



Electricity Distribution Ring-fencing Guidelines

Submission on AER Position Paper September 2012

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Executive Summary

SA Power Networks welcomes the opportunity to provide comments in respect of the Australian Energy Regulator's Position Paper on electricity distribution ring-fencing guidelines and on the broader process of the review.

SA Power Networks agrees with the proposition that there are likely to be greater overall efficiencies for the AER, and for some industry participants, in having national distribution ring-fencing guidelines (National Guidelines) rather than maintaining non-uniform jurisdictional distribution ring-fencing guidelines.

SA Power Networks does not dispute that the obligations that National Guidelines could apply include the 8 that are listed on page 12 of the Position Paper, because those obligations incorporate the list set out in clause 6.17.2(b) of the NER and other mechanisms that are reflected in the existing jurisdictional guidelines.

The AER has asked for submissions about how prescriptive the ring-fencing guidelines should be in specifying the application of particular ring-fencing obligations to address particular concerns, so that the AER can then proceed to draft National Guidelines and publish them for consideration in November 2012.¹ However, SA Power Networks believes that in order to answer that question, and before the AER prepares draft National Guidelines, there should first be consultation, discussion and debate with industry participants about:

- under what circumstances and to what extent each of the potential obligations that might be included in the National Guidelines could be expected to apply, including;
- the criteria that would be applied to assess the parameters, thresholds and other measures that might be applied to each of those obligations; and
- how the economic and practical benefits and costs of applying those criteria and the resulting obligations are likely to be assessed.

Without this detail, stakeholders cannot have an informed, meaningful and appropriately targeted debate about this critical issue, the outcome of which – the content of the National Guidelines – may have significant and long term cost and operational implications for DNSPs.

SA Power Networks therefore strongly recommends that once the AER has received and considered the responses to its Position Paper, the AER should undertake further consultation with industry participants about the substantive content and application of National Guidelines. Only having engaged in and considered the outcomes of this dialogue should the AER then proceed to prepare draft National Guidelines which reflect those outcomes and analyses.

We also note that the schedule for this latest stage of the ring-fencing review suggests a degree of urgency on the part of the AER. SA Power Networks questions whether this urgency is warranted, in view of the significant parallel program of regulatory review processes in progress over this period. In addition to providing for a better-informed process, our proposal for an additional phase of consultation may assist in ensuring that stakeholders are better placed to engage fully in the process.

¹ AER, *Position Paper - Electricity Distribution Ring-fencing Guidelines*, September 2012.

However, if notwithstanding this recommendation the AER remains of the view that it is appropriate to prepare draft National Guidelines without further prior industry consultation, SA Power Networks submits that the AER should:

- in preparing the National Guidelines, reflect a similar level of restriction, content, parameters, thresholds and other measures that are applied in the Transmission Ring-fencing Guidelines (Transmission Guidelines); and
- not seek to expand the National Guidelines beyond the scope of what is, and is not, covered by the Transmission Guidelines (e.g. into areas such as emerging markets) where there are still incomplete policy review processes underway that are likely to have a significant impact on the future landscape for the industry.²

The issues and arguments mentioned above are expanded upon in later parts of this response.

² Such as the AEMC Review: *Power of Choice – Stage 3 DSM Review, Issues Paper*, 15 July 2011 and the resulting AEMC Review: *Power of Choice – Draft Report - giving consumers options in the way they use electricity*, 6 September 2012

Background

AER Discussion Paper

In December 2011 the AER published a Discussion Paper seeking views on whether it should develop a nationally consistent set of distribution ring-fencing guidelines and, if so, what their appropriate content might be, how they should deal with emerging industry trends, and how they should apply to dual function assets.³

Position Paper

In September 2012, the AER published a Position Paper following its consideration of responses to its Discussion Paper.

The AER noted that respondents to its Discussion Paper had generally supported more consistent ring-fencing arrangements, but had differing views as to the application and content of distribution ring-fencing guidelines.

In its Position Paper, the AER analysed existing jurisdictional ring-fencing arrangements against criteria including: their consistency with the terminology used in the NER and the AER's options under clause 6.17.2(b) of the NER; how ring-fenced services were defined; their applicability to emerging markets; their flexibility for special and changing circumstances; and their compliance requirements. The AER noted that ring-fencing should serve the interests of consumers of both regulated and unregulated services, and should promote efficient pricing of regulated services, promote competition in contestable markets and be flexible enough to accommodate changes in the electricity market.

The AER has concluded that it will develop national ring-fencing guidelines to apply to all DNSPs.

