essential energy

Ref: C2075456

28 September 2016

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

Dear Mr Pattas

Submission on Draft Ring-fencing Guideline, Electricity Distribution, August 2016

Essential Energy appreciates the opportunity to respond to the Australian Energy Regulator's (AER's) *Draft Ring-Fencing Guideline, Electricity Distribution* paper (the draft Guideline). We agree that discrimination and cross-subsidisation must be eliminated from contestable markets where they are causing, or likely to cause, market harm. As such, we do support a proportionate and targeted national approach to ring-fencing as it will provide certainty and consistency to market participants and should lead to increased competition that will benefit all electricity consumers.

Given the implications that the draft Guideline would have on distribution network service providers (DNSPs), we harbour concerns as to the adequacy of the current consultation period. This is due to the draft Guideline including undefined terms, wording errors and a mismatch in the terminology and requirements in the draft Guideline and the associated Explanatory Statement. We also believe a lighter handed approach to ring-fencing in the first instance would provide a more proportionate response to the actual or potential harm DNSPs may bring to the emerging markets the draft Guideline intends to protect. These points are discussed below, with some specific comments on the draft Guideline and Explanatory Statement provided in Appendices A and B.

Additional consultation is required on an amended draft Guideline

The draft Guideline and Explanatory statement are inconsistent and confusing as they contain undefined terms, wording errors and differences. For example, **energy related services** has not been defined and is a key term used in the Guideline. Case study 1 refers to unregulated metering services as requiring operation through a separate legal entity where the ring-fencing diagram shows unregulated metering operating as part of the DNSP; and the Guideline uses the term **network services** and **non-network services** where the Explanatory Statement tends to use **distribution services** and **non-distribution services**. This has made it very difficult for Essential Energy to provide adequate and informed comments as, at this stage, it is unclear exactly what services the draft Guideline is intending to ring-fence.

As such, we recommend that the AER publish a further draft Guideline, containing clearly defined terms and consistent terminology, and undertake additional consultation on this revised draft before publishing a final Guideline. This will ensure we have time to adequately comprehend and consider the true repercussions of the draft Guideline, review the case study examples and provide informed comments back to the AER.

This approach is in the best interests of all parties, as a poorly drafted Guideline cannot be adequately considered and consulted upon. As such, it may lead to adverse or unexpected outcomes that potentially undermine the intent of the Guideline.

PO Box 5730 Port Macquarie NSW 2444 | ABN 37 428 185 226
Telephone: (02) 6589 8419 | Interpreter Services 13 14 50 | essentialenergy.com.au

This approach is in the best interests of all parties, as a poorly drafted Guideline cannot be adequately considered and consulted upon. As such, it may lead to adverse or unexpected outcomes that potentially undermine the intent of the Guideline.

A lighter-handed approach to ring-fencing should be adopted in the first instance

At this stage, we see the obligations in the draft Guideline as being disproportionate to the actual or potential harm they seek to avert. The reliance on the service classifications in the Framework and Approach also creates uncertainty for DNSP investments. As a rural operator, Essential Energy would likely be dependent on some level of waivers under the draft Guideline, which adds a further layer of uncertainty. As such, we feel both the costs to comply with the draft obligations and the potential risk of investment losses, due to subsequent service reclassification, may in fact deter DNSPs from participating in these emerging markets, leaving those markets without the benefit of a class of active competitors.

Curtailing the participation of a class of entrants where the market structure, major products and competitors are still uncertain increases the risk of regulatory error and may lead to higher market costs, inefficiencies and lower consumer benefit – factors which would not contribute to the National Electricity Objective (NEO). DNSPs are not the incumbent provider in any of the emerging markets. At this stage, the exact nature of the economies of scale (synergies) that DNSPs may bring to these markets is not well understood and may not emerge until the markets are further developed. Even if synergies do emerge, they may not necessarily create issues. This will indeed be the case for a range of other market participants, not just DNSPs.

DNSPs have the skills set to undertake these services, but removing their ability to utilise existing staff and resources to complete such services will also remove the economies of scale DNSPs can offer customers. These are the very economies of scale that make networks valuable participants in emerging markets, particularly in regional areas with limited or no active participants. It seems unjust to curtail the ability of one market participant to utilise existing assets and resources, but not the ability of the many other market participants.

