



Issues Paper

---

**Ring Fencing for Electricity  
Distribution Entities**

---

*July 1999*

## SUBMISSIONS

The Queensland Competition Authority (the Authority) considers public involvement to be an important element of its decision making processes. It therefore invites submissions from interested parties concerning its investigations into the issue of ring fencing with respect to electricity distribution networks.

To facilitate the publication of submissions on the QCA's website, it is preferred if submissions could be made electronically by disk or by email. However, if this is not possible, submissions can be made in writing.

**Submissions, comments or inquiries** regarding this paper should be directed to:

Queensland Competition Authority  
GPO Box 2257  
Brisbane QLD 4001

Telephone: (07) 3222 0504  
Fax: (07) 3222 0599  
Email: [electricity@qca.org.au](mailto:electricity@qca.org.au)

The **closing date** for submissions is **Friday 21 August 1999**.

### Confidentiality

In the interests of transparency and to promote informed discussion, the Authority would prefer submissions to be made publicly available wherever this is reasonable. However, if a person making a submission does not want that submission to be public, that person should claim confidentiality in respect of the document (or any part of the document). Claims for confidentiality should be clearly noted on the front page of the submission and the relevant sections of the submission should be marked as confidential, so that the remainder of the document can be made publicly available. Again, it would be appreciated if each version (ie. the complete version and another excising confidential information) could be provided electronically (whether or not with a printed copy). Where it is unclear why a submission has been marked "confidential", the status of the submission will be discussed with the person making the submission.

While the Authority will endeavour to identify and protect material claimed as confidential as well as exempt documents (within the meaning of the *Freedom of Information (FOI) Act 1989*), it cannot guarantee that submissions will not be made publicly available. As stated in s187 of the *Queensland Competition Authority Act 1997*, the Authority must take all reasonable steps to ensure the information is not disclosed without the person's consent, provided the Authority is satisfied that the person's belief is justified and that the disclosure of the information would not be in the public interest.

### Public access to submissions

Subject to the above, submissions will normally be made available for public inspection at the Brisbane office of the Authority, or on its website at [www.qca.org.au](http://www.qca.org.au).

Information about the role and current activities of the Authority, including copies of reports, papers and submissions can also be found on the Authority's website.

*Queensland Competition Authority  
Level 19, 12 Creek Street  
GPO Box 2257  
Brisbane QLD 4001*

*Tel: (07) 3222 0555  
Fax: (07) 3222 0599  
Internet: [www.qca.org.au](http://www.qca.org.au)*

## TABLE OF CONTENTS

	PAGE
<b>1. INTRODUCTION</b>	<b>1</b>
<b>2. STRUCTURE OF THE QUEENSLAND ELECTRICITY MARKET</b>	<b>3</b>
<b>3. RING FENCING UNDER THE NATIONAL ELECTRICITY CODE</b>	<b>5</b>
<b>4. OBJECTIVE AND PRINCIPLES OF RING FENCING</b>	<b>8</b>
4.1 What is ring fencing and why is it important?	8
4.2 Objectives of ring fencing	8
4.3 Principles of ring fencing	9
<b>5. APPROACHES TO RING FENCING</b>	<b>11</b>
5.1 Accounting separation	11
5.2 Controls over information flows	12
5.3 Legal separation	12
5.4 Ownership separation	13
<b>6. APPROACHES ADOPTED IN OTHER JURISDICTIONS</b>	<b>14</b>
6.1 Office of the Regulator General (ORG), Victoria	14
6.2 Independent Pricing and Regulatory Tribunal (IPART), NSW	14
6.3 Australian Competition and Consumer Commission (ACCC)	15
6.4 New Zealand	16
<b>7. ISSUES</b>	<b>17</b>
7.1 Choice of ring fencing methodologies	17
7.2 Consistency between jurisdictions and across markets	18
7.3 Use of alternative regulatory tools	18
7.4 Definition of regulated services	19
<i>Attachment A: Consultation Processes Under the National Electricity Code</i>	<i>21</i>
<i>Attachment B: Matters to Consider in Determining Prescribed Services</i>	<i>22</i>

## 1. INTRODUCTION

The Queensland Competition Authority (the QCA or the Authority) is a statutory body established under the *Queensland Competition Authority Act 1997* (the Act). The Act gives the Authority certain responsibilities and functions with respect to National Competition Policy (NCP). Broadly, these include:

- subject to reference or declaration by the Ministers (the Premier and the Treasurer), undertaking prices oversight of monopoly or near monopoly Government business activities;
- receiving and investigating competitive neutrality complaints against significant Government and local government business activities;
- accrediting significant Government and local government business activities as complying with the principle of competitive neutrality;
- overseeing and arbitrating third party access to infrastructure; and
- undertaking such other activities relating to NCP as the Ministers may direct.

The Authority's responsibilities with respect to electricity are set out in:

- 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 Minister for Mines and Energy; and
- the *Electricity – National Scheme (Queensland) Act 1997*, which commenced on 22 May 1997 and gives effect to the National Electricity Code. The Code sets out the objectives for the National Electricity Market and 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, to prepare ring fencing guidelines and to undertake several other roles eg. with respect to network connection.

