Electricity Distribution Ring-Fencing Guidelines Review

Submission from

Jemena Limited

to the

Australian Energy Regulator

24 February 2012

Contact Person

Warwick Tudehope

Manager Network Regulation

Ph: (02) 9455 1551

warwick.tudehope@jemena.com.au

Jemena Limited

ABN 95 052 167 405

321 Ferntree Gully Road
Mt Waverley VIC 3149

Postal Address:

Locked Bag 7000
Mt Waverley VIC 3149

Ph: (03) 8544 9000

Fax: (03) 8544 9888

Table of contents

1 Introduction

This submission by Jemena Limited is made in response to the Discussion Paper entitled *Electricity Distribution Ring-Fencing Guidelines Review* which the Australian Energy Regulator (**AER**) published in December 2011. The Discussion Paper seeks the views of interested parties on whether the AER should develop a nationally consistent set of Distribution Ring-Fencing Guidelines and, if it were to do so, what the scope and content of those guidelines should be.

Jemena has considerable experience in operating electricity and gas distributions businesses, all of which are subject to either jurisdictional ring-fencing arrangements (for electricity) or national arrangements (for gas). Jemena owns two distributions businesses—Jemena Electricity Networks (Vic) Ltd which operates an electricity distribution network in Victoria, and Jemena Gas Networks (NSW) Ltd which operates the principal gas distribution network in NSW. Jemena also holds a 34 percent interest in the United Energy Distribution electricity network in Victoria and a 50 per cent interest in the ActewAGL Distribution partnership which distributes electricity and gas in the ACT.

There are significant structural differences between the way in which ring-fencing is codified in electricity and gas. All ring-fencing requirements for gas are contained in either the National Gas Law (**NGL**) or National Gas Rules (**NGR**) whereas, for electricity, any national arrangements would be established through guidelines made by the AER under the National Electricity Rules (**NER**). In Jemena's view the gas structure is preferable to the electricity structure which has deficiencies that should be corrected.

Apart from the desirable objective of national uniformity, Jemena does not see an immediate need to amend or replace existing jurisdictional ring-fencing arrangements. However, if a uniform national ring-fencing regime is to be established then requirements should be proportionate to the changes that are necessary to promote competition in the provision of contestable services. Experience of ring-fencing over the period since the reforms of the 1990s would suggest that a minimalist approach is all that is required. In particular, some of the requirements that characterise current ring-fencing arrangements, such as legal separation, are no longer appropriate while other requirements such as cost allocation and accounting separation are now covered adequately by other aspects of the regulatory scheme.

Our observations on the AER's discussion paper are contained in section 2 below under the following sub-headings:

2.1 A uniform national approach

2.2 The electricity and gas regimes compared

2.3 Legal separation

2.4 Accounting separation and cost allocation

2.5 Scope of ring-fencing – emerging industry trends

Jemena's position is summarised in section 3.

2 Observations arising from the AER Discussion Paper

2.1 A uniform national approach

Section 6.17 of the NER authorises the AER to develop Distribution Ring-fencing Guidelines and all DNSPs must comply with any such guidelines (s 6.17.1).

Although section 6.17.2(a) provides that ring-fencing guidelines "may vary in application as between different *participating jurisdictions",* Jemena accepts that there is a case to be made for a uniform national approach to ring-fencing given that the legislative regime and market arrangements for electricity apply uniformly in participating jurisdictions and the factors that could justify formalising ring-fencing requirements are likely to be common to those jurisdictions and the distribution businesses that operate within them. There is no apparent justification for maintaining some of the significant differences that currently exist between jurisdictions where, for example, Distribution Network Service Providers (**DNSPs**) are prohibited from participating in related businesses in some jurisdictions but not in others.

At the time of the reforms of the mid and late 1990s, potential competitors in contestable sectors of the gas and electricity industries were understandably concerned that they would be at a disadvantage relative to infrastructure service providers and their associates who might also be competing in those sectors. As a consequence, ring-fencing attracted considerable attention, particularly in gas. Throughout the 15 or so years since then, infrastructure businesses have taken ring-fencing requirements seriously and there have been no serious or persistent breaches of those obligations. Neither has there been a history of complaints. The concerns of competitors have been largely allayed.