The three large Retailers that now dominate the National Electricity Market with over 75% of customers, have arguably developed their own counter-vailing market power in terms of customer information and a retail relationship which may provide them with significant advantage in these markets. In some parts of Australia, vertical integration now also prevails between Retail and Generation businesses (Gentailers), with the major Gentailers now providing significant competitive constraint and market power in energy related services markets. Further, the energy related services field comprises many large, well-resourced global competitors that also bring their own scale advantages.

As such, we believe a lighter handed approach should be adopted in the first instance. The obligations in the guideline are targeted at two main areas: non-discrimination and the prevention of cross-subsidies. Non-discrimination can be readily achieved through the implementation of the obligations outlined in clause 4.1 of the draft Guideline. Rather than requiring independent and separate offices, restricting staff access to key areas would achieve the same outcome at a fraction of the cost. The implementation of associated policies, procedures and staff training would also be required to manage this potential issue.

Cross subsidisation can be managed through the Cost Allocation Method (CAM) and reporting of transactions between business units, eliminating the proposed need for a separate legal entity, physically separate locations and a restriction on staff sharing. This would provide a far cheaper and more proportionate response to the discrimination and cross-subsidisation issues raised by other market participants to date.

This lighter handed approach was successfully employed in creating the NSW contestability framework. This service has operated effectively for many years and ensures that Accredited Service Providers (ASPs) can compete on a level playing field with NSW distributors. The success of this framework is exemplified through the amount of work which is undertaken by ASPs, providing clear evidence that the perceived economies of scale attributed to DNSPs can be effectively managed under a light handed approach to ring-fencing.

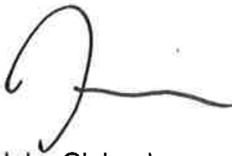
We suggest a lighter handed approach be tested over a few years to determine the number of complaints against DNSPs. Then, only if DNSPs continue to flout these lighter-handed obligations, would we support the revision of the ring-fencing Guideline to include the requirements outlined in the draft Guideline.

At this early stage of market development, we believe it is imperative to encourage participation from as many service providers as possible, one of whom may, naturally, be a DNSP. The ability to provide emerging market services to customers at the lowest price possible is particularly pertinent to rural DNSPs, both in terms of providing a service in regions that may be overlooked by many other market participants, but also whose customers may feel reassured contracting with a provider who has a real and constant presence in the area, particularly when it comes to post installation servicing.

As part of this response, we have included what we consider to be a clearer version of the ring-fencing diagram at Appendix A. We have also included further comments and suggestions on the draft Guideline and Explanatory Statement at Appendix B.

Should you have any questions on this submission, please contact Natalie Lindsay on (02) 6589 8419.

Yours sincerely



John Cleland
Chief Executive Officer

Apprendix A – Suggested network services linkage to ring-fencing diagram for inclusion in the Guideline

Apprendix B – Comments on the draft Guideline and Explanatory Statement

Notwithstanding our suggestions above, we provide the following comments on the draft Guideline and Explanatory Statement.

1. Any new terms should utilise existing definitions from the National Electricity Rules (the NER) and the National Electricity Law (the NEL). This approach will reduce confusion and the likelihood of misinterpretation, leading to misaligned and unintended responses.

   For example, Energy-related services could be defined as "**Electricity services**, other than a **distribution service**, provided to **end users**". These are both NER terms and clearly define the services the Guideline intends to cover.

2. From discussions with the AER, it is our understanding that the Guideline is intended to be consistent with *Figure 1 – Network services linkage to ring-fencing* (the ring-fencing diagram) on page 15 of the Explanatory Statement. However, there is a disconnect between the definitions used in the draft Guideline and the ring-fencing diagram. The terms used in both the Guideline and the Explanatory Statement, including the ring-fencing diagram, should be consistent.

   For example, the Guideline uses the terms **Network services** and **Non-network services**, yet these are not shown in the ring-fencing diagram, which instead adopts the terms **Distribution Services** and **Non-distribution services**. We recommend the use of the term **Distribution services** when referring to **Direct Control Services, Negotiated Distribution Services** and "Unregulated/Unclassified Distribution Services".

3. The term "Unclassified distribution services" is not shown in the diagram, yet is regularly referred to in AER Framework and Approach papers and used interchangeably with the term "Unregulated distribution services"[1]. For clarity and to avoid confusion, both terms should be included in the ring-fencing diagram and the draft Guideline.