Chapter 6 Part G of the National Electricity Code states that Distribution Ring Fencing Guidelines must be developed by each Jurisdictional Regulator, in consultation with the Australian Competition and Consumer Commission (ACCC) and other Jurisdictional Regulators. These Guidelines must provide for the accounting and functional separation of prescribed distribution services from other services provided by Distribution Network Service Providers (DNSPs). The Code states that the QCA is the Jurisdictional Regulator for Queensland for the purpose of the preparation of these Guidelines, while the ACCC is tasked with preparing Transmission Ring Fencing Guidelines.

The Code also indicates the issues that the Guidelines may cover, including legal separation, accounting requirements, allocation of costs, and limits on information flows. A range of matters that each Jurisdictional Regulator is required to consider is also provided, including the need for consistency between jurisdictions and between Transmission and Distribution Ring Fencing Guidelines.

The Code requires that certain consultative processes must be followed in preparing the Guidelines, including consultation with participating jurisdictions, Code participants and other interested parties (see Attachment A). In this regard, the Authority desires to provide an opportunity for distribution entities, their customers and other stakeholders to participate constructively and at an early stage in the development of the regulatory regime for distribution entities. The aim of this Issues Paper is therefore to present a range of issues that relate to the

preparation of the Distribution Ring Fencing Guidelines, with a view to seeking submissions from interested parties.

Following consideration of submissions and meetings with interested parties where appropriate, the Authority will prepare and publish draft Distribution Ring Fencing Guidelines which will be available to all consulted persons, setting out its conclusions and any determinations it has made, the reasons for those conclusions and procedures followed in considering ring fencing issues. Following consideration of any further issues raised by stakeholders, it is envisaged that final Distribution Ring Fencing Guidelines will be published later this year.

## 2. STRUCTURE OF THE QUEENSLAND ELECTRICITY MARKET

Until recently, the structure of Queensland's electricity industry was characterised by full integration, with the Queensland Electricity Commission responsible for delivering a bundled product combining generation, transmission, distribution and retailing services. Tariffs were determined by the Government, and exclusive franchise and licensing arrangements prevented competition.

With recent restructuring, the electricity industry has been separated into generation, transmission, distribution, and retailing functions. Competition has been progressively introduced into those elements of the industry that were considered to be contestable, ie. generation and retailing, with a view to improving efficiency and lowering prices.

In generation, existing capacity was split into three competing entities and licensing arrangements were introduced to allow new generating capacity to be privately built while ensuring that basic conditions (eg. safety) were met.

In transmission and distribution, one entity, Powerlink, now operates the high voltage transmission network in Queensland, while two distribution entities operate all local distribution networks. These entities undertake the physical task of transmitting electricity from the generator to the end consumer. Of the two distribution entities, Energex operates distribution networks in south east Queensland. From 1 July 1999, a second entity, Ergon, has operated distribution networks across the remainder of Queensland.

Both existing distribution entities in Queensland now have separate but subsidiary retailing operations. The role of retailers in the market is to undertake financial or risk management functions, such as trading in the wholesale market and offering different price/service packages to consumers.

In terms of existing ring fencing arrangements, the retailing subsidiaries of the distribution entities have been created through legislation and are owned by the State Government. As statutory Government Owned Corporation subsidiaries, they must still abide by certain provisions of the *Government Owned Corporations Act* in terms of reporting requirements and so on, as they constitute separate legal entities. Beyond this, there are no formal legislative or regulatory requirements to separate these retailing entities from their parent distribution entities.

The retailing subsidiaries of Energex and Ergon were initially given exclusive franchises to retail in specified geographic areas. However, licences for retailing have now been opened up to allow new retailers into the market, while at the same time franchises granting exclusive retailing rights to incumbent retailers have been progressively phased out through the introduction of customer contestability.

Up until 1 July 1999, 473 customers were eligible to change supplier. Of these, as at April 1999, 78 had switched, while a further 178 had renegotiated contracts with their existing supplier. Since 1 July, a total of approximately 6800 of Queensland's almost 1.5 million electricity customers now have choice of supplier. However, if these customers elect to change supplier, they can no longer return to the franchise tariff, which is still determined by the Minister for Mines and Energy. All remaining non-contestable customers are scheduled to become contestable in January 2001.

A number of other retailers are now operational in the Queensland market, including Citipower, Powercor, NorthPower and Boral. Several of these are owned by integrated energy companies which also have electricity distribution assets in Victoria and New South Wales, although are not affiliated with any distribution entities in Queensland. Various other retailers, including

Queensland's three major generating entities have been licensed but are not currently operating in the market.

In summary, at present in Queensland there are:

- 29 entities that have generating authorities;
- one entity with a transmission authority;
- two entities with distribution authorities;
- two entities with retail authorities and an associated geographic retail area where each has responsibilities for supply of electricity to non-contestable customers. These are wholly owned subsidiaries of the distribution companies;
- 19 entities with retail authorities without a retail area; and
- 54 special approvals issued to various entities for particular activities with respect to generation, transmission, distribution, operation of particular electricity lines, connection, and the supply and sale of electricity.

