



**Application for Waiver of Ring-Fencing
Arrangements
by Ergon Energy**

Final Decision

September 2001

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1. OVERVIEW

On 6 June 2001, Ergon Energy Corporation Limited (Ergon) applied to the Authority for an exemption from section 1(b) of the Authority's Ring-fencing Determination in respect of the requirement for Ergon not to carry on a related business within the legal entity of the Distribution Network Service Provider. The waiver would allow Ergon's Isolated Generation services to operate as a related business within the legal entity of the DNSP.

On 22 June 2001, the Authority placed a notice in the Australian Financial Review calling for submissions on the application to be lodged with the Authority no later than 13 July 2001. No submissions were received.

On 8 August 2001, the Authority released its Draft Decision. The Authority's Draft Decision was to issue a notice under section 21 of the Ring-Fencing Determination to waive Ergon's requirements to comply with ring-fencing obligation section 1(b) in respect of Isolated Generation services.

Upon the release of its Draft Decision, the Authority placed a notice in the Australian Financial Review and the Courier Mail calling for submissions on the Draft Decision to be lodged with the Authority by no later than 31 August 2001. Letters were also sent to all parties who had registered their interest in electricity issues with the Authority, advising that a Draft Decision had been made and seeking submissions on the Draft Decision.

Two submissions were received by the Authority with respect to its Draft Decision. Following consideration of Ergon's application, the submissions, the provisions of the Authority's Ring-Fencing Determination, the *Electricity Act 1994* and the National Electricity Code, the Authority has determined that the application should be approved.

2. INTRODUCTION

The Queensland Competition Authority is a statutory body established under the *Queensland Competition Authority Act 1997*. The Authority has certain responsibilities and functions with respect to National Competition Policy.

The Authority's responsibilities with respect to electricity are set out in the *Electricity – National Scheme (Queensland) Act 1997*, which gives effect to the National Electricity Code (the Code). The Code sets out the objectives for the National Electricity Market, and in particular provides for “a regime of light-handed regulation of the market to achieve the market objectives”. The Code provides for the Authority to regulate distribution prices from 19 December 2000 and to prepare ring-fencing guidelines. The Authority also has responsibilities under the *Electricity Act 1994*, which provides that the Authority may prepare and enforce conduct rules, and requires the Authority to monitor standards of service quality if issued by the Treasurer.

The Authority's Ring-Fencing Determination was released in September 2000. The objective of this Determination was to assist in creating an environment where the price, quantity, and quality of electricity traded in the retail market, and the price, quantity and quality of distribution services used to deliver the energy, were not biased by the vertical integration of distribution and other businesses.

However, the Authority was also mindful of the potential for capturing certain activities where the costs imposed by complying with the Determination outweigh the benefit, or any likely benefit, to the public. Accordingly, the Authority included in its Determination the provision whereby the DNSPs could apply to have certain obligations waived where the administration costs of complying with the Determination outweigh the benefit, or any likely benefit, to the public.

3. RING-FENCING DETERMINATION REQUIREMENTS

3.1 Procedures for waiving ring-fencing obligations

Section 1 of the Authority's Ring-Fencing Guidelines detail the minimum ring-fencing obligations imposed on Queensland DNSPs. A DNSP also has the right to seek a waiver from any of its obligations under section 1. This right is provided under section 21 of the Determination. Specifically, section 21 states:

“The QCA may, by notice to a DNSP, waive any of a DNSP's obligations under section 1 provided that the QCA is satisfied that the DNSP can demonstrate that the administrative cost to the DNSP and its Associates of complying with the obligation outweighs the benefit, or any likely benefit, to the public.”

Where a DNSP applies for waiver of its ring-fencing obligations the Authority must follow defined procedures provided for in sections 22 to 30. These obligations have been extracted and reproduced at Appendix A.

3.2 Ergon's submission

Section 1 of the Authority's Ring-Fencing Determination prescribes the minimum ring-fencing requirements that Queensland DNSPs must comply with. The obligation that Ergon seeks a waiver from is section 1(b) that states:

“A Distribution Network Service Provider (DNSP) that provides prescribed distribution services in Queensland must not carry on a related business within that legal entity”.

The Determination defines “related business” as the business of producing, purchasing or selling electricity.

4. QCA ANALYSIS AND POSITION

On 6 June 2001, Ergon Energy Corporation Limited (Ergon) applied to the Authority for an exemption from section 1(b) of the Authority's Ring-fencing Determination in respect of the requirement for Ergon not to carry on a related business within the legal entity of the Distribution Network Service Provider. The waiver would allow Ergon's Isolated Generation services to continue to operate as a related business within the legal entity of the DNSP.

For the purposes of this Determination, Isolated Generation services are generation assets owned and operated by Ergon for the purposes of supplying electricity to a network that is not regulated by the Authority. A list of current isolated generation sites is provided at Appendix B.

The Authority did not consider the application had been made on trivial or vexatious grounds. Accordingly, a notice was subsequently placed in the Australian Financial Review, calling for public submissions on the proposal by no later than 13 July 2001.

The Authority did not receive any submissions on Ergon's application.

On 8 August 2001, the Authority released its Draft Decision. The Authority's Draft Decision was to issue a notice under section 21 of the Ring-Fencing Determination to waive Ergon's requirements to comply with ring-fencing obligation section 1(b) in respect of Isolated Generation services.

Upon the release of its Draft Decision, the Authority placed a notice in the Australian Financial Review and the Courier Mail calling for submissions on the Draft Decision to be lodged with the Authority by no later than 31 August 2001. Letters were also sent to all parties who had registered their interest in electricity issues with the Authority, advising that a Draft Decision had been made and seeking submissions on the Draft Decision.