All that is to say that ring-fencing is now just one aspect of an extensive regulatory regime that covers all aspect of infrastructure operations—economic, technical and market—and involves many hundreds if not thousands of individual requirements and obligations. While the purpose of ring-fencing remains as important and relevant today as it was in the 1990s, there are now many other aspects of regulation that are of equal if not greater significance in terms of their risks and consequences.

If current jurisdictional ring-fencing arrangements for electricity are to be reviewed and/or replaced by uniform national arrangements then the product of that process should reflect the lowest common denominator of current jurisdictional arrangements. As things stand today, there is no justification for raising the bar.

2.2 The electricity and gas regimes compared

While national consistency within electricity is a desirable objective, we note that there are material differences between the way in which ring-fencing is codified in electricity and gas. In particular, for gas, significant aspects of ring-fencing are codified in the NGL and NGR whereas in electricity it is left to the AER to make guidelines in accordance with the very general specification of scope and content set out in section 6.17.2 of the NER. The two regimes are compared in the following table:

NER Section 6.17.2(b)	**Corresponding provision in Gas**
The *Distribution Ring-Fencing Guidelines* may include, but are not limited to: (1) provisions defining the need for and extent of:	
(i) legal separation of the entity through which a *Distribution Network Service Provider* provides *network services* from any other entity through which it conducts business; and	NGL ss 131 and 139
(ii) the establishment and maintenance of consolidated and separate accounts for *standard control services*, *alternative control services* and other services provided by the *Distribution Network Service Provider*; and	NGL s141
(iii) allocation of costs between *standard control services*, *alternative control services* and other services provided by the *Distribution Network Service Provider*; and	AER information gathering powers
(iv) limitations on the flow of information between the *Distribution Network Service Provider* and any other person; and	• NGL s140 (prohibition on sharing of marketing staff) • NGR ss. 136–138 (confidential information)
(v) limitations on the flow of information where there is the potential for a competitive disadvantage between those parts of the *Distribution Network Service Provider's* business which provide *direct control services* and parts of the provider's business which provide any other services	
(2) provisions allowing the AER to add to or to waive a Distribution Network Service Provider's obligations under the Distribution Ring- Fencing Guidelines.	NGL sections 142 to 146.

These structural differences between electricity and gas would appear to be at odds with the Ministerial Council on Energy/ Standing Council on Energy and Resources policy objective to adopt common approaches in electricity and gas where practicable. That is not to say that the gas ring-fencing provisions should be adopted "verbatim" for electricity. Apart from a small number of exemptions, a common set of gas ring-fencing requirements has applied in all jurisdictions since the inception of national gas regime. In electricity, on the other hand, ring-fencing has evolved differently in each jurisdiction and that variety of experiences provides some lessons for future development.

In Jemena's view, it is the structure of the gas arrangements rather than the provisions themselves that warrant consideration for electricity. The placement of gas ring-fencing provisions in the NGL and NGR:

- better reflects the relative importance of those provisions and provides a clearer mechanism for dealing with breaches
- promotes greater certainty and stability for DNSPs in particular
- is more consistent with good practice in terms of the separation of powers

than the arrangements for electricity which leave it to the AER to establish ring-fencing requirements through guidelines which the AER then administers and enforces.

Importantly, the jurisdictional Acts that give effect to the NGL also include provisions that exempt a service provider from duties and/or taxes that the service provider may otherwise be liable for as a result of actions taken to comply with the legal separation and other requirements of the NGL[1]. There is no corresponding provision in the jurisdictional Acts that give effect to the NEL. Jemena sees this as a deficiency in the electricity regime that should be corrected.

Finally, unlike the gas regime (NGL s144) the distribution consultation procedures which the AER must follow in making a ring-fencing guideline under the NER do not require the AER to consider the likely compliance costs of the requirements it imposes.

In Jemena's submission, these are significant deficiencies in the electricity regime when compared to gas. Moreover, compared with the legislative process and the AEMC's rule-making procedures, the distribution consultation procedures under which any electricity ring-fencing guideline would be developed are not an adequate framework for making decisions of such significance.