### 3. RING FENCING UNDER THE NATIONAL ELECTRICITY CODE

The Authority's responsibilities for developing Distribution Ring Fencing Guidelines are derived from Chapter 6 of the National Electricity Code (the Code). In particular, the Authority's task is defined by the following statements in the Code:

- all transmission and distribution network service providers must comply with the relevant Ring Fencing Guidelines;
- Transmission Ring Fencing Guidelines, for the accounting and functional separation of prescribed services (those determined by the regulator not to be contestable) provided by transmission service providers, must be prepared by the Australian Competition and Consumer Commission (ACCC) in consultation with other Jurisdictional Regulators (such as the QCA);
- Distribution Ring Fencing Guidelines, for the accounting and functional separation of prescribed services (those determined by the regulator as being subject to regulation) provided by distribution service providers, must be prepared by each Jurisdictional Regulator in consultation with the ACCC and other Jurisdictional Regulators;
- these Guidelines may include, but are not limited to, provisions for:
  - legal separation of a network services entity from any other entity through which it conducts business;
  - the establishment and maintenance of consolidated and separate accounts for prescribed services and other services provided by network service providers;
  - allocation of costs between prescribed services and other services provided by network service providers;
  - limitations on the flow of information between network service providers and any other person;
  - limitations on the flow of information where there is the potential for a competitive disadvantage; and
  - the relevant regulator to add to or waive a network service provider's obligations under the Guidelines;
- in developing Ring Fencing Guidelines, the ACCC and Jurisdictional Regulators are to consider, but are not limited to, the following matters:
  - the need for consistency in Distribution Ring Fencing Guidelines between participating jurisdictions;
  - the need for consistency with Federal and State regulation in each participating jurisdiction of ring fencing requirements for other utilities;
  - the need for consistency between Transmission and Distribution Ring Fencing Guidelines; and
  - the need for Distribution Ring Fencing Guidelines to be consistent with the arrangements for the retailer of last resort for that jurisdiction;

- in developing Ring Fencing Guidelines, the ACCC and each Jurisdictional Regulator must consult with participating jurisdictions, Code participants and other interested parties; and
- for the purposes of this part of the Code, the Queensland Competition Authority is the Jurisdictional Regulator.

Under the Code, Jurisdictional Regulators are therefore to focus on ring fencing at the distribution level, with specific requirements to ring fence prescribed services provided by DNSPs and to consider various structural, accounting and information issues.

The Authority's task is therefore to:

- define those distribution services provided by DNSPs that should constitute prescribed services; and
- ensure these services are effectively ring fenced from other services provided by DNSPs.

According to the National Electricity Code:

- a *Distribution Network Service Provider* is defined as a person who engages in the activity of owning, controlling, or operating a distribution system;
- *distribution services* are defined as the services provided by a distribution system which are associated with the conveyance of electricity through the distribution system, and include entry services, distribution network use of system services and exit services; and
- *prescribed* distribution services are defined as those distribution services provided by distribution network assets or associated connection assets which are determined by the regulator as being subject to economic regulation.

The Code requires that a Jurisdictional Regulator, in determining prescribed distribution services, must have regard to a range of matters (see Attachment B), including:

- the principles for regulation outlined in the Code;
- the extent of effective competition in the provision of that distribution service;
- whether sufficient competition exists to warrant the application of a regulatory approach which is more light handed than the CPI-X form outlined in the Code;
- the effectiveness of the form of economic regulation specified in the Code in achieving the efficiency objectives of the Code; and
- the form, if any, of that regulation.

In summary, prescribed distribution services are those provided by DNSPs that may be considered to have monopoly characteristics, ie. be considered non-contestable, and accordingly are to be subject to economic regulation under the Code. How prescribed services are defined for the purposes of ring fencing will form the first step in the Authority's review of distribution pricing, as this will determine which services are to be subject to price regulation.

Distribution services which are not prescribed are deemed to be *excluded* distribution services. Costs and revenues for excluded distribution services are excluded from the revenue cap or price cap which applies to prescribed distribution services. The Jurisdictional Regulator must determine the form of regulation (if any) which is to be applied to excluded distribution services.

While the task of ring fencing is generally taken to mean ring fencing of distribution services *from retailing services*, the Code does not specifically state this. The requirements of the Code relate to ring fencing of prescribed distribution services provided by a DNSP from other services it provides.

Consequently, where retailing services are provided by the DNSP (or a related business), the Authority can address this through Distribution Ring Fencing Guidelines. Similarly, where the DNSP provides any other services that do not constitute prescribed distribution services (whether contestable or non-contestable), the Distribution Ring Fencing Guidelines can require ring fencing of these services.

## **4. OBJECTIVE AND PRINCIPLES OF RING FENCING**

There are a number of different approaches to ring fencing that the Authority will need to choose between. These approaches, outlined in detail in section 5, range from accounting separation to the establishment of separately owned entities. However, because each approach has various advantages and disadvantages, there is no single perfect answer to ring fencing. Given this, the choice of approach will largely depend on the objective or outcome desired from ring fencing, as well as the principles that govern how the decision will be made.

### **4.1 What is ring fencing and why is it important?**

In its simplest form, ring fencing can be considered as some form of separation of various elements of a business. This allows rivals to compete in some segments of the market previously protected from competition through their integration with other elements.

