



Western Australia

Economic Regulation Authority

Discussion Paper:

**Development of Ringfencing Rules
under the *Electricity Networks Access
Code 2004 (WA)***

**Economic Regulation Authority
Western Australia**

10 March 2005

Contents

1	Invitation to Make a Submission	3
2	Introduction and the Way Forward	4
2.1	Background	4
2.2	Purpose and Structure	4
2.3	The Way Forward	4
3	Overview	6
4	Current Industry and Regulatory Structure	10
4.1	Industry Structure	10
4.2	Relevant Legislation	12
4.3	Electricity Networks Access Code 2004	14
5	Nature and Objectives of Ringfencing Arrangements	16
5.1	Nature of Ringfencing	16
5.2	Approaches to Ringfencing	17
5.3	Activities Ringfencing Seeks to Control	18
5.4	Ringfencing Objectives in the Access Code	21
5.5	Making Ringfencing Rules under the Access Code	23
5.6	Costs of Ringfencing	24
6	Potential Ringfencing Rules	25
6.1	Application of Ringfencing Arrangements	25
6.2	Separating an Integrated Business	30
6.3	Non-Discrimination in the Provision of Goods and Services	36
6.4	Regulatory Accounting and Cost Allocation	38
6.5	Information Management	45
6.6	Compliance Monitoring and Reporting	47
6.7	Breaches of Ringfencing Arrangements	49
6.8	Timeframe for Introducing Ringfencing Rules	50
	Appendix 1 - Map of Western Australian Electricity Supply Network	51

1 INVITATION TO MAKE A SUBMISSION

The Economic Regulation Authority has prepared this Discussion Paper to assist interested parties in making submissions on ringfencing rules which may be introduced to apply to Western Power Corporation's networks business.

Submissions on any matters raised in this Discussion Paper, with particular reference to the questions posed throughout the document, should be in printed and electronic form and addressed to:

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Submissions should be received by **4pm Thursday 7 April 2005, Western Standard Time**.

In general, all submissions from interested parties will be treated as in the public domain and placed on the Economic Regulation Authority website. The receipt and publication of any submission lodged for the purposes of the *Electricity Networks Access Code 2004* (WA) shall not be taken as indicating that the Economic Regulation Authority has formed an opinion as to whether or not any particular submission contains any information of a confidential nature.

Where an interested party wishes to make a submission in confidence, it should clearly indicate the parts of the submission in respect of which confidentiality is claimed, and specify in reasonable detail the basis upon which the claim is made. Any claim of confidentiality will be considered in accordance with the provisions of section 14.14 of the *Electricity Networks Access Code 2004*.

Any questions concerning this Discussion Paper should be directed to Mr Alistair Butcher at the contact details above.

2 INTRODUCTION AND THE WAY FORWARD

2.1 BACKGROUND

In order to facilitate greater competition in the electricity supply industry, the Minister for Energy established the *Electricity Networks Access Code 2004 (Access Code)*, which came into effect on 30 November 2004. The Access Code provides a basis for third party access to electricity networks and seeks to promote economically efficient investment in, and use of, electricity networks to promote competition in upstream and downstream markets.

The Access Code provides for ringfencing arrangements in Chapter 13 to ensure that network service providers deal with related businesses and other associates on an arms-length, commercial, basis. Ringfencing seeks to ensure that integrated service providers that have monopoly power in parts of their business do not gain an unfair advantage in contestable markets in which related parts of their business compete. Chapter 13 gives the Economic Regulation Authority (**Authority**) powers to monitor and enforce ringfencing arrangements, including by establishing ringfencing rules.

2.2 PURPOSE AND STRUCTURE

The purpose of this paper is to examine issues relevant to the Authority introducing ringfencing rules under the Access Code.

This paper is structured as follows:

- section 3 provides an overview of this paper and describes the issues that ringfencing rules could address;
- section 4 summarises the structure of Western Australia's electricity supply industry and the regulatory arrangements relevant to introducing ringfencing arrangements;
- section 5 examines the nature and objectives of ringfencing, the types of behaviour that ringfencing is seeking to address and the requirements of the Access Code in establishing ringfencing rules; and
- section 6 examines issues that could be addressed in ringfencing rules and the types of ringfencing rules that could be used to complement the existing provisions of the Access Code.

