for a national approach, while acknowledging that wider application of these guidelines, beyond generating and selling electricity, is warranted. Energex supports the intent of the AER's Preliminary Positions Paper but has a number of concerns with the positions proposed which are articulated in this submission. If implemented these positions would likely increase costs for customers and reduce competition in emerging markets. Energex values the opportunity to continue to work with the AER and other stakeholders in developing a guideline that is effective in achieving ring-fencing goals without imposing unnecessary compliance costs on the industry and ultimately customers.

## 1.1 Complementarity of new technologies and economies of scope

Energex notes that the national electricity market has evolved considerably since it was established in the late 1990s and that, in particular, technological change is continuing to blur the traditional boundaries within Australia's electricity supply chain.

Most importantly, in Energex's experience as a supplier of regulated network services, the interface between regulated and unregulated services is becoming inherently more complex, as new products and services are emerging that complement and/or are substitutes for existing network services.

Energex has been a direct participant in these technological and market changes, including facilitating one of the highest penetration rates of small-scale solar photovoltaic generation in the world. Energex has also recently sought and gained a ring-fencing waiver under the existing jurisdictional distribution ring-fencing guideline to undertake a battery storage trial. The ability to test these types of new technology in order to understand their impact on the

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network, and to potentially use this technology to lower regulated network costs, is critical to the future efficiency and safety of Australia's electricity networks.

An important issue that arises from both the breath Energex has across its existing unregulated businesses, as well as the emerging supply chain innovation/disruption, relates to the efficiency gains potentially available from distribution networks' participation in existing and newly contestable markets. These efficiency gains will potentially accrue from the achievement of what is known as economies of scope in service provision. Scope economies can derive from a range of factors including specialised assets (particularly IT systems), knowledge and expertise.

Economies of scope for a network business refer to the reduction in its average costs by increasing the range of products or services it produces from the same set of capital and labour resources. In practice, this means the total cost of the network business supplying multiple services is less than the cost of each service being supplied individually. In Energex's view, this is a benefit that results from being a large and diverse player in the market – no different to similar benefits enjoyed by, say, a large retailer – rather the benefits accrue from an affiliation with a regulated business. Accordingly, these benefits should not be targeted as something inappropriate to be addressed through ring-fencing.

Energex also considers that these benefits are very relevant to the achievement of the National Electricity Objective (NEO). In Energex's view, the extent of technological change in the Australian electricity supply industry and the pervasiveness of the impacts of new technology at all levels of the supply chain makes scope economies much more important to the long term interests of customers than was the case when the National Electricity Market was established. Hence, scope economies accruing from networks supplying services into contestable markets are likely to be more beneficial to customers than ever before, including through lowering prices and providing a wider choice of suppliers and their service offerings.

One example that supports this view is in relation to controlled load. Energex has controlled hot water load on behalf of customers for many years, providing choice and lower costs to customers who choose to take up this option as well as lower overall network costs for all customers. This has been an unequivocally good outcome for all electricity customers and is consistent with the NEO.

Despite this, as technology continues to change and load control moves into areas such as air-conditioners and energy storage, there seems to have emerged a view that suggests that networks having the ability to compete in this space is not appropriate, or is somehow stifling competition. The reality is that without networks pioneering load control, these benefits would not have been gained and the genuinely contestable market that is now emerging may not otherwise have evolved. There seems little recognition of these benefits in the initial positions put forward in the AER's paper.

Further examples of scope economies relate to IT systems which may serve back office needs of multiple services, such as payroll, human resources and accounting systems. This sharing delivers significant efficiency gains for customers of all services, and it is arguably not the intention of ring-fencing to prevent the sharing of systems in such a manner. Nonetheless, the AER's Preliminary Positions Paper contemplates potentially prohibiting

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these benefits from being captured.

Consequently, in the context of the development of the national distribution ring-fencing guideline, Energex is concerned that the regulated network businesses in the energy supply chain will be restricted in offering both flexible, innovative responses to changing customer needs and low cost, efficient inputs. The scope economies these can generate are significant, whereas other players in contestable markets face no such constraints. Such restrictions will be to the detriment of the market and ultimately customers.