2.3 Legal separation

Section 6.17.2(b)(1)(i) provides for the AER to include in a ring-fencing guideline provisions defining the need for and extent of legal separation of the entity through which a Distribution Network Service Provider provides network services from any other entity through which it conducts business.

[1] Note that there is some variation between jurisdictions in the extent of exemptions provided. For example, Victoria and NSW provide an exemption from "Any duty or other tax" (s13), and SA provides an exemption from "Any stamp duty or other tax" (s17), while Queensland provides an exemption from "Any tax, other than a duty under the Duties Act 2001" (s13).

In section 4.2.1 of the discussion paper the AER summarises the legal separation requirements in jurisdictional ring-fencing arrangements. DNSPs are prohibited from participating in related businesses in some jurisdictions but not in others. In fact ring-fencing arrangements are not the only source of cross-ownership restrictions. For example, the Electricity Industry Act (**EIA**) in Victoria currently prohibits a DNSP or a person who has a controlling interest in a DNSP from holding an entitlement to more than 200 megawatts of generating capacity.[2] The Victorian Department of Primary Industries (**DPI**) has indicated that it expects that restriction to be repealed as part of the changes that will occur with the introduction of the National Energy Customer Framework (**NECF**) in Victoria. In reaching that position the DPI accepted submissions that the Competition and Consumer Act 2010 (**CCA**) provides adequate protection.

> The EIA and GIA [Gas Industry Act] contain "cross-ownership" regimes which are designed to prevent vertical integration between owners of generation, transmission and distribution infrastructure.
>
> The current cross-ownership provisions are complex and do not override or substantially depart from the broader Competition and Consumer Act 2010 merger and competition regime. The provisions' only substantive effect in 2011 is to preclude parties from challenging the Australian Competition and Consumer Commission (ACCC)'s views on the merits of a particular merger, which is inappropriate.
>
> DPI's issues paper on Victorian licensing arrangements sought feedback from stakeholders regarding any issues with the abolition of the Victorian cross-ownership provisions. Submissions did not identify any issues and noted that the provisions in the EIA and GIA were not required in light of the Competition and Consumer Act 2010. As a result, the cross-ownership provisions contained in Part 3 of the EIA and Part 6 of the EIA (sic.) will be repealed, effective at NECF commencement.[3]

Jemena supports the DPI's position.

The AER discusses the CCA in section 3.2.3 of the discussion paper and concludes that it is not a substitute for ring-fencing. Jemena accepts that is the case. However, it is not clear whether the AER considers legal separation to be a necessary component of ring-fencing.

The Essential Services Commission (**ESC**) in Victoria considered the need for legal separation in making its electricity ring-fencing guideline in 2004 and concluded as follows:

> After weighing up the costs to industry of implementing legal separation against the public benefits expected to be derived, the Commission decided that it will not require

[2] Electricity Industry Act 2000, s68.

[3] http://www.dpi.vic.gov.au/energy/about/legislation-and-regulation/national-energy-customer-framework/the-national-energy-customer-framework-in-victoria, accessed 20 February 2012.

> legal separation of electricity distribution and retail businesses. The Commission believes there is insufficient evidence to establish that the public benefits of legal separation outweigh the significant implementation costs that industry would incur.
>
> The Commission considers that operational separation measures will be necessary irrespective of whether legal separation is required. Behind a structure of separate legal entities, businesses could continue to operate in a highly integrated fashion. While legal separation may assist in the prevention of some forms of anti-competitive conduct, without behavioural requirements it is insufficient to realise competitive conduct in substance. The Commission maintains that implementing the ring-fencing measures proposed in the draft decision paper will be sufficient to achieve the objectives of ring-fencing without the need for legal separation.[4]

That is, legal separation comes at a cost and, on its own, will not ensure that the purposes of ring-fencing are achieved.

As far as Jemena is aware, no material concerns or issues of a ring-fencing nature have arisen in those jurisdictions where there is no prohibition on DNSPs participating in related businesses. On that basis, and on the basis of the exemptions already granted by the AER and the expected position in Victoria upon commencement of the NECF, any remaining prohibitions on DNSPs being involved in generation could safely be removed. Certainly there should be no prohibition on DNSPs generating for their own use or for network support purposes.