The paper identifies a number of matters, which are highlighted in shaded boxes, where decisions are required by the Authority in developing ringfencing rules but on which the Authority seeks the views of the public before the rules are made.

2.3 THE WAY FORWARD

The Authority intends that this discussion paper will foster public comment on the scope of the ringfencing rules which may subsequently be drafted. Consequently, interested parties are specifically requested to address the questions which appear in shaded boxes throughout this document, when making submissions.

For the information of interested parties, the Authority notes that it is obliged under section A7.9 of the Access Code to limit the public consultation period to no more than 20 business days following the publication of this paper.

Following the closing date for receipt of public submissions, the Authority will draw upon submissions received and may develop draft ringfencing rules. In the event that draft ringfencing rules are developed, the Authority will undertake a further round of public consultation.

3 OVERVIEW

Ringfencing is concerned with the potential for integrated service providers to gain an unfair advantage in contestable markets in which related parts of their business compete. The principal ways in which a service provider can gain advantage are by:

- cross-subsidising the contestable parts of a business, for example by the network business bearing an inappropriate proportion of the costs of a related User (which under the Access Code includes a retailer or a generator), thereby giving the User an unfair advantage when competing against other Users;
- providing access to services on a discriminatory basis, for example by providing network services to a related User on more favourable terms than for non-related Users. It is noted that this could include network services provided to retailers or generators;¹
- providing commercial information to a related User which it could use to gain a commercial advantage over its competitors in a contestable market; or
- providing a related User with preferential or exclusive rights to joint marketing or products.

These practices have the potential to:

- weaken competitive forces in contestable generation and retail markets and so discourage new entrants into those markets or prevent existing suppliers competing in those markets on an equal footing; or
- reduce the effectiveness of the regulation of monopoly activities and so result in customers paying more, or receiving inferior service, than should otherwise be the case.

Ringfencing arrangements can be used to address these practices to:

- promote competition by preventing a monopoly service provider preferentially dealing with a related User in a contestable market; and
- improve the regulation of a monopoly business, including by preventing costs attributable to contestable activities being recovered through regulated charges.

As a basis for the facilitation of a competitive electricity supply industry in Western Australia, the Minister for Energy established the Access Code pursuant to section 104 of the *Electricity Industry Act 2004*.

The Access Code, which took effect on 30 November 2004, provides a basis for third party access to electricity networks and seeks to promote economically efficient investment in, and use of, those networks, to promote competition in upstream and downstream markets. The

¹ One form of discriminatory dealing could involve the service provider unreasonably delaying the provision of network services. Chapter 5 of the Access Code seeks to prevent this by requiring that the service provider's access arrangement include an "Applications and Queuing Policy". Section 5.7(c) of the Code requires that this policy must "set out a reasonable timeline for the commencement, progressing and finalisation of access contract negotiations between the service provider and an applicant, and oblige the service provider to use reasonable endeavours to adhere to the timeline".

Access Code includes ringfencing arrangements to ensure that network service providers deal with related businesses and other associates on an arms-length basis. Central to these arrangements are “ringfencing objectives” that:

- prevent a ringfenced business carrying on a related business;
- restrict access to, or possession or use of, commercially sensitive information to specific types of staff of a service provider;
- require the ringfenced business to provide, or receive, goods or services to or from an associate or a third party on reasonable terms, as if they were dealing at arm’s length;
- require the service provider to maintain comprehensive accounts and records of its covered network; and
- require the service provider to ensure that any service agreements it enters into facilitate the ringfencing objectives and any ringfencing rules.

The Access Code requires service providers of a covered network to comply with the ringfencing objectives and makes the Authority responsible for ensuring that the ringfencing objectives are promoted.²

In order to do this, the Access Code gives the Authority broad powers to make ringfencing rules but requires that it consult with the public in accordance with Appendix 7 of the Access Code before doing so.

Ringfencing rules can be used to provide specific support for the ringfencing arrangements set out in the Access Code. Ringfencing rules may be developed by either a regulated service provider or the Authority in order to promote the ringfencing objectives. To enhance the effectiveness of regulation, the Authority has additional powers in the development of ringfencing rules where an “integrated provider” is concerned.

