Ring-fencing Guideline

Submission in response to the

Australian Energy Regulator’s Draft Guideline

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Energy Consumers Australia

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Background

Energy Consumers Australia (ECA) congratulates the Australian Energy Regulator (the AER) on the forthright approach it has taken to ring-fencing in its Draft Guideline (the Guideline). In particular, we strongly support the AER's approach in recognising the potential harm from the participation of network businesses in contestable markets.

The review of the ring-fencing guideline has been, in part, triggered by the *Power of Choice* reform to introduce metering contestability. Most network providers, having experience of metering, have signaled their intent to enter the contestable metering market.

The review of the guideline has also been triggered by the Australian Energy Market Commission (AEMC) review of storage, noting that the ring-fencing guideline will apply to any storage service that is regarded as being in a contestable market.

The Australian energy market is premised on the principle of imposing a strict separation between potentially competitive markets and those that exhibit natural monopoly characteristics. The ring-fencing guideline is not the mechanism that determines what separation should occur, it is only the mechanism that restricts how the separation should be policed when one organisation is participating in both markets.

ECA believes that the strict separation embodied in the overall market design continues to be an important element. The particular relevance of the Guideline is how effective it can be and how its design should then inform other regulatory and policy decisions.

ECA's evaluation of the Guideline is therefore framed by the understanding that the Guideline is not the means by which decisions on what needs to be separated are determined, and that ultimately the effectiveness of the Guideline will inform those decisions. Instead it is appropriate that decisions about separation will be considered in the pending rule change before the Australian Energy Market Commission, *The contestability of energy services.*

The case for *ex-ante* protections

ECA supports the AER's identification of the potential harms from network businesses operating in potentially competitive markets, namely cross-subsidisation and non-discrimination. It is appropriate to require *ex ante* protections against these harms to the maximum extent possible.

A counter view can be advanced that such protections result in the potential dissipation of "benefits" that can accrue from the operation of both services by the one entity. However, these supposed "benefits" are, from ECA's perspective, almost always simply examples of the harms.

One benefit that is argued is the efficiency of scope in costs. However, this argument is inseparable from an argument that cross-subsidisation is appropriate. More specifically if the benefits of joint production between the monopoly and competitive markets are greater than the benefits of competition, the correct conclusion is to simply include the service in the monopoly market. In short, this is a service classification argument not a ring-fencing argument.

A further benefit often advanced is that the information available to the monopoly business can benefit consumers in the competitive market. This is explicitly an argument that the network should be able to exploit its information benefits in the competitive market. The purpose of the non-discrimination rule is to guarantee that this does not occur.

ECA is however concerned that specific measures to address each of these harms provided for in the Guideline do not cover all the circumstances. In particular, we have the following concerns:

- the ability for cross-subsidization to occur via sub-contracting;
- the ability of senior executives to be information conduits;
- the requirement for system separation; and
- the means of providing non-discriminatory access to information.

Underlying our concerns is our view that the participation by a network business in a competitive market automatically works as a signal to the market that the network business believes the ring-fencing is ineffective.

Our reasoning is based on the drivers for investors in regulated utilities and competitive businesses.

Network businesses are regulated utilities, and in the Australian case have fairly explicit guarantees on return of, and for, investment. For investors this is classed as a utility stock, which are highly sought after by investors such as superannuation funds. On the other hand, investments in stocks in competitive markets are riskier. These are classically regarded as growth stocks with significantly greater prospects of higher returns than the guaranteed returns of regulated utilities.

Investors choose to diversify their risks by deciding on their how much exposure they want to utility and growth stocks. Where a utility stock blend these risks, such as a network business also operating in a competitive market, they are expected to trade at discount to the prices that would apply if they were traded separately because they internalize the diversification.

In these circumstances, the only reason why a utility would choose to participate in a competitive market is because they expect to be able to exploit their market power to an extent that financially benefits their competitive activity by a greater amount than the discount on their stock price by blending risk profiles.

As a consequence, ECA believes that it is appropriate that *ex ante* protections should be put in place that create obligations that go beyond specific measures for “equivalent treatment” as proposed in the AER’s Guideline.

Addressing the AER Guideline specific measures

Sub-contracting

The ring-fencing guideline requires that a distribution network service provider (DNSP) can only engage in the provision of non-network services (over a $500,000 threshold) through a separate legal entity referred to as a related body corporate (RBC).

The provision to prohibit cross-subsidisation is based on the maintenance of separate accounts and cost allocation principles.

There is, however, a means by which the DNSP and the RBC could share costs that is not captured by these rules. The example would be a case where both the DNSP and the RBC contracted with a third party to provide services, for example under a single contract for field work to be performed for both the DNSP and the RBC. If both the DNSP and RBC issue the contract to the same third party, then that third party can provide the services to the RBC at a cheaper price than could be obtained by other RBCs that are not able to bundle the service.

