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Dear Mr Pattas

### **Electricity Ring-fencing Guideline**

Origin Energy (Origin) appreciates the opportunity to provide input into the Australian Energy Regulator's (AER) review of national ring-fencing arrangements in the National Electricity Market (NEM).

Origin is strongly supportive of nationally consistent ring-fencing arrangements that eliminate monopoly power that damages competition and ensure that markets for emerging technologies such as storage solutions are able to evolve and deliver customers with choice and innovation.

We believe that structural separation provides the most effective solution to ring-fencing problems in the sense that it modifies the incentives for a network service provider (NSP) in terms of how it participates in contestable markets. The application of ring-fencing guidelines on the other hand imposes behavioural measures that are aimed to address specific conduct. However, unlike structural policies, behavioural measures do not eliminate the incentive of the NSP to restrict competition.

In this regard, the challenge for the AER is to understand how NSP conduct in different markets impacts the competitive dynamic and in response develop guidelines that not only dampen the incentive for anti-competitive conduct but also provide clear, unambiguous and unbiased rules for all market participants to operate within.

Origin supports the majority of the AER's preliminary positions and looks forward to working with the AER as it develops these positions into formal guidelines.

Origin's responses to specific issues identified in the AER's Issues Paper are set out below.

#### *Objective of Ring-fencing*

The AER states that to establish the objectives of ring-fencing it must answer the question: what is the potential harm that ring-fencing is intended to address?

Origin is strongly of the view that ring-fencing must ensure that the regulated NSP is prevented from distorting competition in contestable areas of the electricity supply industry. Therefore, the potential harm that must be addressed is the ability of an NSP to engage in conduct in contestable markets associated with its distribution system that has the effect or likely effect of distorting competition. Furthermore, ring-fencing must also recognise that the promotion of competition is not an end in itself; rather competitive markets are generally the best way to enhance welfare by ensuring that goods and services are developed and supplied at the most efficient cost.



The AER notes that arguably regulated businesses should be excluded from offering services that can be obtained in contestable markets. We agree that structural separation provides the most effective means of separating an integrated NSP into competitive and regulated parts. We believe that robust separation is essential to remove any adverse impact on the likely levels of investment and technological innovation in emerging contestable markets such as storage technologies. We have concerns that behavioural policies such as ring-fencing are a second best solution and are limited in their ability to fully eliminate both price and non-price discrimination against competitors to the NSP.

However, the AER considers that the National Electricity Rules (NER) do not confer it with the powers to make such decisions. Notwithstanding, we believe the AER has an obligation to identify measures that will deliver optimal outcomes. If it considers that the NER constrains its ability to deliver optimal outcomes, then it should identify both the desired outcome and the impediment to enable relevant policy agencies to respond in a fully informed manner.

In the absence of structural separation we support the AER's proposed objectives to: 1) remove the anti-competitive effects of cross-subsidies; 2) avoid discriminatory interactions; 3) avoid preferential dealings; and 4) promote an even playing field.

#### *Classification of Services*

We support the AER's preliminary view to link ring-fencing to the classification of services. This will provide a defined set of services and the ring-fencing arrangements to apply to those services at the outset of each regulatory control period.

However, we are concerned that applying ring-fencing to Direct Control Services will inadvertently result in a number of contestable activities not being appropriately ring-fenced. Namely, the AER defines Alternative Control Services as a customer specific or customer requested service. These services may also have potential for provision on a competitive basis rather than by the NSP. For this reason, the AER sets service specific prices to enable the NSP to recover the full cost of each service from customers using that service.

As a result, potentially contestable activities may fall within the definition of an Alternative Control Service. We believe a more appropriate point of delineation would be to ring-fence those services defined as Standard Control Services. This would provide for an unambiguous capture of only regulated distribution services.