In view of the integrated nature of Western Power, the Authority is currently considering the necessity of ringfencing rules. The Authority therefore seeks the views of interested parties as to the rules which may be developed in relation to each of the following issues:

- *the parties to whom ringfencing arrangements apply* – the Access Code limits the potential parties to whom ringfencing arrangements can apply to service providers of covered networks and their associates. This would currently be Western Power’s SWIS network business and its associates. Ringfencing rules could be used to distinguish between types of services provided by covered networks, such as Western Power’s transmission and distribution services, or to impose requirements specific to Western Power. Rules could also be used to provide guidance about when a party is deemed to be an “associate” and therefore potentially subject to ringfencing arrangements, and when the Authority will grant exemptions from these arrangements;
- *separating integrated businesses* – the Authority could use ringfencing rules to require an integrated service provider to “separate” parts of its business to ensure that it complies with the ringfencing objective which prevents a service provider from carrying on a

² A service provider is not required to comply with the ringfencing objectives where the Authority has granted an exemption. It is noted that section 13.29 precludes the Authority from granting Western Power an exemption from Chapter 13.

related business. This could potentially entail operational, management or separation of business premises. The Authority's powers do not extend to compelling ownership or legal separation. Therefore, only options for operational separation have been considered in this paper. These options could include introducing ringfencing rules that separate a service provider's management team, physical premises, personnel, branding and marketing or information systems for its regulated and non-regulated activities;

- *non-discrimination in the provision of goods and services* – the Access Code prevents a ringfenced business discriminating between associates or third parties in providing or receiving goods and services and allows the Authority to review and, if necessary amend, terms and conditions of supply to ensure that a ringfenced business' contracts promote the ringfencing objectives. Ringfencing rules could be introduced to detail how the Authority will monitor and enforce these contracts to ensure the ringfencing objectives are promoted effectively;
- *regulatory accounting and cost allocation arrangements* – the Access Code requires service providers, and their associates if required by the Authority, to maintain comprehensive accounts and records relating to the covered network. In order to give practical effect to this requirement, the Authority may consider approving cost allocation and regulatory accounting procedures which detail how a regulated business should allocate its costs between its regulated and other activities and prepare its regulatory accounts. The Authority will consider whether it is more appropriate to specify in ringfencing rules the cost allocation and regulatory accounting principles that it requires to be reflected in detailed procedures. The service provider would then be required to prepare the initial version of the procedures for submission to the Authority for approval. Once approved, the service provider would be required to comply with the procedures. The Authority seeks the views of interested parties on the suitability of this proposed approach;
- *information management* – ringfencing arrangements can be used to prevent a monopoly service provider giving preferential access to information that can advantage a related business over its competitors. The Authority will consider whether it is more appropriate to specify in ringfencing rules, principles in relation to the treatment of confidential information and disclosure and provision of information to associates and third parties that it requires to be reflected in detailed procedures. The service provider would then be required to prepare the initial version of the procedures for submission to the Authority for approval. Once approved, the service provider would be required to comply with the procedures. The Authority seeks the views of interested parties on the suitability of this proposed approach;
- *monitoring and reporting compliance with the ringfencing rules* – the Access Code requires a service provider of a covered network to establish, maintain and implement procedures to ensure that it complies with its ringfencing obligations. The Authority will consider whether it is more appropriate to specify in ringfencing rules the principles that it requires to be reflected in compliance procedures. The service provider would then be required to prepare the initial version of the procedures for submission to the Authority for approval. Once approved, the service provider would be required to comply with the procedures. The Authority seeks the views of interested parties on the suitability of this proposed approach; and
- *breaches of ringfencing obligations* – the Authority considers that ringfencing rules could be introduced to clarify service providers' and third parties' rights and obligations in the event that a service provider breaches its ringfencing obligations, which would clarify the

operation of sections 13.42 and 13.43 of the Access Code. This is important to ensure that all market participants have confidence that any such breaches will be appropriately addressed.

4 CURRENT INDUSTRY AND REGULATORY STRUCTURE

4.1 INDUSTRY STRUCTURE

The Western Australian electricity supply industry comprises:

- the South West Interconnected System (**SWIS**), which covers an area in the south west of the state from Albany in the south, to Kalbarri in the north and the Goldfields region in the east;
- the North West Interconnected System (**NWIS**), which covers an area in the Pilbara from Dampier/Karratha to Roebourne/Cape Lambert and across to Port Hedland; and
- non-interconnected systems, which include remote communities and mines across the state.