## **1.2 Limiting competition**

Energex is also concerned that the Preliminary Positions Paper does not recognise the disadvantages associated with limiting the ability of DNSPs to compete. While Energex appreciates the importance of ensuring that DNSPs compete on an equal footing with others in contestable markets, it would appear counter-intuitive to introduce regulation which could be seen to limit competition per se as a means of improving efficiency. For this reason, such proposals need to be considered very carefully to ensure they are justified, and should only be implemented where there is no alternative better way of protecting the integrity of these markets – that is, where existing regulatory and competition mechanisms are clearly deficient.

In addition, Energex notes that current jurisdictional guidelines in Queensland do not appear to have impeded the development of competitive markets. For example, Energex has seen competition occur in markets traditionally serviced by DNSPs, including metering (types 1-4), large customer connections and public lighting services. Energex has also observed service providers entering markets prior to regulatory changes facilitating competition – for example, a number of energy retailers are currently installing interval / type 4 meters ahead of the introduction of metering contestability. This evidence points to the fact that there is no inherent issue that requires a significant tightening of ring-fencing requirements.

## **1.3 Net benefits of increasing regulation**

Energex agrees that ring-fencing should be applied in a way that will (or is likely to) contribute to the achievement of the NEO. Energex notes that in considering whether the proposed ring-fencing measures are likely to contribute to the NEO, the AER is required to consider any impact on the efficiency of the electricity supply chain, including the potential for duplication and compliance costs. Energex is of the view that the AER should articulate the expected costs and benefits of ring-fencing in order to demonstrate that, considered holistically, existing ring-fencing requirements in combination with other regulatory mechanisms (such as the *Competition and Consumer Act*) are deficient, and that increasing regulation through more onerous ring-fencing requirements will enhance the overall energy market to the benefit of customers.

## **1.4 Proportionate regulation**

Consistent with the above point, Energex considers that, in the event that further regulation



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is considered necessary to improve outcomes for customers, the extent of additional ring-fencing requirements imposed on DNSPs should be proportionate to the ‘harm’, if any, that networks may cause through inappropriately leveraging the benefits associated with operating a regulated business. Energex is of the view that there is a spectrum of ring-fencing compliance requirements, and that selecting an appropriate point along this spectrum should also be supported through the demonstration of net benefits for customers.

## **1.5 Blanket arrangements**

It is of particular concern to Energex that the AER’s default approach is to presume that significant harm will occur, which justifies subjecting all other network services (i.e. non direct control services) and non-network services provided by DNSPs to more stringent ring-fencing requirements, with ring-fencing waivers then used to remove any services where there is no net benefit from their application. In Energex’s view, adopting such an extreme approach, even while recognising that the waiver process can be used to remove activities caught unintentionally, will impose unnecessary and onerous compliance costs on DNSPs and ultimately their customers.

Energex considers that the scope of services to be ring-fenced should be determined based on a set of clearly defined principles, including whether the service is a direct control service, whether the service is contestable/potentially contestable and the materiality of the revenue earned. Energex believes that this approach would be more balanced and better target the objectives of ring-fencing.

## **1.6 Administrative arrangements**

Energex would strongly encourage the AER to prepare the guidelines as a standalone document, such that all key concepts and terms are clearly defined and set out within the guidelines, including the waiver arrangements. The debate and development of the guidelines would benefit from consistent use of terminology, if only to provide greater clarity on the application of the guidelines. For example the guideline should make clear that NER contemplates ring-fencing of the provision of regulated service as opposed to unregulated services. Moreover the guideline should distinguish between where accounting and functional separation is permitted and where legal separation is permitted under the NER. Furthermore, it would be valuable for all key terms, such as “contestable” and “Associate” to be defined in the guidelines.

Transitional arrangements also need to be carefully considered as part of the development of the guideline, particularly as the scope of services to be separated from the ring-fenced regulated business and the application of obligations will not be fully apparent until sometime after the publication of the final guidelines. Certainty for DNSPs as to the scope of ring-fencing and the obligations to apply will only be realised following DNSPs having the opportunity to make waiver applications and/or develop AER approved protocols. This emphasises the need for the guideline to set out wherever possible the treatment of other network services (that is not direct control services) and non-network services. Energex strongly supports a staged transition period to minimise the compliance costs which are potentially significant if system changes are required. The costs of compliance will likely be

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greater the shorter the transition period.