Submissions

The AER has asked for submissions on the criteria, assessment and conclusions set out in its Position Paper, and has also asked two specific questions:

- How prescriptive the ring-fencing guidelines should be in specifying the application of particular ring-fencing obligations to address particular concerns; and
- Whether any other requirements, in addition to accounting separation supported by approved cost allocation methodologies, are necessary where an entity owns multiple regulated businesses.

The AER has indicated that it will take into account the submissions made on the Discussion Paper, and any submissions provided on the Position Paper, in developing draft distribution ring-fencing guidelines by November 2012.

³ AER, *Electricity Distribution Ring-fencing Guidelines Review – Discussion Paper*, December 2011.

SA Power Networks' Response

Criteria

The AER has called for submissions on the criteria that were applied by it in assessing whether the existing jurisdictional ring-fencing guidelines should be maintained, or whether National Guidelines should be developed instead.

SA Power Networks considers that the criteria that were applied by the AER were appropriate for the assessment of whether National Guidelines are more appropriate.

However, SA Power Networks notes that the Position Paper does not set out in appropriate detail the criteria that the AER has applied, or will apply, when it comes to determining the substantive obligations that should be addressed in the National Guidelines, particularly the criteria that should be applied in considering how the National Guidelines should deal with emerging industry trends and with dual function assets, both of which were identified as issues to be addressed in this review.⁴

Assessment

The AER has called for submissions on its assessment of the existing jurisdictional guidelines.

In response to its Discussion Paper – the purpose of which was principally to seek views on whether the AER should develop a nationally consistent set of distribution ring-fencing guidelines – the AER received some submissions on significant items of guideline content and how they might be applied.

While the AER has indicated that its Position Paper addresses the fundamental issue of whether the existing jurisdictional ring-fencing guidelines place adequate obligations on DNSPs,⁵ the AER's assessment appears to have been undertaken in relation to the significantly narrower question of whether or not national distribution ring-fencing guidelines are preferable to the current jurisdictional arrangements. The Position Paper makes reference to certain of the abovementioned submissions, but does not discuss the concepts that have been raised in any depth.

SA Power Networks is therefore very concerned that the critically important issues going to the substantive content of the guidelines, and how the guidelines should be applied, have not been given the appropriate weight, consideration or analysis in the consultations that have taken place to date with industry participants. That is, although many issues of guideline content, and their application, have been raised in the assessment by the AER of whether a national set of distribution ring-fencing guidelines should be adopted, there has been no separate analysis of possible guideline content, or application, by reference to relevant criteria.

As a result, DNSPs have very little information at this stage as to the detail that they might expect to see in the draft National Guidelines which the AER has indicated it will proceed to publish in only two months time.

SA Power Networks is concerned that once draft National Guidelines are published, the opportunity for substantive discussion and debate with industry participants regarding the practical and economic issues arising from the content and application of the National Guidelines, will be significantly reduced.

Of particular concern to SA Power Networks is that, in the conclusions to its assessment, the AER has identified its belief that the ring-fencing of contestable emerging markets, particularly advanced meter services, is a significant issue and one that requires a different approach to that in the existing jurisdictional ring-fencing

⁴ AER, *Electricity Distribution Ring-fencing Guidelines Review – Discussion Paper*, December 2011.

⁵ *Ibid*, p.1.

guidelines. The AER goes on to conclude that its preferred approach, namely the development of National Guidelines, will provide the consistency to allow the AER to efficiently address this issue. However, SA Power Networks notes that the AER has not clearly identified or explained, in either the Discussion Paper or the Position Paper, the specific problem(s) that DNSP involvement in emerging markets is perceived by the AER to present.

Further, by making reference to some stakeholders' apparent concerns about DNSP incentives to pursue opportunities and to entrench advantages that arise from holding the information and assets associated with a regulated DNSP, the AER appears to have gone outside the discussion about national consistency and efficiency, into more substantive issues of obligation and application, without having undertaken appropriate industry consultation as required by NER s6.17.2(d). SA Power Networks is therefore genuinely concerned that, as a result, the opportunity for comprehensive industry consultation on these substantive issues, prior to the publication of the draft National Guidelines, may be missed.

The conclusions to the AER's assessment also raised the issue of generation for the purpose of network support, and noted that some submissions to the Discussion Paper supported the approach to this issue taken by the Transmission Guidelines. Subject to the intended definition of "related business" and the revenue threshold that might be applied in the National Guidelines, SA Power Networks supports such a practical, materiality based approach to this issue.