Appendix 1 provides a map of the areas serviced by these systems.

4.1.1 Western Power

Western Power is the major electricity supplier in the State. It was established as a vertically integrated State owned corporation on 1 January 1995 under the *Electricity Corporation Act 1994* following the disaggregation of the State Energy Commission of Western Australia (**SECWA**) into separate electricity and gas businesses.

Western Power has five main business units – generation, networks, retail, regional power and corporate:

- the generation business operates about 60% of the state's electricity generation capacity, and is principally located in the SWIS;
- the networks business operates the transmission and distribution networks servicing the SWIS and is responsible for system operations, planning and metering within the area;
- the retail business supplies about 840,000 customers in the SWIS;
- the regional power business supplies the NWIS and non-interconnected systems; and
- the corporate business provides corporate services across the organisation.

During 2004, Western Power created four operational areas – generation, networks, retail and regional – as separate Strengthened Business Units (**SBU**s) and has advised the Authority that it is in the process of establishing transparent and commercially based contractual arrangements between the SBUs so that they will increasingly operate independently. Despite this, it is understood that in the immediate term Western Power will remain a single legal entity which, amongst other things, means that one company employs all the staff, owns all the assets, shares information systems, reports its financial performance as a consolidated entity and uses common branding to market itself to its customers.

However, in order to promote greater degree independence for the four SBUs within this structure, Western Power has advised that it is in the process of undertaking a number of ringfencing initiatives, including:

- establishing separate internal accounting and reporting arrangements;
- increasing internal security and physical separation;
- restricting access across the SBUs to commercially sensitive information; and
- establishing service level agreements between the SBUs.

Western Power has also advised that it has a range of commercial, management, accounting, quality assurance, confidentiality and information technology measures to ringfence its Networks SBU, although it does not have a consolidated set of ringfencing procedures. For example, it advises that it:

- has a Grant of Access document that details the terms and conditions for the provision of access to the network for the Retail SBU;
- is in the process of renewing the service level agreement with the Retail SBU, which recently expired;
- is in the process of developing a new service level agreement with the Generation SBU;
- has financial policies and procedures in place to ensure that it does not misuse its market power in the provision of unregulated contestable services;
- has quality assurance arrangements to achieve confidentiality of various information;
- controls access to information technology systems and data by controlling users' access, although Western Power's information technology systems continue to be integrated;
- prepares separate financial accounts for the Networks SBU in accordance with the *Financial Administration and Audit Act 1985*;
- has a well developed cost allocation framework for allocating costs between its transmission and distribution activities;
- prepares special purpose financial reports for its transmission and distribution activities in accordance with the *Electricity Corporation Act 1994*; and
- has established a security controlled access office for part of the Networks SBU within Western Power's head office.

The Authority has not reviewed these arrangements in preparing this paper.

In addition to these internally imposed ringfencing arrangements, there is a requirement under the Wholesale Electricity Market Rules³ that Western Power's System Management function, which is responsible for operating the SWIS in a secure and reliable manner, be ringfenced from the rest of the business' operations.

Specifically, clause 2.2.1 of the Rules requires that System Management be a "segregated business unit" and the notes to clause 2.2 state that "System Management will be a ring-fenced business unit of Western Power and will report to the Western Power Board with

³ Established under regulation 5(2) of the *Electricity Industry (Wholesale Electricity Market) Regulations 2004*.

regard to performance against budgets and objectives, including its compliance with the Market Rules”.

How effective are Western Power’s existing ringfencing arrangements? In what areas, if any, should they be augmented?

4.1.2 Other Industry Participants

There are also a small number of privately owned generators and transmission and distribution lines across the state, which mainly service mining and mineral processing operations.

The State’s retail electricity market is progressively being made contestable based on a system of open access to Western Power’s electricity transmission and distribution networks. All consumers with annual demand greater than 50 MWh became contestable on 1 January 2005 before which time only general consumers with annual demand greater than 300 MWh, or consumers with annual demand greater than 50 MWh using renewable energy, could choose their retail supplier.