Energex's responses to the specific questions asked in the Preliminary Positions Paper are provided in section 2 of this submission. As a member of the Energy Networks Association (ENA), Energex has also contributed to and is supportive of the views contained in the ENA's submission.

Energex looks forward to further participating in the development of the national distribution ring-fencing guideline, to ensure an optimal outcome for the electricity supply market and customers.

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## 2 Energex Response to AER questions

### Question 1: What aspects of current jurisdictional ring-fencing arrangements have or have not worked well?

Energex considers that the current Queensland jurisdictional distribution ring-fencing guidelines have worked well, particularly in terms of the following key areas:

- **Clarity and consistency/predictability:** the areas subject to ring-fencing and the associated obligations are clearly defined and understood by stakeholders (i.e. market participants and potential new entrants). This is evidenced through increasing levels of market participation and Energex's positive audit findings (in the areas of staff awareness and stakeholder feedback).
- **Effectiveness:** the guidelines provide an appropriate balance between restraints on operational practices (to ensure the efficient operation of Energex's network business is not compromised) and the need to provide market conditions conducive to encouraging competition and innovation. This has been evidenced through the development of competitive markets in areas traditionally provided solely by Energex. For example, under the current framework, Energex has seen competition occur in markets traditionally serviced by DNSPs, including metering (types 1-4), large customer connections and public lighting services. For example, Energex notes that the classification of large customer connections changed to an alternative control service from 1 July 2010 and that over 50 per cent of this work is now delivered by other service providers. Energex has also observed service providers taking market positions without the full support of the regulatory framework. For example, a number of energy retailers are currently installing interval / type 4 meters ahead of the metering contestability rule change provisions commencing.
- **Balance:** Energex considers the guidelines are proportionate to the potential for harm that could occur in a contestable market due to Energex's inappropriate participation in it. Whilst Energex incurs ongoing compliance costs and initial costs to establish compliant processes and procedures when offering a new service, these costs are currently not excessive.
- **Flexibility:** through the existing ring-fencing provisions, Energex has been able to innovate, and develop and test new services so that it is able to meet the changing needs of its customers and to ensure electricity is supplied efficiently and safely. An example is Energex's recently approved temporary waiver to install PV and batteries at Rocklea, which is an important step in understanding how customers are using this technology on the Energex network, in order for Energex to better facilitate customer uptake.
- **Complementarity to other measures:** the ring-fencing guidelines are supported by a

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range of complementary control measures, for example and most importantly the cost allocation guidelines, connection arrangements and the shared asset guideline, as well as more general measures under law, such as the *Competition and Consumer Act*. These supporting obligations have, in conjunction with the ring-fencing arrangements, delivered the objectives of ring-fencing, without the need to take a heavy handed regulatory approach, or require structural or physical separation.

Energex also notes that there have been no formal issues or complaints raised in regard to the efficacy of these guidelines, which have been in operation for a number of years.

**Question 2: Do you consider the objectives discussed in section 2.1 adequately reflect the harm ring-fencing is seeking to avoid and the benefits of an even playing field?**

Energex notes that the purpose of ring-fencing is not to restrict or regulate the activities of businesses in contestable markets. Rather, the purpose of ring-fencing (as reflected in the empowering NER provision) is to ring-fence regulated activities from all other activities that the business may wish to undertake.

The objectives identified by the AER provide a good summary of the types of harm ring-fencing is seeking to address, and Energex has no in-principle issue with these objectives. However, Energex stresses that the actual ring-fencing requirements imposed in seeking to achieve these objectives need to be proportionate to the risk of this harm actually arising. This assessment needs to form part of any consideration to impose further, more onerous ring-fencing requirements than those currently in place.

Whilst the AER has acknowledged there are increased levels of competition across the electricity supply chain, it has not clearly identified the areas in which the current ring-fencing obligations have failed to identify or prevent harm caused by DNSPs participating in emerging or mature contestable markets. Without this evidence, it is difficult to justify the need for the imposition of materially more onerous ring-fencing obligations as envisaged in the Preliminary Positions Paper.

**Question 3: Do you agree with the service classification approach to ring-fencing which is discussed in section 3.3? Is there a better alternative?**

Energex has considered this question in two parts: firstly, what services should be subjected to ring-fencing, and secondly, what degree of separation should be required for those services determined as needing to be ring-fenced.