4. It is our view that when a service becomes fully contestable, for example metering from 1 December 2017, that this service would no longer be classified as a **distribution service** and would, therefore, be required to be undertaken in a separate legal entity as an **energy related service** and be subject to the non-discrimination clauses in the draft Guideline.

   This approach will ensure that fully contestable services, that may otherwise be captured by the term **distribution service**, are dealt with appropriately through the Guideline. It will also ensure that any unclassified/unregulated distribution services can still be appropriately undertaken by the DNSP using shared locations and staff.

5. We suggest the inclusion of some sort of waiver clause from the need for a separate legal entity where the impacted business is operating in another regulated market or is merely the result of a government arrangement. This is because, in its present form, the Guideline would require both Essential Energy's water business and generation assets to sit under a new legal entity. Both these services are undertaken by Essential Energy on behalf of the NSW government and relate to fully impaired assets. Neither service gives rise to potential discrimination issues and the elimination of cross-subsidisation is effectively managed through our existing CAM.

   Essential Energy is attempting to divest what remains of the Generation assets. Our water customers in the Broken Hill region do not have the capacity to pay for the full costs associated with the water business as it stands, let alone the associated costs that would result from the need to create a new legal entity. The water business is separately regulated

[1] For example, "Final Framework and approach for Energex and Ergon Energy, Regulatory control period commencing 1 July 2015", Australian Energy Regulator, p.12 and "Final Framework and approach for the Victorian Electricity Distributors, Regulatory control period commencing 1 January 2016", Australian Energy Regulator, p.18 and "Stage 1 Framework and approach paper, Ausgrid, Endeavour Energy and Essential Energy, Transitional regulatory control period 1 July 2014 to 30 June 2015, Subsequent regulatory control period 1 July 2015 to 30 June 2019" Australian Energy Regulator, p.15

by IPART and the AER should be able to rely on IPART validating the adequacy and appropriateness of the associated business costs.

Implementing such a waiver would prevent unwarranted costs being thrust upon impacted consumers. It would also provide a clearer means for Transmission services to sit within the same legal entity as the DNSP. We have attempted to show this pictorially in our suggested ring-fencing diagram at Appendix A to this letter.

6. Clause 3.1(b) - the $500,000 proposed threshold for providing **non-network services**. From our discussions with the AER, we understand that the term **non-network services** is intended to relate to the **energy-related services**, **other services** and **other energy services** boxes in the ring-fencing diagram. Given the number of potential services that could be captured within these three boxes, we see the $500,000 as being an arbitrary and an extremely low amount. As such, we suggest the threshold be scaled to better reflect the size of the DNSP, say one per cent of the DNSPs annual revenue requirement, consistent with the current materiality threshold.

7. Clause 4 – Non-discrimination. From our discussions with the AER we understand that this clause is intended to relate only to the **Energy-related services** box in the ring-fencing diagram, however this is not at all clear in the wording. We suggest the addition of words under clause 4 Non-discrimination along the lines of: "All clauses within this section relate only to **energy related services**".

8. Clause 4.1(b)(vi) and 4.1(c) – separate branding and no ability to waiver. The Guideline is unclear as to how the separate branding is intended to work in conjunction with a successful waiver for staff and location sharing.

   For example, if a regional area is successful in applying for a waiver to share offices and staff, does the building require both brands to be shown? Will uniforms and vehicles require both brands to be shown? In the interests of keeping costs to customers as low as possible, our preference would be to not require branding on buildings, uniforms and trucks in locations where waivers have been granted.

   We suggest that the branding requirement, clause 4.1(b)(vi) be moved into a separate clause with the ability for a waiver to be granted.

9. Clause 4.2.1 – Physical separation/co-location. Requires an additional clause, like that provided in 4.2.2(b)(iv), to ensure that locations used to provide direct control services can also be used to provide negotiated and unclassified/unregulated distribution services.

10. Clause 4.2.2(c) – staff remuneration. In principal we agree with the intention of this clause, but believe it requires rewording to clarify that remuneration is not linked to staff behaviours that would contradict the Guideline. We suggest the following "A **DNSP** must not remunerate or otherwise incentivise its staff in a manner which encourages behaviour or conduct which is prohibited by this **Guideline**".

11. Clause 4.3.3 - Disclosure of information. This clause requires additional wording to ensure that where DNSPs are legally required to share customer information under other legislation that they can do so without requiring explicit customer consent. As such, we suggest the following additional words to the end of the paragraph "....to whom the information relates, **unless required by other legislation**."