Similarly, there has been and is no prohibition on electricity DNSPs offering retail services in some jurisdictions, and very few DNSPs still have any interest in retailing, either directly or indirectly through an associate. That being the case, there is no apparent reason to continue the remaining prohibitions on DNSPs being involved in retailing.

Given that there is no protection from consequential duty and tax liabilities and no formal requirement for the AER to consider the associated compliance costs when making electricity ring-fencing guidelines, Jemena would be particularly concerned if the AER was to proceed to publish a ring-fencing guideline that required any form of legal separation where that requirement does not already exist. In fact, in Jemena's view there is a real question as to whether it is appropriate for the AER to have the power to require legal separation at all given the significant property and cost considerations that are associated with legal separation.

If legal separation is to be imposed at all, then it should be done where and as required through the operation of the CCA and not as part of ring-fencing.

[4] ESC, *Final Decision: Ring-Fencing in the Victorian Electricity Industry*, October 2004, p 15.

2.4 Accounting separation and cost allocation

Section 6.17.2(b)(1)(ii) and (iii) provide for the AER to include in a ring-fencing guideline provisions relating to the establishment of accounts and cost allocation.

Given current processes for service classification, current requirements for approval and publication of cost allocation methods, and the AER's general information gathering powers, there should be no need for cost allocation and accounting matters to be dealt with as a part of any ring-fencing guideline.

2.5 Scope of ring-fencing – emerging industry trends

In section 5.1.2 of the discussion paper, the AER discusses developing trends in services that might have ring-fencing implications observing, correctly, that the AEMC is currently considering a number of issues surrounding emerging markets, and that classification of services as standard control, alternative control or negotiated services is a matter for consideration as part of the AER's framework and approach process.

Service classification decisions must be made carefully. When considered superficially, a service might appear to be a candidate for contestable provision whereas a more thorough analysis would conclude that it is not. For example, load management services are a valuable tool that DNSPs can use to optimise the provision of standard control services. Opening load management services to contestable provision would almost certainly detract from their effectiveness as a network management tool. When services are opened to contestable provision there can be no certainty that the interests of competing providers will be aligned with those of the DNSP and consumers—in fact it is almost certain that they will not be aligned. A DNSP may choose to offer load management and similar services directly or through other parties such as retailers but, ultimately, they must remain within the control of the DNSP.

Even where it is considered necessary to extend ring-fencing to cover a particular service or class of services, it is unlikely that a one-size-fits-all approach will be appropriate. For example, if some form of separation is considered necessary there is a range of options available. Functional or operational separation is likely to be an adequate and proportionate response in most cases. Full legal separation should be the exception. That being the case, it is premature to prescribe what form ring-fencing should take for emerging services either generally or for any particular service. We suggest that there is a three step process that should be applied to each service or class of services:

- Is the service properly a candidate for contestable provision?

- What features of existing arrangements are inhibiting the development of competition?
- What is the proportionate response?

A proportionate response for a defined contestable service could include provisions requiring the DNSP to:

- implement functional or operational separation of its monopoly activities from those associated with the contestable service
- manage and control access to confidential information obtained from or provided to it by competitors
- give competitors equal access to relevant information
- not erect barriers or engage in behaviours that may favour any competitor, including itself, in the provision of the contestable service.

3 Summary

Apart from the desirable objective of national uniformity, there does not appear to be an immediate need to amend or replace existing jurisdictional ring-fencing arrangements. However, if a uniform national ring-fencing regime is to be established then:

- it should take as its starting point the lowest common denominator of existing jurisdictional arrangements
- there are serious questions as to whether the entire regime should be specified in a guideline made by the AER or whether parts of the regime (at least) should be codified in the NEL and/or NER as is the case for gas.

Historically, ring-fencing in electricity has been directed at supporting the development of competition in the generation and retailing sectors of the industry. Where it is considered necessary to extend ring-fencing to cover new services, that should only be done after careful consideration of:

- whether the service is properly a candidate for contestable provision;
- the features (if any) of existing arrangements that may be inhibiting the development of competition; and
- what is the proportionate response to those features.