AER Preferred Approach and Conclusions

The AER has called for submissions on its preferred approach and conclusions.

National Guidelines

SA Power Networks supports the AER's preferred position that National Guidelines should be developed and applied in place of the jurisdictional ring-fencing guidelines.

SA Power Networks can understand that the AER would benefit from the efficiencies associated with national consistency, particularly in the areas of consistent terminology and definitions, and from having a consistent approach to assessing and monitoring compliance. SA Power Networks can also understand that the ability to address issues arising from emerging markets and technologies in a consistent and therefore efficient manner would be facilitated by the development of National Guidelines.

The AER has also concluded that having National Guidelines will provide DNSPs with the benefits of having clear obligations in national markets, but it is not clear to SA Power Networks how this will provide a material benefit to the DNSPs.

Emerging Markets

In its Discussion Paper, the AER stated that its review of ring-fencing guidelines was not seeking to address the policy issues associated with demand side participation that were being considered by the AEMC,⁶ as the AER was unsure when the outcomes of that review would be known. However the AER did highlight that any revisions to the current ring-fencing guidelines should be made with these developments in mind, and SA Power Networks strongly supports that view. The development of National Guidelines should have significant regard to these policy issues, which are highly relevant to the emerging markets issues raised by the AER and in stakeholder submissions.

⁶ The AER referenced the AEMC Review: *Power of Choice – Stage 3 DSM Review, Issues Paper*, 15 July 2011

SA Power Networks notes that the AEMC has now released its draft recommendations for changes to existing market and regulatory arrangements,⁷ and it is likely that the AEMC will conclude its review with recommendations to the SCER within a reasonable time frame. Given that these recommendations are so relevant to the AER's review of ring-fencing guidelines, SA Power Networks submits that it would be prudent for the AER to delay making any substantive decisions or proposals in relation to the possible content of National Guidelines until the AEMC has made its recommendations.

However, if, as it has indicated, the AER determines that it will keep to the timeframe for completion of its ring-fencing review as set out in the Position Paper, then SA Power Networks submits that a reasonable alternative is for the AER to not make any substantive decisions or proposals in relation to the possible content of those parts of the National Guidelines that might impact on the issue of emerging markets and technologies, until after the views of the AEMC and the SCER are better known.

Possible ring-fencing obligations and their application

SA Power Networks submits that the identification and selection of the particular ring-fencing obligations, and how they will be applied, requires significantly more consideration and analysis than that which the AER has undertaken, which has focussed on the narrow question of whether there should be national, rather than jurisdictional, guidelines.

The AER has formed the preliminary view that the obligations that could be applied to DNSPs include legal, accounting, and operational forms of separation, cost allocation, information control, non-discrimination, and compliance and reporting, with flexibility facilitated by waiver as appropriate. However it is not evident from either the Discussion Paper or the Position Paper whether or not the AER has considered or intends to consult on the criteria it will apply in assessing whether any particular service should be ring-fenced and how an appropriate measure of obligation would be determined if it is.

SA Power Networks strongly supports the AER's recognition that the application of ring-fencing guidelines must consider the costs of compliance within the context of the identified issue,⁸ (i.e. the potential or actual problem) that any particular proposed ring fencing obligation is intended to solve. For that reason, in developing or applying ring fencing obligations, it is essential that the AER clearly identifies, and assesses, the actual or potential impact of the perceived problem or risk that the obligation is intended to mitigate.

Furthermore, just as the AER developed criteria for the assessment of the appropriateness of having national, rather than jurisdictional, ring-fencing guidelines, the AER should develop explicit criteria for the assessment of the appropriateness of each potential ring-fencing obligation. SA Power Networks suggests that such criteria be based on the economic principles that support the objectives of ring-fencing: the promotion of efficient pricing of regulated services, and of competition in contestable markets where that is appropriate. We would add that appropriateness of promoting competition needs to be assessed in the context the National Electricity Objective, which focuses on the long term interest of electricity consumers.

In the opinion of SA Power Networks, these criteria are already explicit in the existing jurisdictional ring-fencing guidelines and/or in other regulatory instruments (or those pending implementation), even if there is not complete consistency across all jurisdictions.

⁷ AEMC Review: *Power of Choice – Draft Report - giving consumers options in the way they use electricity*, 6 September 2012
⁸ Position Paper, op cit, p.16.

Efficient pricing of regulated services

SA Power Networks believes that efficient pricing of regulated services is best served by the DNSP having an obligation to consistently apply its approved cost allocation method. This can be supported by the implementation of appropriate reporting requirements. However, SA Power Networks notes that DNSPs are already subject to separate requirements in respect of the approval and publication of cost allocation methods, and therefore queries the value of duplicating such requirements in the National Guidelines.