The *ex ante* remedy could be a requirement that in these instances, the DNSP must enable other RBC's or their contractors to do the network work for their service orders under the same terms and conditions as apply to the DNSP contractor. Additional protections should include that in its cost allocation reporting that the DNSP must report on all contracts where both the DNSP and RBC use the same contractor.

Senior Executives

Neither the Guideline nor the Explanatory Statement defines "senior executive" though it may be drawn from some other aspect of the regulatory scheme.

The implication of the exemption for senior executives to work in both the DNSP and RBC carries the implication that this is a person whose operating level is such that they have no familiarity with any operating details. It is ECA's view that this is unlikely to apply to the responsibilities of senior executives in the real world.

It is acknowledged that the RBC will often be constructed as a subsidiary of the DNSP and so some executive of the latter will have a responsibility for the former and that some level of cross functionality is inevitable.

It is, however, appropriate to institute rules and procedures to ensure these executives keep their dual roles separate. An extreme version would be a communications recoding system that includes the following:

- separate email addresses for the executives two roles;
- retention of all emails, written correspondence or reports received;
- a record of all the meetings the executive participates in in both roles and who the other participants were in those meetings;
- a record of all telephone calls between the executive and any employee in either entity; and
- retention of an audio recording of all meetings the executive participates in (in either business).

ECA is not requiring that the Guideline include a complete specification of how such regimes must operate, as that would be excessive. The Guideline should, however, include a section on the obligations of the DNSP in relation to the staff identified in clause 4.2.2 that:

1. the staff that it is proposed are covered by the provision of 4.2.2 (b) must be listed by the DNSP in a publicly available register; and
2. for the senior executives referred to in 4.2.2(b)(ii) the procedures that the DNSP has put in place to record the communications that the senior executive has with the two businesses, and these procedures to also be supplied on the register.

System Separation

The provision of section 4.3 (information access and disclosure) of the Guideline makes no specific reference to IT systems. The easiest way for the two businesses to inadvertently share information will be by use of common IT systems. As any of the potentially competitive businesses would only need to transact with the network business on the same basis as any other third party there is no other benefit from IT system sharing other than an implicit cross subsidy.

Therefore, this section of the Guideline must include a provision that the RBC must maintain its own customer and service provision information systems and that any interface between these systems and the DNSP must be through industry standard B2B procedures.

In the case of the DNSP metering services the requirement for system separation should come into effect on 1 December 2017.

Means of providing non-discriminatory access to information

It is not a sufficient protection for the firms competing with the RBC that data is made available to it at only the same time or way that the data is provided to the RBC (clause 4.3.2).

Knowing that information will become available can be of commercial advantage.

Ideally the provision of this clause in the Guideline would specify a framework for the proactive provision of information by the DNSP that could assist any of the competitive businesses. In the absence of such a provision, clause 4.3.2 of the Guideline should include an obligation on the DNSP to publish an information sharing protocol that will outline the means by which the DNSP will give effect to the requirement for equality of access to information. Compliance with the protocol will not be evidence of compliance, but failure to observe the protocol would be evidence of non-compliance.

Compliance

The effectiveness of the Guideline will be best assessed by how effective competition is in markets in which the RBCs of DNSPs participate.

Compliance reporting will assist in ensuring that DNSPs are regularly reviewing how effectively they are ensuring the harms that the Guidelines seek to address are being prevented.

The businesses that need to be most satisfied that the Guideline measures are being properly applied are those that are competing (or are considering competing) against the RBCs. Therefore, nothing in the annual compliance reporting proposed in clause 6.2.1(a) of the Guideline should be confidential to the DNSP. Accordingly, the Guideline should require that the annual report be published on the DNSP website.

However, it is unclear what purpose the assessment by a “suitably qualified independent authority” of the annual report is. That can either be a report on how effective the internal measures are or simply whether the report provided accurately describes the measures.

In practical terms neither adds much value. What would be more valuable is for the AER to require that the most senior executive of the DNSP takes personal responsibility that the DNSP is meeting the requirements of the guideline.

To that extent the annual report should be accompanied by a certification from the DNSP CEO that the Guideline has been complied with. This is actually a higher standard of assurance than an independent certificate.

Conclusion

The ECA has proposed a number of practical suggestions in this submission that could be incorporated into the Guideline to improve its effectiveness.

While an effective Guideline has value, it cannot be relied upon as a sufficient remedy to prevent the potential for harm from the participation of network businesses in competitive markets.

ECA recognises that consideration of *ex ante* protections that provide for structural separation of monopoly and competitive businesses is not within the scope of the AER's authority. These issues will be appropriately addressed in the AEMC's pending rule change on *The contestability of energy services*. However, we encourage the AER to join with ECA in reminding other regulatory bodies and policy makers that the Ring-fencing Guideline cannot be relied on alone.

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