Additionally, a new electricity licensing regime commenced on 1 January 2005. The new regime provides for the licensing of generation, transmission, distribution and retail activities in the State.

4.2 RELEVANT LEGISLATION

A number of statutory instruments are relevant to the establishment of ringfencing arrangements:

- *Electricity Corporation Act 1994:*
 - section 31A, which has not yet been utilised, provides for the development of regulations for:
 - the segregation of any segment of the corporation’s operations mentioned in section 62(2) from the other functions or operations of the corporation.*
 - section 62(2)(a) provides for Western Power’s annual report to be:
 - ...divided into the following segments or such other segments as may be agreed between the corporation and the Minister –*
 - (i) the generation of electricity within the South West interconnection system;*
 - (ii) the transmission and distribution of electricity within the South West interconnection system;*
 - (iii) the sale of electricity within the South West interconnection system;*
 - (iv) the Pilbara interconnected system; and*
 - (v) the remote power systems.*

Section 62(2)(b) provides that “separate profit and loss accounts and balance sheets are to be prepared in respect of each of these segments”.

- *Electricity Industry Act 2004*:
 - section 104(2)(i) provides for the Minister to establish a Code, which must include provisions:
 - setting out the obligations of a network service provider in respect of the segregation of the functions and business of providing services from the network service provider's other functions and business and enabling the Authority to add to those obligations or waive any of them;*
 - section 118 provides for regulations to be established for the enforcement of the Access Code, including “that a provision of the Access Code specified in the regulations, or a class specified in the regulations, is a civil penalty provision for the purposes of the Access Code”, for which the Supreme Court may impose financial penalties up to \$100,000. No such regulations have as yet been established and the Access Code currently does not include any penalties for breaches of ringfencing obligations; and
 - section 130(3) provides that a “person adversely affected by a decision or direction to which this section applies may apply to the Board for a review of the decision” – the Board being the Gas Review Board. Section 130(2)(j) provides that this application can extend to:
 - a decision by the Authority to add to the obligations of a network service provider under the Access Code in respect of the segregation of the functions and business of providing services from the network service provider's other functions and business, or to waive any of those obligations.*
- the *Economic Regulation Authority Act 2003* established the Authority and its functions include “the functions it is given under any other enactment”. One of these other enactments is the *Electricity Industry Act 2004*, in which section 112 confers certain functions on the Authority:
 - The Authority:*
 - (a) *is responsible for monitoring and enforcing compliance by network service providers with this Part, the Access Code and access arrangements; and*
 - (b) *also has the functions given by particular provisions of this Part and the Access Code.*
- the *Electricity Industry Customer Transfer Code 2004* (**Transfer Code**) was established under section 39(2a) of the *Electricity Industry Act 2004* and commenced on 7 January 2005, being the date the *Electricity Industry (Licence Conditions) Regulations 2005* was published.

The Transfer Code details arrangements for providing information relating to contestable customers between retailers and network operators and for transferring contestable customers from one retailer to another. The Transfer Code sets out certain responsibilities and obligations on retailers and network operators in relation to these arrangements.

Section 2.2(1) of the Transfer Code requires a network operator to treat retailers that are its associates on an arms-length basis and not to provide any benefit to those retailers unless the network operator also makes that benefit available to other retailers. However, section 2.2(2) of the Transfer Code provides that, subject to the ringfencing objectives and any ringfencing rules made under the *Electricity Networks Access Code 2004* or any regulations made under section 31A of the *Electricity Act 1994*:

.....if the network operator is an integrated operator (as defined in the Access Code), a reference in clause 2.2(1) to an associate of the network operator does not include the integrated provider.

In developing ringfencing rules it will therefore be necessary to consider the need to extend the requirements of section 2.2(1) of the Transfer Code to integrated providers, such as Western Power. In the absence of such an extension, an integrated provider would be exempt from the obligation to comply with key aspects of the Transfer Code.

4.3 ELECTRICITY NETWORKS ACCESS CODE 2004

The Access Code was established under Part 8 of the *Electricity Industry Act 2004* and commenced on 30 November 2004, being the date on which it was published in the *Government Gazette*.

The objective of the Access Code is detailed in clause 2.1 of the Access Code and is:

to promote the economically efficient:

(a) investment in; and

(b) operation of and use of,

networks and services of networks in Western Australia in order to promote competition in markets upstream and downstream of the networks.