We also recognise that this approach could capture a number of services and activities that may not warrant being ring-fenced. However, as noted by the AER, this outcome could be addressed efficiently and cost effectively through fast track or bulk waivers at the outset of the regulatory period; this approach could be largely administrative thereby imposing immaterial costs on the NSP.

The initial separation by Standard Control Service will provide a more appropriate and cost effective separation of contestable activities from monopoly services provided by the NSP. We see this approach conceptually no different to the AER's preferred option 3 except that it applies a wider ring-fencing coverage in the first instance.

#### *Development of Contestable Storage Markets*

The AER identifies three possible models where a NSP could acquire or purchase distributed energy resources (DER) for network benefits being through: 1) Direct Control Services; 2) a separate ring-fenced entity that it owns; or 3) a third party.



The challenge for the AER is that DER has multiple values including regulated and contestable services. The NSP has an incentive to install DER both as an alternative to traditional network investment within its distribution system and as a demand side management tool behind the customer's meter; whereas retailers have an incentive to install DER as part of a package of services that allow customers to optimise their usage profile and better respond to network pricing signals.

For this reason there is a legitimate argument that DER could meet the definition of both a Direct Control Service and an Unclassified Service. However, where a NSP is able to leverage an advantage from having DER it has installed behind the meter classified as a regulated service, this has the potential to crowd out investment for other uses and harm the efficient operation of the contestable market for DER.

The AEMC observed this potential in its Integration of Energy Storage Final Report. It noted that it is not appropriate for NSPs to own or directly control storage behind the meter except through a ring-fenced entity. The AEMC posited that, if storage behind the meter is of value to NSPs, then they should contract with consumers, retailers or third parties to gain services, or create price signals or offer rebates that would reward consumers for operating storage in the desired way.<sup>1</sup>

The AEMC went on to conclude that ring-fencing provisions must prevent any ability of the NSP to favour affiliated businesses.

Origin's preferred position is that the NSP or its ring-fenced affiliate should not participate in the installation of storage assets beyond the customer's meter as this has a high risk of distorting market outcomes. However, we do recognise that behind the meter storage may have a value for network purposes; especially as a tool for managing peak load. In this event, the NSP should source any load from behind the meter directly from consumers, retailers or other providers in a manner envisaged by the AEMC. This would remove the potential harm to the competitive market by ensuring there are no preferential dealings between the NSP and its associate ring-fenced entity.

This arrangement could be facilitated through a number of pricing models which could be non-discriminatory and made available to all providers of the service. Furthermore, because the DER isn't being procured from a related party there is no incentive for preferential dealings that would crowd out new entrants. Importantly, this arrangement would not limit the NSP from accessing behind the meter load for network purposes with its costs recoverable through the regulatory opex allowance.

#### *Proposed Ring-fencing Obligations*

In the absence of structural separation, Origin strongly supports the requirement for a NSP not to carry on a ring-fenced service unless it is within a separate legal entity. We also support the AER's proposed obligations for the requirement for separate physical locations, staff, accounts and information.

We recognise that having a rigid separation of staff and premises could result in lost scale and scope and that demonstrating this compliance will also impose costs. However, under the AER's proposed classification of services approach, those services that do not warrant being ring-fenced will be removed through the fast track or bulk waiver process thereby removing administrative costs.

The remaining services are those activities that should be legitimately separated. Origin is not aware of any independently verified costs that demonstrate the materiality of different separation options. We are strongly of the view that to the extent that the costs of complying with the ring-fencing obligations are

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<sup>1</sup> AEMC, *Integration of Energy Storage Regulatory Implications, Final Report*, December 2015, p. 6.



developed for the purposes of demonstrating a cost benefit waiver case that these should be made publicly available to ensure they are considered by all stakeholders.

The AER has also suggested that there could be exemptions to its obligations in certain circumstances. The AER provides the example of where a NSP shares an employee with an associate that takes part in a related business. Our understanding is the preliminary position is clear that a NSP providing Direct Control Services not share physical locations, staff and information. It is not clear why the example of where a NSP shares an employee with an associate is grounds for an exemption (notwithstanding this is an example). We would welcome a more detailed explanation from the AER of when and how exemptions apply and the framework for making these decisions.