In Australia, electricity supply has traditionally been performed by integrated monopoly businesses, from generation through to transmission, distribution, retail supply and ancillary services. Most aspects of these monopolies were regulated through various means, including ownership by State Governments.

More recently, the structure of the industry has undergone major change, being separated into different businesses. This has allowed the entry of new participants and increased competition in elements of the market that may be contestable, such as retailing.

In creating these new and contestable markets, it is important that the separation of monopoly and contestable functions is effective. This will ensure that new players in the contestable elements of the market can compete on a fair and equal basis, without fear that vertically integrated incumbents will be able to gain a competitive advantage. In stipulating the rules that enforce separation, ring fencing is therefore critical to the development of the market in terms of encouraging competition.

Further, if ring fencing is successful in separating monopoly elements of the industry from contestable functions, this should alter the incentives faced by the “monopolist”. Incentives to maximise sales to spread high fixed costs across as many users as possible will be increased, and incentives to try and exploit monopoly power by favouring one retailer over another will be reduced.

### **4.2 Objectives of ring fencing**

In Queensland, the issue of ring fencing arises mainly because there is joint ownership of distribution entities and some retailers. There may also be other elements of the distribution businesses that are contestable, which it may be desirable to ring fence from distribution services.

The existence of relationships between contestable and non-contestable businesses creates a number of potential problems. Primarily:

- there is an incentive for the aggregated entity to have as many of the expenses of a contestable business included in the cost base of the regulated monopoly business as possible;
- incentives exist for the profits of the aggregated entity to be shifted from the regulated activities of the firm to the contestable activities; and

- there is the potential and incentive to share specific information that can commercially advantage both contestable and non-contestable activities.

Overcoming these potential problems is fundamental to the objective of the ring fencing exercise.

In addition, the focus of developing Distribution Ring Fencing Guidelines should be on delivering improved outcomes from what would be expected in their absence. The objective should therefore explicitly relate to the market price, quantity, and quality of electricity and distribution services.

Taking these factors into account, the objective of the ring fencing guidelines is to engender a commercial environment where the price, quantity and quality of electricity traded in the retail market and the distribution services used to deliver the energy are not uneconomically biased by the vertical integration of distribution and other businesses.

### 4.3 Principles of ring fencing

Ring fencing constrains the commercial behaviour of a firm by requiring particular forms of conduct. As such, it is an inherently intrusive activity. Through ring fencing, the regulator, either implicitly or explicitly, provides the business with an organisational structure. In addition, monitoring compliance with ring fencing will mean that the regulator will require ongoing information about the operations of the business.

The degree of structural change required and the extent to which ring fencing intrudes upon normal business activities will vary depending on the approach adopted. While accounting separation, for example, may have a relatively low impact on the structure of the firm, it could potentially require a significant level of detail to be provided to the regulator in terms of ongoing operations of the business, resulting in a higher level of intrusiveness. By contrast, ownership separation is likely to require significant restructuring of the firm upfront, but far fewer (if any) ongoing rules or detailed knowledge of the operations of the business by the regulator, and could therefore be considered less intrusive.

Any requirement for structural change in a firm being regulated is therefore likely to involve significant upfront costs and disruption to the business. By comparison, the higher the degree of intrusiveness in terms of the day to day operations of the business, the greater the role of the regulator in “running” the business and the greater the regulatory risk to the firm, industry and market.

- The first principle for evaluating alternative ring fencing arrangements is to weigh up the benefits of structural change, with potentially higher upfront costs, versus ongoing intrusiveness, which has potentially greater ongoing costs.

Even where ring fencing provides a net benefit, ie. results in better overall performance of the market, it will impose net costs on some individual participants in the market. To the extent that the Distribution Ring Fencing Guidelines impose a burden on individual participants, these costs need to be compared to the expected benefits to arrive at the best outcome from the perspective of the community as a whole.

- A second principle for evaluating alternative ring fencing arrangements is to measure the costs and benefits to individual participants in the market.

Ring fencing presumes that the costs of market failure (ie. the abuse of market power stemming from vertical integration) outweigh the potential costs of government failure (ie. the imposition of a regulatory framework that may lead to worse outcomes). Government intrusion into the commercial activities of market participants may have unintended consequences that negate the direct benefits of such intervention.

- A third principle for deciding among alternative approaches to ring fencing is to evaluate the potential for unintended consequences from regulatory intervention.

The final recommended principle is that, all other things equal:

- the Guidelines themselves should be as simple, clear and easy to administer as possible.

## 5. APPROACHES TO RING FENCING

The objective and principles of ring fencing outlined above provide guidance as to how to consider the range of possible approaches to ring fencing that may be adopted. Possible approaches include accounting separation, controls over information flows, separation of the various elements of the business, and ownership separation. In practice, various combinations of these options may also be employed.

As noted earlier, accounting separation and information controls in themselves may be seen as having less impact on the structure of the businesses being regulated, but often require significant detail to ensure appropriate compliance. In contrast, legal separation will have a greater impact on the business structure of the regulated entities, and detailed ongoing requirements may be commensurately less. Ownership separation, by requiring that the separated entities be owned by and report to completely different shareholders, is effectively a substitute for ring fencing requirements, as it removes the incentive for bias by removing all aspects of integration.