Clause 2.2 of the Access Code provides that:

The Minister, the Authority and the arbitrator must have regard to the [Access] Code objective when performing a function under this Code whether or not the provision refers expressly to the Code objective.

Chapter 13 of the Access Code deals with ringfencing arrangements for network service providers and their associates. In particular, Chapter 13 includes provisions which:

- define the ringfencing objectives with which network service providers must comply and allow the Authority to add to these objectives;
- require network service providers to document, and to provide to the Authority on request, the terms and conditions on which they provide services to their related businesses and associates. The Authority can require these terms and conditions to be amended to achieve compliance with the Access Code's objectives;
- allow the Authority to draft and approve ringfencing rules and associated ringfencing procedures to ensure the Access Code's objectives are being achieved. The rules may require a network service provider to procure its associate's compliance with the rules, the Access Code's objectives or any ringfencing compliance procedures;
- allow the Authority to set the time for approving, varying or revoking ringfencing rules;

- allow the Authority to grant exemptions to the ringfencing rules, except that it may not grant Western Power an exemption from Chapter 13 of the Access Code;
- provide for monitoring and reporting compliance with Chapter 13 of the Access Code; and
- deal with breaches of Chapter 13 of the Access Code.

In discharging its responsibilities under Chapter 13, the Authority in some instances must, and in other instances may choose to, consult the public in accordance with the arrangements set out in Appendix 7 of the Access Code. These arrangements may require the Authority to:

- publish an issues paper;
- invite a first round of public submissions;
- publish a draft decision;
- invite a second round of public submissions; and
- publish a final decision.

5 NATURE AND OBJECTIVES OF RINGFENCING ARRANGEMENTS

5.1 NATURE OF RINGFENCING

The Utility Regulators' Forum has defined ringfencing as:

.....identifying and isolating the activities, assets, costs, revenues and community service obligations of goods or services that are derived from a monopoly element, or one not subject to strong competitive pressures, that are provided by an integrated entity.⁴

Ringfencing arrangements are typically introduced where a single business, or an associated business, provides related monopoly and contestable goods or services. Ringfencing seeks to:

- promote competition by preventing a monopoly service provider preferentially dealing with a related User in a contestable market; and
- improve the regulation of a monopoly business, including by preventing costs attributable to contestable activities being recovered through regulated charges.

Ringfencing can impose various types of obligations on a business, including in relation to its:

- ownership – for example, by preventing someone owning businesses that undertake both monopoly activities and related competitive activities;
- legal structure – for example, by requiring that related monopoly and competitive activities be undertaken in separate legal entities;
- financial accounting – for example, by requiring an integrated business to maintain separate financial accounts for related monopoly and competitive activities and to allocate costs between these activities in a specified manner;
- operations – for example, by requiring an integrated business to undertake its monopoly and related competitive operations separately;
- personnel – for example, by requiring that personnel within an integrated business only work on either monopoly or competitive activities, not both;
- physical location – for example, by requiring that an integrated business undertakes its monopoly or related competitive activities in physically separate premises;
- information dissemination – for example, by limiting the information that can be shared between an integrated business' monopoly and related competitive functions;
- information systems – for example, by requiring that an integrated business separate its information systems for its monopoly and competitive activities; and

⁴ Utility Regulators' Forum, "Information gathering for ring fencing and other regulatory purposes", Discussion Paper, October 1999, page 2.

- terms and conditions of supply – for example by requiring an integrated business not to discriminate in supplying its monopoly goods and services between related and unrelated customers.

5.2 APPROACHES TO RINGFENCING

There are two broad approaches that can be taken to ringfencing arrangements. The Independent Regulatory Pricing and Regulatory Tribunal of New South Wales (**IPART**) referred to these approaches as the “high level approach” and the “specific rules approach” when it considered this matter in developing ringfencing arrangements to apply to the NSW electricity distributors in 2000/01:⁵

- a “high level approach” involves detailing a general set of objectives that ringfencing is seeking to achieve and leaving it to the network service provider to interpret how these objectives may be most appropriately applied to its business; and
- a “specific rules approach” gives detailed direction to a service provider in the conduct of its network business, including in its dealings with associated businesses and in the provision of related services, such as electricity retailing and generation.

