



Final Decision

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

February 2004

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1. EXECUTIVE SUMMARY

On 1 October 2003, Ergon Energy Corporation Limited (Ergon) applied to the Authority for a waiver of section 1(b) of the Authority's Ring-fencing Guidelines (not to carry on a related business within the legal entity of the Distribution Network Service Provider (DNSP)) with respect to Ergon's grid-connected generation assets used for network support.

On 15 October 2003, the Authority placed notices in the *Courier Mail* and *Australian Financial Review* calling for submissions on the application to be lodged with the Authority no later than 17 November 2003. No submissions were received.

Following consideration of the Ergon application, the provisions of the Authority's Ring-fencing Guidelines, the *Electricity Act 1994* and the National Electricity Code (the Code), the Authority released a Draft Decision on 15 December 2003 indicating its intention to issue a notice under section 21 of the Ring-fencing Guidelines to waive Ergon's requirement to comply with ring-fencing obligation section 1(b) of the Guidelines in respect of its four existing grid-connected generation sites used for network support.

Submissions were sought on the Draft Decision by 23 January 2004. One submission was received, from Origin Energy (Origin), which did not support the Authority's Draft Decision that a waiver should be granted.

However, the Authority was not persuaded by Origin's arguments that granting the waiver would have an affect on NEM prices and investment in generation assets or that it would create an undesirable precedent.

As no new other information on the use of the grid-connected sites has emerged, the Authority has decided to maintain its position as reported in its Draft Decision and approve Ergon's waiver application in respect of its four existing grid-connected generation sites used for network support.

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 Code. 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, among other things, that the Authority may prepare and enforce conduct rules.

The Authority's Ring-fencing Guidelines were released in September 2000. The objective of the Guidelines 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 activities where the costs imposed by complying with the Guidelines might outweigh the benefits, or any likely benefits, to the public. Accordingly, the Authority included a provision whereby the DNSPs could apply to have certain obligations waived.

3. RING-FENCING GUIDELINES 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 Guidelines. 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 of the Guidelines. These obligations are reproduced at Appendix A.

3.2 Ergon's Waiver Application

The ring-fencing 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 Guidelines define "related business" as the business of producing, purchasing or selling electricity.

4. ASSESSMENT

4.1 Background

On 1 October 2003, Ergon Energy Corporation Limited (Ergon) applied to the Authority for an exemption from section 1(b) of the Authority's Ring-fencing Guidelines in respect of the requirement for Ergon not to carry on a related business within the legal entity of the DNSP. Ergon sought the waiver in respect of its ownership of existing and future network support grid-connected generation.

The grid-connected generation sites used for network support are generation assets owned and operated by Ergon solely for the purpose of augmenting the existing distribution network used to supply prescribed distribution services. A list of the four grid-connected generation sites identified by Ergon in its application is provided at Appendix B.

A notice was placed in the *Courier Mail* and *Australian Financial Review* calling for public submissions on the proposal by no later than 17 November 2003. The Authority did not receive any submissions in response to these advertisements.

Under section 21 of the Ring-fencing Guidelines, 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.

4.2 Ergon's Supporting Arguments

In support of the argument that a waiver should be granted, Ergon claimed that:

- the Code permits the use of generation as an alternative to augmenting the distribution network;
- it can be technically and economically more efficient to operate generation sites, as opposed to augmenting the existing network, in order to provide reliable performance of its long rural distribution feeders;
- the Electricity Act and Electricity Regulations provide that Ergon may use generation sites in order to fulfil its obligation of ensuring electricity supply;
- grid-connected generation sites used for network support are not used for entering either the generation or retail markets and have no impact on the National Electricity Market; and
- there are significant costs associated with establishing a separate legal entity in which to house grid-connected generation sites. Irrespective of where these services are legally housed, there is no offsetting public benefit. Therefore, the costs outweigh the benefits of requiring grid-connected generation sites to be housed under a separate legal entity.

In closing its argument, Ergon stated:

that this Waiver application is reasonable on the grounds that the extra costs, bureaucracy and complexity to remove Network Support Grid-Connected Generation into a separate legal entity to the one that is providing prescribed distribution services (ie EECL) is not commensurate with the benefits to be derived (if any) to the public and that the use of these assets by a distribution network service provider complies with the provisions and intent of the Code and the Queensland legislation.

4.3 Draft Decision

Following consideration of the Ergon application, the provisions of the Authority's Ring-fencing Guidelines, the Electricity Act 1994 and the National Electricity Code (the Code), the Authority released a Draft Decision on 15 December 2003 indicating its intention to issue a notice under section 21 of the Ring-fencing Guidelines to waive Ergon's requirement to comply with ring-fencing obligation section 1(b) of the Guidelines in respect of its four existing grid-connected generation sites used for network support.