In Queensland, legal separation has already been effected between the distribution and retailing functions of the two major electricity entities, Energex and Ergon. However, legal separation in itself is unlikely to be sufficient in terms of ring fencing requirements to ensure that market outcomes are not biased by the (still) integrated structure of these businesses. Additional requirements, relating to accounts or information flows, may also be required.

### 5.1 Accounting separation

Accounting separation requires that separate sets of accounts be prepared for prescribed services, as identified by the regulator. Accounting separation can be strict or more flexible, depending on the detail specified by the regulator eg. reporting requirements may be either very specific or very broad, acceptable cost allocation methodologies may be determined upfront by the regulator or the onus may be placed on the firm to demonstrate the effectiveness of its cost allocation processes, and so on.

Requirements under accounting separation may include:

- financial statements must be disaggregated between prescribed (or regulated) and non-prescribed services;
- information contained within financial statements for prescribed services must come from audited financial statements of the total business;
- financial statements for prescribed services must be audited before submission to the regulator, and must be accompanied by a Directors' Responsibility Statement;
- costs must be allocated based on cause, or if this is not possible, the basis of allocation must be outlined;
- the rationale and explanations for any forecasts must be included;
- forecasts must be updated regularly where there are unforeseen changes in circumstances;
- assets must be valued according to a particular methodology (eg. DORC), and may be periodically revalued to include or exclude particular assets;
- depreciation must be accounted for in a particular manner (eg. must reflect the change in economic value of assets); and

- transactions above a specified limit may be determined as material and required to be separately disclosed.

This approach aims to ensure that there is adequate ring fencing between distribution and contestable entities through transparency of accounts, which must demonstrate that revenues are related to costs associated with each of these businesses.

The major benefit of this approach is that it is relatively straightforward, as the focus is only on accounting issues rather than information flows and structural issues. In addition, accounting separation is generally considered a minimum requirement for ring fencing. The level of detail required will obviously affect the level of intrusiveness and the ongoing costs of compliance.

## 5.2 Controls over information flows

This form of ring fencing involves imposing limits on the sharing of information between related businesses in order to minimise any potential competitive advantages that the monopoly business can provide to any related businesses. Alternatively, requirements to publish certain information, or make information available to all retailers or related contestable businesses on an equal basis, may be used.

Information flows can be controlled by a number of means including requiring:

- that staff employed by the monopoly business are not also working for a related business;
- that communication between staff of the monopoly business and other related business is limited to certain matters;
- the regulated business is to be physically located in separate premises;
- all parties related to the regulated entity are to be notified to the regulator (eg. those subject to control by the regulated entity, those subject to control by the same entity that controls the regulated entity, any Director of the regulated entity or a related entity);
- transactions between regulated entities and related parties are to be disclosed, including for example details of magnitude and price;
- transactions that relate to financing are to be disclosed;
- Directors of regulated entities must not be Directors of related businesses; and
- specified electronic and physical security measures must be met.

While each of these measures can assist in mitigating the potential for a competitive advantage to be conferred on a related business, the costs of implementing them may be high and they are likely to prove difficult to enforce. In particular, the monitoring of numerous transactions and various security measures will be time consuming and involve ongoing costs to the regulator and the business.

## 5.3 Legal separation

Legal separation requires that the monopoly and contestable functions be separately located in legal entities under Corporations Law, as is required under the Gas Code. This requirement still permits monopoly and contestable businesses to be both owned by a holding company, or contestable businesses to be subsidiaries of the monopoly business. As noted earlier, legal separation for Queensland distribution businesses has been effected in terms of the retailing

function. However, it is possible that there are additional contestable elements within distribution businesses which could be established as separate legal entities.

Legal separation allows the regulator to more clearly identify the services and assets associated with monopoly and contestable functions. It also requires the monopoly and contestable businesses to enter into more formal contractual and reporting arrangements, and as a consequence requires each business to better identify their respective roles. Specifically, the relationship between the monopoly and contestable businesses would become more transparent, with commensurate benefits from having the clearest possible separation of the businesses and an additional benefit of less ongoing regulatory intervention. However, legal separation in itself is unlikely to be sufficient in terms of ring fencing requirements to ensure that market outcomes are not biased, given there is still common ownership and (usually) some common board membership.

#### **5.4 Ownership separation**

Ownership separation requires that the regulated business and related businesses have completely separate ownership structures. The regulated business must divest itself of unregulated business activities under this model.

This approach provides the clearest possible incentive for the regulated business to operate independently of other businesses in the market, and requires minimal, if any, ongoing ring fencing regulation. Conversely, it also has the greatest costs in terms of structural adjustment, and has the greatest potential for efficiency losses as a result of losing synergies between related businesses that cannot be captured through contracting.

## 6. APPROACHES ADOPTED IN OTHER JURISDICTIONS

### 6.1 Office of the Regulator General (ORG), Victoria

The approach adopted by the ORG focuses on accounting separation. In establishing ring fencing requirements, the ORG defines the distribution business according to its activities and not the structure it adopts through incorporation.