Submissions were received from ENERGEX and Queensland Treasury.

The submission from ENERGEX supported the Authority's approach. ENERGEX agreed that the cost of compliance would outweigh any public benefit arising from compliance.

The submission from Queensland Treasury also supported the Draft Decision.

In accordance with section 29 of the Determination, the Authority is now issuing its Final Decision.

Under section 21 of the Determination, the Authority may waive a ring-fencing requirement in relation to section 1 where it is satisfied that the administrative costs to the DNSP and its Associates of complying with the obligations outweigh the benefit, or any likely benefit, to the public.

Ergon Comments

In support of the argument that a waiver should be granted on the above grounds, Ergon has claimed that:

- it has no commercial basis for supplying isolated generation services, rather, it is obligated to do so under the Electricity Act 1994 and the Electricity Regulation 1994;

- despite isolated generation services residing within the DNSP, the services are subject to a clear separation of assets, costs and accounting records and all other ring-fencing and cost allocation requirements;
- there are a number of defined costs in order to establish a separate Ergon subsidiary company for isolated generation services. Ergon identify ASIC fees, audit fees, the operation of separate sets of accounts, separate directors and legal expenses. Ergon estimate these costs at between \$30,000 to \$40,000 per annum as well as any one-off establishment costs to establish the separate legal entity;
- costs associated with isolated generation (both the generation units and associated network assets) are regulated by the Office of Energy. (Isolated generation is not included in the Authority's regulated revenue base); and
- there are no additional benefits, either financial or non-financial, that would accrue to the public with the legal separation of isolated generation.

In closing their argument Ergon stated:

“As this area is already totally ring-fenced with a separate revenue regime, complying with clause 1(b) would only add a layer of bureaucracy, complexity and costs with no added benefits. In fact the costs would be viewed as legitimate costs of running the business and would be built into the costs making up the regulatory revenue requirements. Consequently, legal separation would burden Treasury with further community service obligations with no commensurate difference in service to customers. This clearly demonstrates that the cost of complying with obligation 1(b) outweighs the benefits to the public.”

QCA Analysis and Position

Having considered this case, the Authority is of the view that:

- there will be costs associated with meeting this particular ring-fencing requirement. While the costs reported by Ergon are perhaps higher than might be necessary, the Authority has reviewed these costs and accepts that they are, nevertheless, reasonable; and
- there is no apparent public benefit in enforcing the ring-fencing requirement that Isolated Generation services be a separate legal entity.

The Authority generally considers the requirement of legal separation a necessary aspect of its regulation of distribution businesses, particularly in effectively separating any upstream or downstream business activities from the monopoly business and reinforcing the Authority's commitment to eliminate cross-subsidies, enforce stringent accounting separation and to eliminate perverse incentives to undertake anti-competitive behaviour. However, the Authority considers that each case should be judged on its merits.

It is important to note that Ergon's isolated generation activities will remain subject to all other aspects of the Ring-Fencing Guidelines and that being subject to a separate regulatory regime assets, costs, and accounting records will need to be separately identifiable.

5. FINAL DECISION

The Authority's Final Decision is to issue a notice under section 21 of the Ring-Fencing Determination to waive Ergon's requirement to comply with ring-fencing obligation section 1(b) in respect of Isolated Generation services.

Appendix A

Procedure for Waiving Ring-Fencing Obligations¹

22. A DNSP may apply to the QCA requesting the QCA to issue a notice under section 21.
23. When the QCA receives an application under section 22 the QCA must:
 - (a) if it considers that the application has been made on trivial or vexatious grounds, reject the application without further consideration; or
 - (b) in all other cases within 14 days after receipt of the application, inform each person known to the QCA who the QCA believes has a sufficient interest in the matter that it has received the application by publishing a notice in a national daily newspaper which at least:
 - (i) states who the DNSP concerned is and the obligations that the application seeks to have waived;
 - (ii) states how copies of the application can be obtained;
 - (iii) requests submissions by a date specified in the notice (not being a date earlier than 14 days after the date of the notice).
24. The QCA must provide a copy of the application to any person within 7 days after the person requests a copy and pays any reasonable fee required by the QCA.
25. The QCA must consider any submissions received by the date specified in the notice published under section 23 and it may (but is not obliged to) consider any submissions received after that date.
26. Within 30 days after the last day for submissions specified in the notice published under section 23 the QCA must issue a draft decision stating whether or not it intends to issue a notice under section 21.
27. The QCA must:
 - (a) provide a copy of its draft decision to the DNSP, any person who made a submission on the matter and any other person who requests a copy; and
 - (b) request submissions from persons to whom it provides the draft decision by a specified date (not being a date earlier than 14 days after the date the draft decision was issued).
28. The QCA must consider any submissions it receives by the date specified by the QCA under section 27 and it may (but is not obliged to) consider any submissions received after that date.

¹ Queensland Competition Authority, *Final Determination: Electricity Distribution: Ring-Fencing Guidelines*, September 2000, pp. 24-25.

29. Within 30 days after the last day for submissions on the draft decision specified by the QCA, the QCA must issue a final decision stating whether or not it will issue a notice under section 21.
30. A notice under section 21 has effect 14 days after the notice is given to the DNSP or such later date as the QCA specifies in the notice.

Appendix B

Isolated Generation Sites

Aurukun	Kowanyama
Badu	Kubin
Bamaga	Lockhart
Bedourie	Mabuiag
Birdsville	Mapoon
Boigu	Murray
Boulia	Palm Island
Burketown	Pormpuraaw
Camooweal	Saibai
Coconut	Stephen
Coen	Thursday Island
Darnley	Warraber
Dauan	Wasaga
Doomadgee	Windorah
Gununa	Yam
Hammond	Yorke
Jundah	