*What services should be subject to ring-fencing?*

Energex agrees with the AER that ring-fencing should apply to services rather than assets given it is services that are either subject to economic regulation under Chapter 6 of the NER or unregulated depending on the AER’s service classification decisions.

As noted by the AER, Option 3 represents a material change from current jurisdictional arrangements as all existing unregulated services will fall outside the DNSPs’ remit and, as a result, it may capture services that do not warrant being ring-fenced. In this regard, Energex would support a principles-based approach to determining what services should be ring-fenced. Principles that could be considered include contestability, and consideration as to whether a service is:

- provided in a mature, contestable market;
- provided in an emerging/potentially contestable market; or
- provided in a market where there is no competition and limited prospects of competition.

Other principles worthy of consideration could include materiality; that is whether the provision of the service meets a materiality threshold, similar to that which has been included in the Shared Asset Guideline. This principles-based approach is preferred as it is more likely to ensure that ring-fencing is applied only where the benefits outweigh the costs, and that services which it makes no sense to ring-fence are not inadvertently caught.

Energex currently provides a wide range of unclassified (including distribution and non-distribution unregulated) services – see Table 1. It is assumed that all of these services would be subject to the national ring-fencing guideline as currently envisaged, regardless of whether there is, or potentially is, a contestable market for such services, and regardless of the size of the activity in the market.

**Table 1 Energex’s Unregulated Services**

<b>Unclassified Distribution Services</b>	<b>Unregulated Non-distribution Services</b>
Emergency recoverable works	Rental of distributor owned property
Type 1 – 4 metering	Material sales (e.g. transformers)
Watchman lights	Testing, inspection and calibration of equipment
High load escorts	Property services (e.g. property searches)
	Contracting services to other NSPs (e.g. market transition centre)
	Provision of training to external parties
	Safety testing of equipment
	Operation and maintenance of customer assets

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Note: Table 1 lists unclassified and unregulated services provided by Energex Limited. Energy Impact, as a subsidiary of Energex Limited provides generation services which are not listed above.

From the list of services above, there are obvious examples of where no contestable market currently exists or is likely to exist, such as emergency recoverable works and rental of distributor owned property. Equally, there are services which are likely to be considered immaterial in terms of Energex's share of or impact on the market (e.g. property searches). While Energex appreciates the waiver approach can be applied to services clearly not meant to be caught by ring-fencing, it would be useful to explore alternate means for defining what services need to be ring-fenced upfront, in order to provide a more targeted starting point compared to this blanket approach. This would reduce overall compliance costs to be borne by DNSPs, the AER and ultimately customers.

The implications of an unnecessarily broad scope of ring-fencing services may also result in a DNSP choosing to no longer provide these services due to the financial impact of full compliance and onerous reporting and waiver application processes. Energex considers these outcomes are not desirable from a customer perspective, both in terms of higher prices and/or the possibility that there may be no or fewer providers in the market offering these services.

*What degree of separation should be required for ring-fenced services?*

Once it has been determined what services should be ring-fenced, the question arises as to the degree of separation that is needed to provide a balanced overall approach to managing the risk of harm against the cost of compliance.

Energex's view on this matter is that ring-fencing should be applied in a way that will or is likely to contribute to the achievement of the NEO. Accordingly, Energex believes the AER should articulate a view on the costs and benefits of ring-fencing, in order to demonstrate that, considered holistically, existing ring-fencing requirements in combination with other regulatory mechanisms (such as the *Competition and Consumer Act*) are deficient, and that increasing regulation through more onerous ring-fencing requirements will enhance the overall energy market to the benefit of customers.

Energex considers that, in the event that further regulation is considered necessary to improve outcomes for customers, the extent of additional ring-fencing requirements imposed on DNSPs should be proportionate to the 'harm', if any, that networks may cause through inappropriately leveraging the benefits associated with operating a regulated business.

In particular, Energex is of the view that the elements of the proposed positions around sharing of staff, and by implication the sharing of assets which may be used by shared staff, need to be tested in this way. For example, Energex notes that under the shared asset principles of Chapter 6 of the NER, DNSPs 'should be encouraged to use assets that

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provide standard control services for the provision of other kinds of services where that use is efficient and does not materially prejudice the provision of those services'.<sup>1</sup>

These NER provisions are clearly in the long term interests of consumers as they allow a DNSP to evolve, innovate and adapt the ways in which it provides its regulated and unregulated services to customers and to do so efficiently.