ORG's position is articulated in its *Electricity Industry Guideline 3: Regulatory Information Requirements* that sets out strict accounting reporting requirements for distribution companies, including the provision of:

- Regulatory Accounting Statements, which must contain the entirety of the regulated business including eliminating non-distribution business costs, incorporating all directly attributable costs, and allocating joint and common costs on an appropriate basis;
- any Regulatory Accounting Principles and Policies that may have been used to prepare the Regulatory Accounting Statements (for example cost allocation methodologies); and
- any change, including reasons for and effects of the change, since the preceding Regulatory Accounting Statements were prepared.

Other major points from the ORG approach include:

- historical cost accounting principles shall be used to determine fixed asset balances, adjusted for CPI, with no asset revaluations permitted. Depreciation is to be on a straight line basis. Customer contributions to the asset base must be disclosed;
- an objective and independent audit of accounts is required, through a tripartite contract between the ORG, the distribution licensee and the auditor. The ORG is to formally approve the audit firm selected, which may be engaged for a period not exceeding five years and may not perform any other fee earning work for the licensee during that period;
- transactions between different segments of the distribution business must not be netted off, and should be separately disclosed; and
- a revenue analysis must be provided by tariff category, a requirement that complements the requirements of the forthcoming distribution pricing review.

### 6.2 Independent Pricing and Regulatory Tribunal (IPART), NSW

While IPART is yet to release formal ring fencing guidelines, there are a number of regulatory and legislative mechanisms in place aimed at enforcing accounting separation and preventing cross subsidisation between distribution and retail companies. These include:

- licensing requirements for electricity distributors and retail suppliers (set out in the Guidelines and Requirements Policy developed by the NSW Department of Energy). These require the separation of operational affairs from other affairs of the licensed electricity distributor, through compliance with an Accounting Separation Code of Practice that is approved by IPART. Licensing requirements also include provision for cost allocation and dispute resolution;

- the IPART *Accounting Separation Code of Practice for Electricity Distributors in NSW*. This sets out the principles for the accounting separation and reporting requirements of designated NSW electricity distributors with the primary objective of ring fencing, in an accounting sense, the network and franchise retail businesses. This aims to ensure transparency of cost allocation between regulated and unregulated business segments; and
- *Regulatory Information Requirements and Guidelines for Electricity Distributors in NSW* developed by IPART. The guidelines are being developed by IPART to support the Accounting Separation Code. Specifically, the guidelines provide a practical format for the collection, allocation and recording of business data by the distribution businesses. Under the guidelines a distributor must provide Regulatory Accounting Statements which must be consistent with the Accounting Separation Code and comply with Australian Accounting Standards where applicable. The Regulatory Accounting Statements and supporting schedules should be subject to an auditor's opinion. The guidelines are currently in draft form.

### 6.3 Australian Competition and Consumer Commission (ACCC)

On 27 May 1999, the ACCC released a draft *Statement of Principles for the Regulation of Transmission Revenues* under the National Electricity Code. This Statement details the ACCC's draft approach to a range of issues in electricity transmission, including asset valuation, rate of return, benefit sharing, service standards, information requirements and ring fencing.

The Commission's objective in developing the ring fencing Guidelines within the *Draft Regulatory Principles* has been to attempt to reinforce the effectiveness of the regulatory process by limiting the ability of the transmission networks to extend their monopoly powers from the network business into the contestable parts of the industry. In general, the issues faced by the ACCC differ from those being addressed by Jurisdictional Regulators, as transmission entities are less likely to be associated with related contestable entities such as retailing businesses. However, the Statement also notes that it is possible that the networks of the future will grow into businesses quite unlike those of the past and will provide a range of contestable services.

The Commission has proposed to adopt ring fencing arrangements which are based on the requirements outlined in the National Third Party Access Code for Natural Gas Pipeline Systems. The Commission had retained the right to waive or add to ring fencing arrangements where the benefits of doing so outweigh the costs. It does not intend to publish specific accounting or auditing guidelines at this point in time, although the Statement itself does have information and reporting requirements which are pertinent to ring fencing.

In particular, the Statement requires that an entity that provides ring fenced services must:

- be a legal entity;
- not carry on a related business (ie. any activity other than the provision of prescribed services);
- establish and maintain separate accounts;
- allocate costs that are shared with non-regulated activities according to a methodology that accords with any guidelines that might apply; and
- ensure that staff of a ring fenced entity are not also staff of an associate, as defined under Corporations Law.

In terms of additional ring fencing obligations, the ACCC may require that:

- servants, consultants, contractors or agents of the transmission network service provider are not also servants, consultants, contractors or agents of an associate that takes part in a related business and, in the event that they are, ensure their immediate removal from their position with the transmission entity;
- at least one Director of a transmission network service provider is not also a Director of a company that takes part in a related business or is a Code participant or intending participant; and
- the electronic, physical and procedural security measures employed in respect of the offices of the transmission network service provider and all of the offices of its associates are satisfactory.

The ACCC approach therefore involves significant and detailed requirements relating to accounting separation and information flows as well as requiring legal separation.

#### **6.4 New Zealand**

Under the ring fencing requirements of New Zealand's *Electricity Industry Reform Act 1998*, corporate separation of lines and energy businesses was to be achieved by 1 April 1999, while full ownership separation is to occur by no later than 31 December 2003. There are no other ring fencing requirements in the New Zealand electricity market.