12. Clause 6.3 - Compliance breaches. We suggest the five-day reporting deadline be extended to 20 business days to allow for the DNSP to not only report the breach, but also to investigate how the breach occurred and include the recommendations that have been made to minimise the chance of the breach occurring again.

13. Clause 6.4 - Complaints and investigations. This section is extremely brief and would benefit from expansion and clarification. We suggest a graduated approach to dealing with complaints and investigations. For example, we would not want severe penalties due to teething issues being handed out from day one.

14. Appendix A - Transitional arrangements. Many of the proposed obligations require more transitional time than that allowed in the draft Guideline. For example, a DNSP may be

contracted to a building lease that cannot be revoked within the six-month period outlined in the draft Guideline. Forcing the DNSP to move **energy related services** staff to new premises ahead of the lease expiry will only lead to higher electricity prices for customers as the existing **distribution services** lease costs can no longer be shared with the **energy related services** business.

Instead, we suggest the following transitional arrangements:

- From day one – all behavioural obligations under clause 4.1 (excluding the branding issues noted at point 8 above)
- Separate branding and legal entity within 12 months - it is currently impossible for Essential Energy to satisfy the day one proposed start for separate branding. This is because we do not yet know the requirements of the final Guideline. As mentioned in points 5 and 8 above, in its present form, the draft Guideline captures our Water and Generation businesses as needing to be in a separate legal entity and to require separate branding. We cannot afford to waste time and resources beginning to separate and rebrand these businesses between now and 1 December 2016 only to find out it is not required. As such, we suggest a minimum 12-month timing for both legal separation and rebranding.
- Separate locations within 12 months - but recognising that long term leases may mean that this obligation increases costs to electricity users in the short term and may, therefore be contrary to the NEO. A lighter handed ring-fencing approach, for example allowing secure areas with limited staff access, would eliminate such an outcome.
- Staff sharing within 12 months - given this is tied in with separating locations, it makes sense for these obligations to have the same transitional timing. Again, it is important to note that this obligation will likely lead to outcomes contrary to the NEO as existing distribution services staff cannot be further utilised to provide competitive services. This again serves only to increase electricity prices.

  Again, a lighter handed approach making use of the CAM and timesheets would better serve the NEO, particularly in more rural areas where there is generally less competitors. Whilst it can be argued that the draft Guideline allows for this situation as a DNSP can apply for a staff sharing waiver, compliance is not a costless exercise. Waiver applications take time and money to prepare and any associated process roll-outs will be costlier to implement as waivers will lead to a duplication of policies and procedures, one version for locations not subject to a waiver and one version for locations with successful waivers.

15. The case studies within the explanatory statement need tidying up to ensure the accuracy of terminology and alignment with the ring-fencing diagram.

    For example, case study 1 begins with a regional depot providing regulated connection services and unregulated metering services. It then goes on to say that the unregulated metering services must operate through a separate legal entity. This is a direct contradiction to the ring-fencing diagram that shows unregulated distribution services as not requiring legal separation. In this case, it would appear that the metering services referred to here are meant to be "**contestable** metering services and should, as such, be considered **energy related services**".

    We would also appreciate case studies dealing with the following services and associated questions:

    - Energy Storage attached to the network – Can a DNSP own it? How does its use determine where it sits in the ring-fencing diagram? Where should it sit if a DNSP wants to offset the sunk cost with other market benefits, for example, frequency control ancillary services, spot price etc.
    - MicroGrids – Can a DNSP own and operate them and if so how can they be part of **Standard Control Services**? When would they require ownership by a separate legal entity? Will the need for legal separation potentially create a disincentive to move to microgrids?

- Embedded grid operator – Similar to the microgrids questions.
- Hot water and air conditioner load control – will this remain within **Standard Control Services**? In what circumstances would it be considered an **energy related service**?
- Electric Vehicles – Would installations and associated services be required to be undertaken by a separate legal entity as an **energy related service**? How can a **DNSP** participate in incentivising electric vehicles through subsidies and marketing?
- Power factor correction as a service – Is this envisaged to be provided by a separate legal entity as an **energy related service**?
- Load curtailment – we currently have negotiated connection agreements with some customers to curtail their load, for example, a customer is required to disconnect under the n-1 condition (where we lose part of the network). Would we still be able to have these negotiated contracts?