Further, the sharing of staff and/or assets is currently subject to the DNSPs' approved cost allocation methodologies (CAM) and the AER's Shared Asset Guideline, ensuring that consumers of the regulated businesses are not cross-subsidising unregulated activities. It is not clear that the AER has considered these existing regulatory mechanisms against its proposed ring-fencing objectives, what issues (if any) there may be with the current CAM and whether these could be addressed by improving the CAM. Moreover, it is not clear what net benefits would arise from taking a more heavy handed approach.

The benefits in sharing staff across regulated and unregulated businesses, and the acceptability of using cost allocation to ensure ring-fencing is maintained, were noted by Essential Services Commission of South Australia (ESCOSA) in 2003<sup>2</sup>:

...there are strong economic and commercial reasons for a distributor to operate multi-skilled crews that may be "shared" between prescribed and contestable businesses. It is therefore the view of ESCOSA that any ring fencing of operational staff between prescribed and contestable businesses is not practical. Having said that, the appropriate allocation of costs between the two businesses is essential and should be reflected in the regulatory accounts...

Energex agrees with this view, and considers the AER should particularly revisit the issue of prohibiting sharing of staff in the guideline, including demonstrating the net costs or benefits that would result from such separation.

**Question 4: Does the proposed approach to ring-fencing adequately deal with the prospects for development of the contestable market for Distributed Energy Resources (DER)?**

Energex acknowledges that it is important that DNSPs do not inappropriately leverage the benefits associated with the regulated business to unfairly compete in any contestable market. In this sense, the DER market is no different to any other, and the comments in the rest of this submission apply equally to DER.

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<sup>1</sup> Rule 6.4.4(c)(1))

<sup>2</sup> ESCOSA. 2003. *Operational Ring Fencing Requirements for the SA Electricity Supply Industry: Final Determination*. June. p 13.

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More specifically in relation to DER, Energex is of the view that the AER's approach fails to take a holistic approach to the development and adoption of DER for the supply of electricity. Whilst it is acknowledged there is scope for a DNSP to choose to use DER devices for the provision of direct control services (i.e. standard and alternative control services), the administrative and compliance costs associated with adopting such an approach under the proposed guideline are potentially prohibitive.

Under Option 1 (a DNSP chooses to use DER to provide direct control services), the AER states it will require the DNSP to show this is the most efficient option. It is unclear whether this obligation refers to the current requirement to demonstrate prudence and efficiency of the capital expenditure as part of the normal regulatory proposal process or whether it is proposed as an additional obligation. Energex seeks further clarification from the AER on how it sees this obligation being met.

Energex is of the view that the AER's proposed approach has the potential to restrict DNSPs from using DER devices for the provision of regulated services (as noted above) and unregulated services where that use is efficient. This approach may lead to the inefficient use of regulated infrastructure and the foregoing of significant customer benefits (i.e. via scope economies). Furthermore, by potentially limiting DNSPs to the three options identified it may result in:

- the least expensive option not being adopted because the least cost option is the network option;
- a DNSP's ability to flexibly manage their networks being compromised;
- additional costs and administrative burden being placed on DNSPs; or
- DNSPs withdrawing from the provision of unregulated services when they are made unviable solely by the ring-fencing requirements, and being replaced by higher cost service providers (loss of economies of scope).

Energex proposes a more efficient approach might be that, where the DER is primarily used for the provision of standard control services but is also used to provide contestable services, the Shared Asset Guideline would apply.

**Question 5: Are there other ring-fencing obligations we should impose on NSPs that provide services into contestable markets?**

As noted in the context of Questions 2 and 3, it is important the regulatory response is proportionate to current market circumstances and the potential for harm to be caused. Consideration should also be given to the other control measures established in the NER that provide additional safeguards. Examples include cost separation via the approved cost allocation method, benefits sharing schemes and transparency of network information, such as through the Distribution Annual Planning Report (DAPR).