## 7. ISSUES

### 7.1 Choice of ring fencing methodologies

The Authority's choice of approach to ring fencing will need to weigh up the advantages and disadvantages of each option identified in this paper, including the possibility of some combination of options. In addition, consistency between jurisdictions and across the energy sector will need to be considered.

Accounting separation is favoured by ORG, and also forms part of the ring fencing requirements of the ACCC (which has placed greater reliance on information controls and structural and legal separation requirements).

Potential benefits of relying only on accounting separation include:

- greater flexibility in the market in terms of legal structures that can be adopted by distribution entities, retaining any potential efficiencies in terms of economies of scale or scope; and
- lower upfront costs in terms of implementation for regulated companies.

Possible drawbacks of this approach include:

- the reporting requirements impose significant costs on distribution entities, in that:
  - there is likely to be a need for fairly prescriptive regulatory requirements in terms of how the accounts are to be prepared, along with stringent auditing requirements;
  - in the ORG case, specification of experience and the requirement for auditors not to carry on any other work for the distribution entities may draw a premium from the auditing firm;
- costs may also be incurred if the legal structure adopted differs from that required by the regulator for reporting purposes; and
- this approach may be inadequate in deterring collusive behaviour between related entities.

The proposed ACCC approach involves a combination of accounting requirements, information controls (eg. in terms of involvement of Directors in different companies), and legal separation.

The potential benefits of this approach include:

- greater consistency with the provisions of the National Gas Code, which has the same minimum requirements specified by the ACCC (including legal separation);
- increased confidence in the effectiveness of the arrangements; and
- consistency between the approaches adopted for transmission and distribution.

Disadvantages of this approach potentially include:

- it is more difficult and costly to enforce, although in part these costs are borne upfront in setting up the requirements; and

- it is more prescriptive in terms of dictating market outcomes, leaving less scope for distribution entities to evolve as the market changes and therefore greater risk to the regulator that the entity being ring fenced has been correctly defined through the ring fencing requirements.

**Given that legal separation between retailing and distribution operations is already in place in Queensland, the Authority invites comment on the need for additional ring fencing requirements such as accounting separation/information controls, in terms of meeting its objective and in relation to the principles for ring fencing articulated in this paper.**

## 7.2 Consistency between jurisdictions and across markets

A further issue is the potential for inconsistency between the approaches by ORG, IPART and the ACCC, and any approach adopted by the Authority. To some extent, these issues are already material in the different approaches proposed by ORG and the ACCC. The choice for the Authority is to adopt one of the models put forward by these regulators, or pursue an alternative approach. In this sense, there may be some trade-off to be made between consistency with other jurisdictions and markets, and choosing the best approach.

Inconsistency could impose significant costs on regulated businesses, particularly as the national market develops. This occurs as the legal structure that must be adopted and the structures put in place to comply with regulatory requirements can potentially vary from state to state or across competing industries, raising the costs of compliance and creating a disincentive for entities to operate across jurisdictions. This is particularly relevant in Queensland, as there are a number of competing retailers already present in the market which are affiliated with distribution entities both in Queensland and interstate. Further, one participant in the Queensland market, Energex, also has significant interests in gas distribution.

**The Authority invites comment on the issue of consistency in approach to ring fencing between jurisdictions and across energy markets, versus the issue of choosing the best approach to ring fencing, which may result in different forms of regulation across related markets.**

## 7.3 Use of alternative regulatory tools

While ring fencing is the primary means of addressing any potential bias created by the vertical integration of distribution and other energy related businesses, there are other tools available to the Authority which may be used to address particular issues such as control of information flows and cost allocation. In particular, the Authority has responsibility for the preparation of conduct rules, which may deal with:

- curtailing interference with customers seeking to change retail entity;
- assigning responsibility amongst distribution entities, retail entities and customers, so that customers can change retailer quickly and at minimum cost;
- the charges that may be levied by a distribution entity or retail entity on customers changing retailer;
- ensuring that the advice distribution or retail entities give to customers to induce customers to change or not change retailer is accurate; and
- ensuring a retail entity with contestable and non-contestable customers does not assign costs from one to the other to the detriment of non-contestable customers.

A particular benefit of using conduct rules rather than Distribution Ring Fencing Guidelines to address any of the above issues is that these rules have their foundation in State legislation rather than the National Electricity Code. As a result, they can be applicable to retail entities, which are generally not Code participants.

In addition, the Authority will in the future have responsibility for distribution network pricing under Chapter 6 Part D of the National Electricity Code. The ring fencing exercise in effect forms the first part of this task, in defining those services to which pricing regulation will apply. In undertaking its pricing responsibilities, the Authority is required to consider issues such as:

- whether concerns over monopoly pricing could be addressed through the introduction of competition in distribution services;
- the creation of incentives for distribution network owners to increase efficiency; and
- which distribution services should be subject to economic regulation (see below).

Again, some aspects of the behaviour targeted by ring fencing may be mitigated by the approach to distribution pricing adopted by the Authority.