One other aspect of ring-fencing we consider must be included as an explicit requirement is for the NSP to provide non-discriminatory access to their network. Specifically, a third party who installs battery or solar installation at a customer's premises must be afforded the same access rights and be subject to the same connection requirements as a related party of the NSP. To resolve this issue, we believe there must be a ring-fencing obligation that: 1) prevents the NSP from installing behind the meter storage solutions (as per our discussion under development of contestable storage markets); or 2) NSP must have in place a non-discriminatory connection regime for all market participants and that this regime is subject to an annual audit consistent with other key ring-fencing obligations.

#### *Asset Sharing*

The AER has suggested that the effectiveness of ring-fencing to date and in other industry sectors could be investigated to determine whether more restrictive approaches to asset sharing are warranted.

Origin considers that compliance with the existing jurisdictional ring-fencing arrangements has not been comprehensively assessed in recent years for a number of reasons.

Given the evolving nature of contestable services we consider that the functional separation of assets would provide an appropriate ring-fencing obligation. At this stage in the development of the AER's ring-fencing arrangement, we consider this would provide participants in contestable services an element of comfort around the enforceability and effectiveness of ring-fencing obligations. For this reason we do not support the sharing of assets between regulated and contestable service provision.

#### *Ring-fencing Waivers and Costs of Compliance*

Origin recognises that by applying a classification of services approach, some activities that may not warrant ring-fencing could be captured. For this reason we support the intent behind the fast track and bulk waiver proposal.

Origin supports the factors proposed by the AER and the AEMC for assessing waiver applications subject to the AER providing a clear process that sets out how applications are to be made and the assessment criteria for their appraisal.

Furthermore, we consider a fundamental aspect of any cost benefit analysis with respect to ring-fencing must be the costs to the public of a lessening of competition in the relevant service subject to an application.

#### *Transitional Arrangements*

All NSPs have been subject to existing jurisdictional ring-fencing obligations for a number of years. While these guidelines vary in terms of their prescription, ring-fencing compliance is not new to the NSPs.



Furthermore, the AER process to develop its guidelines is expected to take the better part of 8 months with multiple document releases and consultation gateways.

We recognise that it may take time for some NSPs to put in place the necessary systems and protocols to achieve compliance, whereas for other NSPs they may already be fully compliant. In light of the NSPs existing understanding of ring-fencing and the extensive AER development process, we would be deeply concerned should the NSPs be given any extended period beyond the AER process before their compliance is assessed.

We encourage the AER to adopt more prescriptive transitional arrangements in light of the rapid evolution of a number of contestable services. Furthermore, we consider there needs to be a demonstration from the AER that in the lead up (including now) to the implementation of its guidelines there isn't inappropriate information, cost and asset sharing between NSPs and related businesses.

#### *Compliance and Enforcement*

Ring-fencing arrangements will only be effective to the extent that there is a robust compliance assessment regime with credible penalties for non-compliance.

Annual ring-fencing compliance must demonstrate that a NSP has the necessary systems, processes and restrictions in place and that these measures are operating as intended. To provide confidence to market participants of the independence of the audit process, we believe the AER must take ownership of the engagement of independent auditors to undertake financial, information control and access audits rather than have the onus put on the NSP.

To remove discretion and ambiguity we also believe the ring-fencing guidelines must define a compliance monitoring framework accompanied by a civil penalties regime where penalties are proportionate to the breach.

#### *Closing*

We look forward to continued participation in the AER process as it develops its Draft Guidelines.

If you have any questions regarding this submission please contact Sean Greenup in the first instance on (07) 3867 0620.

Yours sincerely

A handwritten signature in blue ink, appearing to read "K. Robertson".

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