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In light of the effectiveness of the current jurisdictional ring-fencing arrangements (as noted in Question 1) which do not appear to have constrained competition in the provision of unregulated services, Energex believes less intrusive alternatives could be applied to achieve the AER's stated ring-fencing objectives. An approach which mirrors the QCA guidelines, supplemented by voluntary undertakings, for example, around sharing of network information, is one option that could be further explored.

#### **Question 6: What costs would be incurred in meeting these obligations?**

The costs of ring-fencing obligations arise from the imposition of incremental additional compliance and administration requirements (and establishment costs in some instances) on distribution businesses compared to the status quo. These additional requirements may result in reduced economic efficiencies through the loss of economies of scope and possibly scale. They also result in additional costs that are likely to be material, such as:

- the need to duplicate IT infrastructure;
- changes to works management processes and systems;
- loss of synergies from loss of staff sharing opportunities; and
- physical location separation costs.

These costs are difficult to quantify at this stage as they will be influenced by the way the proposed requirements are imposed, that is:

- what services must be ring-fenced;
- how they are interpreted and applied by the AER;
- how compliance must be demonstrated by the DNSP; and
- how compliance is assessed by the AER.

Each of these elements on their own can have a material impact on the costs borne by the DNSP and the AER.

Once further guidance is provided by the AER, Energex is willing to provide evidence to the AER on the costs it estimates it will incur in meeting the proposed ring-fencing requirements, including the additional costs that will be incurred compared to the current jurisdictional ring-fencing guideline. However Energex's preliminary view is that the compliance costs that would be imposed by the introduction of the regime envisaged by the AER would be material. This would result in increases to operating costs which would need to be considered as part of any benchmarking analysis.

The discussion above considers the costs to a DNSP but arguably there are potential customer and market costs from preventing the sharing of staff. For example, there are economies of scope in having one service provider deliver connection and metering

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services; that is, Energex as the provider of small customer connection services could also install a type 4 meter on behalf of a metering provider using the same staff. Energex has already been approached by other participants to undertake this work on their behalf. This could reduce costs of providing both services in that only one site visit would be required thereby benefitting the customer. Moreover, this could also facilitate metering competition by allowing smaller scale retailers or third party providers into the market.

**Question 7: Should asset sharing be restricted between regulated services and contestable service provision?**

As noted earlier, Energex does not consider that asset sharing should be restricted between regulated services and contestable service provision beyond existing safeguards set out in the NER, including the Cost Allocation and Shared Asset Guidelines.

Rather, Energex supports the position that DNSPs should be encouraged to use regulated assets for the provision of unregulated services where that use is efficient. As noted in our response to question 3, this approach is encouraged under the shared asset principles in the NER and consistent with achievement of the NEO.

Further, Energex seeks clarification from the AER on the proposed need for additional restrictions on asset sharing (i.e. beyond the Shared Asset Guideline, which applies when unregulated revenues are earned from the use of regulated assets). Clarification is also sought on the policy intent of the other schemes and mechanisms currently in place that seek to promote efficient use of regulated assets with savings rebated to users (for example Demand Management Incentive Scheme (DMIS)).

**Question 8: Do the factors set out above reflect the issues we should consider in deciding whether to grant a ring-fencing waiver?**

In addition to the factors listed by the AER, when assessing a waiver application, consideration should also be given to:

- the potential for ring-fencing to stifle participation, investment and innovation in potentially competitive markets;
- the extent to which competition in the relevant contestable market would be distorted in the absence of ring-fencing; and
- the possibility that not applying a waiver will reduce customer benefits by eliminating existing economic efficiencies in service provision.

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Consistent with the current jurisdictional ring-fencing guidelines, consideration should also be given to the compliance costs of the regulatory obligations imposed on the network business. Energex supports the inclusion of a waiver mechanism, however, it should be noted that it imposes additional administrative costs on the AER, the network companies, industry stakeholders and customers. Consequently, the design of the ring-fencing guideline should aim to ensure the need for ring-fencing waivers does not arise frequently.

**Question 9: In which circumstances should the customers of ring-fenced services and not customers of the DNSPs' services in general pay the additional costs of complying with ring-fencing obligations?**

Energex believes that the costs of ring-fencing are appropriately borne by the regulated business, as it is the 'ring-fenced entity' and the purpose of ring-fencing is not to restrict or regulate the activities of businesses in contestable markets. Rather, the purpose of ring-fencing (as reflected in the empowering NER provision) is to ring-fence regulated activities from all other activities that the business may wish to undertake. In addition, imposing costs on contestable businesses for no reason other than an affiliation with a regulated business, has the potential to distort costs in competitive markets and create an unfair disadvantage for those businesses.