**The Authority invites comment on how its requirement to prepare Distribution Ring Fencing Guidelines for electricity distribution entities may be assisted by its other roles with respect to conduct rules and distribution network pricing, in achieving its objective of ensuring the market is not uneconomically biased by the vertical integration of distribution and other contestable businesses.**

#### 7.4 Definition of regulated services

The issue of what constitutes prescribed distribution services was discussed in section 3. From a ring fencing perspective, the question arises as to what services and/or assets have monopoly elements and should therefore be included in the definition of prescribed services, and what functions might be contestable if separated.

The various activities performed in the electricity market can be broadly divided into retailing, connection, transportation and information services. Retailing is already undertaken by legally separate entities.

In terms of the *retailing* function, the activities of a retailer might include:

- buying and selling of electricity;
- hedging of trading positions through financial markets;
- purchase of capacity and/or transport services from distribution entities;
- purchase of services such as metering, billing and connection from other service providers; and
- provision of services to end users, from direct sale of the commodity of electricity through to bundled products including services such as transport, interruptible supply, metering and connection.

In terms of *connection* of customers to the network, functions may include:

- installing connection lines between customers and the network;

- installation of meters;
- maintenance of these connection lines;
- maintenance of meters; and
- disconnection and reconnection to the network;

In terms of *transportation*, major functions potentially include:

- taking delivery of electricity at the input point/s of the network;
- delivery of electricity to customer meters;
- capital investment to augment or update the network;
- network maintenance;
- monitoring of the quality of electricity to meet prescribed standards; and
- management of electricity losses.

In terms of *information services*, functions could include:

- reading of meters;
- storage of meter and systems data;
- provision of metering data for reconciliation;
- billing; and
- settlement.

Of these services, prescribed services would be defined as those services with potential natural monopoly elements while those that are potentially contestable would be considered excluded distribution services.

How prescribed services are defined by the regulator in undertaking ring fencing will have important implications for the businesses in question. In particular, distribution businesses will face additional costs if the regulatory definitions of business elements are different from their own business structure.

**The Authority invites comment on the activities identified above in terms of their comprehensiveness, whether these may be considered potentially contestable or having monopoly elements, and whether these services should be defined as prescribed or excluded distribution services.**

**ATTACHMENT A****CONSULTATION PROCESSES UNDER THE NATIONAL ELECTRICITY CODE**

The National Electricity Code's requirements for consultation are set out in section 8.9, which states that:

- all Code participants and intending participants must be given a notice of the matters under consultation;
- the notice must invite written submissions;
- submissions may request a meeting with the Authority;
- submissions must be received by no later than the date specified, which must be at least 14 days after the notice is given;
- all valid submissions must be considered by the Authority within a period of not more than a further 30 days, with any meetings to be held with consulted persons within a further 14 days;
- following such meetings and consideration of submissions, the Authority must publish a report, available to all consulted persons, setting out the conclusions and any determinations it has made, its reasons for those conclusions and the procedures followed in considering the matter;
- subject to the confidentiality provisions outlined in section 8.6 of the Code, copies of any material submitted to the Authority must be made available to all consulted persons on request; and
- the Authority must not make a decision or determination in relation to any matter to which the Code consultation processes apply until it has completed all the procedures set out in section 8.9.

**ATTACHMENT B****MATTERS TO CONSIDER IN DETERMINING PRESCRIBED SERVICES**

Part G Section 6.20.2 (b) of the National Electricity Code provides that ring fencing guidelines must be developed by each Jurisdictional Regulator for the accounting and functional separation of the provision of prescribed distribution services by DNSPs from the provision of other services by DNSPs.

The Code glossary defines prescribed distribution services as those provided by distribution network assets or associated connection assets which are determined by the Jurisdictional Regulator as those which should be subject to economic regulation under clause 6.10.4 (a).

Clause 6.10.4 (a) provides that the Jurisdictional Regulator is responsible for determining which, if any, distribution services provided by a Distribution Network Owner or DNSP should be deemed to be prescribed distribution services and accordingly subject to economic regulation under clauses 6.10.3 and 6.10.5. In making this determination, the Jurisdictional Regulator is to have regard to:

- (1) the principles for regulation of distribution service pricing described in 6.10.3, which can be summarised as:
  - concerns over monopoly pricing will be addressed through the introduction of competition;
  - where pro-competitive and structural reforms alone are not practicable or adequate to address monopoly pricing, the form of economic regulation in 6.10.5 is to be applied (basically CPI-X);
  - the form of economic regulation to be applied must not be changed during a regulatory control period;
  - the regulatory regime to be administered by the Jurisdictional Regulator is to be consistent with the objectives outlined in clause 6.10.2 (which include an efficient and cost effective regulatory environment, efficiency in upstream and downstream investment, efficient use of existing infrastructure, and regulatory accountability through transparency), and must also have regard to factors such as incentives, energy storage, network augmentation, allocation of risk, a fair and reasonable rate of return, and certainty and consistency;
- (2) the extent of effective competition in the provision of that distribution service;
- (3) whether sufficient competition exists to warrant the application of a regulatory approach which is more light handed than the CPI-X approach outlined in 6.10.5;
- (4) the effectiveness of the form of economic regulation specified under clause 6.10.5 in achieving the efficiency objectives in clause 6.10.2; and
- (5) the form, if any, of that regulation.