In its Draft Decision, the Authority indicated that it 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 eliminate incentives to undertake anti-competitive behaviour. However, the Authority considered that each case should be judged on its merits.

Having considered Ergon's arguments, the Authority accepted that Ergon would incur some administrative costs in complying with the requirement that its grid-connected generation sites used for network support be housed in a separate legal entity. While these costs would not be substantial in terms of the overall costs of the distribution business, they would ultimately be reflected in distribution tariffs.

The Authority also found that the public benefit in requiring these sites to be housed in a separate legal entity was not apparent. The grid-connected generation sites are not being used by Ergon to enter either the generation or retail markets and, as a result, are unlikely to have any impact on the competitive outcomes in these markets to the public detriment. Rather, the generation assets are being used solely in the supply of prescribed distribution services. The Authority concluded that requiring Ergon to establish a separate legal entity appeared to have no public benefit to offset Ergon's administration compliance costs.

Moreover, it was considered likely that Ergon's choice to utilise network support generation in these remote locations in preference to augmenting the network would reduce potential costs to consumers.

The Authority noted that, if the waiver was granted, Ergon's grid-connected generation sites used for network support would remain subject to all other aspects of the Ring-fencing Guidelines.

Ergon's waiver application extended to all future grid-connected sites used for network support as well as existing sites. The Authority considered that there could be risks in providing an open-ended approval to operate grid-connected generation sites in the future, as there was no guarantee that such sites would operate along the same lines as those subject to this waiver application. Consequently, the Authority proposed that the waiver would be approved only for the four existing grid-connected generation sites identified in the application.

4.4 Submissions in Response to Draft Decision

Submissions were sought on the Draft Decision by no later than 23 January 2004. One submission was received, from Origin Energy, which did not support the Authority's Draft Decision that a waiver should be granted. Origin maintained that NEM prices and investment in generation assets would be affected by the existence of Ergon's grid-connected sites. In its view, effective ring-fencing (including the application of the subject provision) is required because of the scope for cost shifting (cross-subsidisation) between Ergon's generation and distribution activities.

Origin's argument that NEM prices and investment in generation assets could potentially be affected by the existence of Ergon's grid-connected sites assumes that, if these sites did not exist, retailers would have to buy more electricity from the NEM. However, Ergon's alternative to network support generation in these remote locations is to spend significant sums augmenting the long rural distribution feeders on its network to ensure a reliable supply of (an unchanged quantity of) electricity. Despite electricity to customers in these locations at times being supplied or supplemented from Ergon's network support generators (the network support generators only run when the distribution system is under stress or physically damaged), the Authority understands that market settlement occurs as if the customer had been supplied entirely from the NEM. This is transparent to customers who receive the same quantity of electricity and pay the same price to their retailer as if all their power had been purchased from the NEM.

Ergon's argument that the use of grid-connected sites for network support is a more cost effective alternative to augmenting its distribution network is reasonable and is supported by the Code and Queensland electricity legislation.

Origin also argued that the granting of a waiver in this case would establish a precedent for future (potentially more significant) waiver applications. In Origin's view, the market-wide benefits of a consistent and unambiguous application of the Authority's Ring-fencing Guidelines outweighed the costs in this case.

However, this argument fails to recognise that, by limiting the waiver to Ergon's four existing grid-connected sites used for network support only (and explicitly declining the request to extend the waiver to future similar activities), the Authority is reserving itself scope to revisit its decision if the purpose of Ergon's grid-connected sites changes or if the purpose of future sites is different to those currently being considered. By its explicit rejection of the proposed extension of the waiver to cover future similar activities, the Authority has made clear its intention that this decision should not be seen as creating a precedent for future applications.

5. FINAL DECISION

As the Authority has not been persuaded by Origin's arguments, and no new information on the use of the grid-connected sites has emerged, there is no reason to change the Authority's position outlined in its Draft Decision. Consequently, this Final Decision incorporates the Authority's position as reported in its Draft Decision.

The Authority's Final Decision (issued in accordance with section 26 of the Ring-fencing Guidelines) is to issue a notice under section 21 of the Ring-fencing Guidelines to waive Ergon's requirement to comply with ring-fencing obligation section 1(b) of the Guidelines in respect of the four grid-connected generation sites used for network support identified in Appendix B.

This decision does not extend to any future grid-connected generation sites.

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.
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.

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

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**Grid-connected generation sites used for network support**

Location	Network	Size
Winton	National Grid	1,300 kW
Cooktown	National Grid	4,500 kW
Dajarra	Mt Isa/Cloncurry	250 kW
Kajabbi	Mt Isa/Cloncurry	150 kW