Promoting competition in contestable (and emerging) markets

SA Power Networks believes that effective competition is best served by avoiding the creation of an unfair competitive advantage. This will be facilitated by ensuring the fair treatment of information having regard to the purpose for which it was obtained, and ensuring regulated services are provided to all parties on a transparently arms-length basis. These requirements can be effected in a number of ways, including obligations to implement and monitor relevant policies and procedures and physical or other operational separation, and will be supported by effective compliance regimes that include appropriate penalties for breach.

SA Power Networks notes that with emerging technologies, it is possible that circumstances will arise in which it will be in the best interests of direct control services consumers for the DNSP to provide specific unregulated services directly to consumers, rather than to attempt to facilitate effective competition at a significantly increased overall cost or to the detriment of its network management effectiveness. These issues are extensively discussed in the AEMC's Draft Report⁹, and SA Power Networks submits that the AER should therefore not take any action in its approach to the content of the National Guidelines that might pre-empt any relevant NER changes.

SA Power Networks agrees with the AER that in such circumstances, to the extent shared network assets are used to earn unregulated revenue, direct control service customers should benefit appropriately. SA Power Networks notes the AEMC's draft rule change in respect of the shared asset cost adjustment.¹⁰

In such circumstances it would be inefficient and illogical to lock the DNSP out of a market (as appears to be recommended by electricity retailers in submissions to the Discussion Paper).¹¹ The application of competitive neutrality (even as applied to non-government businesses) must be subject to the condition that the benefits are greater than the associated costs. The application of effective ring-fencing obligations should be targeted at ensuring, after the conduct of an appropriate cost/benefit analysis, that competition is in fact the most cost effective way to deliver services to consumers. Further, where it is found to be appropriate to facilitate a competitive market, it is unreasonable to suggest (without due consideration) that only DNSPs must be obliged to apply appropriate ring-fencing mechanisms. It may be the case that in order to ensure overall competitive neutrality in such a market, other regulated businesses (including retailers) would need to be made subject to similar ring-fencing provisions.

⁹ AEMC Review: *Power of Choice – Draft Report - giving consumers options in the way they use electricity*, 6 September 2012.

¹⁰ AEMC Rule Change: *Draft Rule Determinations Draft National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012*, 23 August 2012, Section 11.3.

¹¹ For example Origin submission, 24 February 2012, and ERAA submission 24 February 2012.

AER Specific Questions

How prescriptive should the National Guidelines be?

The AER has asked for stakeholder views on how prescriptive the ring-fencing guidelines should be in specifying the application of particular ring-fencing obligations to address particular concerns.

Although it has posed this question, SA Power Networks' reading of the Position Paper indicates that the AER favours an approach which is less prescriptive, "more flexible" and which might be applied on a "case-by-case" basis.

SA Power Networks believes that it is not feasible to adopt a position regarding a desirable level of prescription when it does not have an understanding of the criteria the AER would apply in assessing whether any particular service should be ring-fenced and how an appropriate form and measure of obligation would be determined if it is.

In relation to the AER's apparent preference for a more flexible approach, SA Power Networks is somewhat concerned with the AER's comment that "it may be preferable for the guidelines to operate in a more flexible way [which] could mean, for example, the guidelines applying any of the possible ring-fencing obligations, on a case-by-case basis". This is unsettling for a number of reasons. As a business operator, SA Power Networks naturally prefers clarity and certainty where this is possible. Further, such a tailored approach would seem to denigrate the potential for National Guidelines to provide the desired benefits arising from consistency of approach. Furthermore, it would also seem to have the potential to undermine the requirements of Part H of Chapter 6 of the NER, which entrenches a transparent and appropriate process for the AER to follow if it is of the view that changes to guidelines are warranted at any point in time.

As noted above, SA Power Networks considers an essential step before National Guidelines are drafted is for there to be consultation about the specific content of the National Guidelines. In that consultation, the question of the appropriate degree of prescription can be asked in respect of each of the risks that the National Guidelines are being designed to mitigate.

Additional requirements where regulated businesses share a parent

The AER has asked for stakeholder views as to whether any other requirements, in addition to accounting separation supported by approved cost allocation methodologies, are necessary where an entity owns multiple regulated businesses.

The measures noted by the AER would seem to be adequate in the case that regulated businesses share a parent. SA Power Networks therefore makes no recommendation regarding any other requirements.