Energex also notes that consumers will also bear the broader economic costs of unduly strict ring-fencing requirements due to lost economies of scope, potential exit of DNSPs from some markets and higher service costs.

**Question 10: How else could the AER minimise the administrative cost of ring-fencing while maintaining the integrity of its approach?**

The primary avenue to minimise the administrative costs of ring-fencing is to ensure the measures implemented are appropriately scoped and proportionate to reflect the potential for harm to occur in specific contestable markets.

As noted above, Energex considers the ring-fencing requirements proposed by the AER are unduly restrictive and would only be a proportionate response if it can be shown that the current less restrictive jurisdictional measures will fail to address potential harm in the future.

Energex also supports the inclusion of provisions to minimise the cost of compliance requirements, for example fast track waiver applications. Energex is keen to work with the AER to develop its suggestion of stylised or illustrative 'bulk waiver' case studies through the guideline process (or immediately after) to provide network and other businesses with

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greater certainty around the need to make efficient structural and market entry/exit decisions.

**Question 11: Is it reasonable for the AER to consider these transitional arrangements to the new ring-fencing guideline?**

It is important that the ring-fencing guideline provides certainty in relation to:

- how existing arrangements will be treated;
- how long DNSPs will be given to address current practices that become non-compliant by virtue of the final stage of the framework and approach processes; and
- an unsuccessful waiver application.

Addressing these issues would require transitional arrangements which should come into effect once the AER has issued its final decision.

Energex would like to work with the AER on the term of this transitional period as in some cases the proposed transitional period (i.e. one year) may not be sufficient to:

- decide whether to withdraw from the market;
- implement measures to achieve compliance having consideration for costs; or
- provide existing customers with sufficient time to find an alternative supplier.

As outlined in section 1.6, Energex strongly supports a staged transition period to minimise the compliance costs which are potentially significant. The costs of compliance will be greater the shorter the transition period.

**Other issues raised by AER**

*Research and Development*

As evidenced through the trials and investments made by DNSPs and other market participants, research and development (R&D) can result in significant benefits for all parties, including consumers. The AER's narrow approach to research and development; that is that potentially only R&D directly related to the operation of the shared network could be granted a waiver, fails to acknowledge the benefits attributable to scope economies or the way in which innovation occurs in a market environment.

*Information sharing*

Energex notes that information sharing is potentially an important part of contestable market development, with DNSPs already providing substantial amounts of information in the public sphere in relation to their networks and services under the National Electricity Law/NER.

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Specifically, DNSPs' Regulatory Information Notice (RIN) submissions including Demand Management Incentive Allowance reports and the value of related party transactions are published by the AER. Energex's DAPR is also available on Energex's website, in addition to Energex's connection policy and approved cost allocation methodology. Moreover, Energex sets out a list of alternative service providers of large customer connections on its website, to inform customers about their choice as to who can provide their large customer connection service.

To address any concerns regarding information asymmetry and intellectual property (IP) being shared between a ring-fenced business and affiliated contestable businesses, Energex is willing to consider publishing additional information or learnings/IP to the marketplace. Energex notes in this regard that it intends to publish learnings from its current Battery Energy Storage System trials.

#### *Triggers and openers*

Dependent on the ring-fencing provisions adopted, there may be a case for including triggers to re-open the classification of services. However it is important to note the impact these may have on the market and that there are administrative costs associated with these processes, which are borne by all stakeholders including DNSPs, the AER and consumers.

#### **Question 12: How can we ensure ring-fencing compliance is robust and effective without imposing excessive costs that may ultimately be borne by consumers?**

Energex believes the current NER and jurisdictional enforcement mechanisms are effective. Energex has previously undertaken formal and independent audits of compliance, and considers that such audits may be useful in an environment of changed ring-fencing obligations.

Consistent with the other obligations under the NER, there are already mechanisms in place to address a failure to comply with ring-fencing. Accordingly, Energex is of the view that no additional measures are required.