A “high level approach” has some potential advantages over a “specific rules” approach. It is less intrusive in a regulated business’ affairs and, because it is more generally defined, could require less change over time to accommodate the evolving needs of an industry. It may also deal more readily with significant differences in the need for ringfencing within different regulated businesses and, because of its light-handed approach, may involve lower compliance costs.

Despite this, there are few recent examples of a “high level approach” to ringfencing having been applied in Australia. Rather, Australian regulators have generally favoured a “specific rules approach” primarily because it is far less open to interpretation and ambiguity than the high level alternative. This is because a specific rules approach clearly specifies what is required of the regulated business and accordingly reduces regulatory uncertainty. As IPART has noted:

*Where a regulator actively promotes the high level statements of principle, DNSPs (Distribution Network Service Providers) may only become aware of their practical obligations only once they have been found to be in breach.*⁶

IPART considered that by clearly stating what is required in order to comply with the ringfencing arrangements, and by reducing the discretion available to the regulator and regulated business, a “specific rules approach” would most effectively achieve its ringfencing objectives.

Other Australian regulators have taken similar views and have introduced detailed ringfencing procedures for their electricity industries, although there are differences in the detail of these procedures to accommodate the unique characteristics of the industry in each jurisdiction.

⁵ IPART, “Ring fencing of New South Wales Electricity Distribution Network Service Providers”, September 2000, pages 13-15.

⁶ IPART, September 2000, page 14.

The following table highlights the key differences in the impacts of the two approaches.

Impact	High level approach	Specific rules approach
Defines ringfencing requirements clearly and explicitly, avoiding ambiguity and regulatory uncertainty	Less	More
Intrusion in regulated business	Less	More
Accommodates an industry’s changing ringfencing needs	More	Less
Accommodates differences in regulated businesses	More	Less
Cost to regulated business	Less	More

The Access Code details a set of ringfencing objectives, as a “high level approach”, but enables the Authority to establish specific “ringfencing rules” to promote the effective delivery of these objectives if it considers that it is appropriate to do so.

Section 6 of this paper considers the types of matters that the Authority may choose to address through specific ringfencing rules.

5.3 ACTIVITIES RINGFENCING SEEKS TO CONTROL

There is a variety of ways in which a regulated service provider, such as an electricity networks business, could weaken:

- competitive forces in a contestable market that it services, and so discourage new entrants into that market or prevent existing suppliers competing in that market on an equal footing; or
- the effectiveness of the regulation of its monopoly activities, and so result in customers being charged more, or receiving inferior service, than should otherwise be the case.

The principal ways in which a service provider could do this are by:

- cross-subsidising the contestable parts of a business, for example by the network business bearing an inappropriate proportion of the costs of a related contestable User (which under the Access Code includes a retailer or generator), thereby giving the User an unfair advantage when competing against other Users;
- providing access to services on a discriminatory basis, for example by providing network services to a related User on more favourable terms than for non-related Users;
- providing commercial information to a related User which it could use to gain a commercial advantage over its competitors; or
- providing a related User with preferential or exclusive rights to joint marketing or products.

These four types of activities are discussed further below.

5.3.1 CROSS-SUBSIDISATION

The principle of economic efficiency requires that users pay the costs incurred in supplying the service that they receive. Cross-subsidisation occurs when users pay either above or below the efficient cost of delivering their service.

From a ringfencing perspective, regulators aim to limit the extent to which a monopolist can allocate costs from the contestable part of a business, such as a related retailer or generator, to the network business. If costs are attributed to a regulated service that should rightly be attributed to a contestable service then the regulated cost base, and in turn the resultant regulated prices, will be inappropriately inflated. Moreover, the regulated service provider's related business operating in the contestable market will have a cost advantage over its competitors. Both of these factors can ultimately disadvantage end customers.

In order to prevent inappropriate cost shifting between regulated and contestable activities, regulators typically require that cost allocation procedures be applied in preparing a regulated business' financial accounts. Costs which are directly incurred by a specific entity or function can be readily attributed, however, an appropriate basis needs to be determined for attributing common or shared costs between regulated and contestable activities.

Ringfencing arrangements can be used to specify how a regulated service provider should appropriately allocate its costs and prepare its regulatory accounts to ensure that the regulator has an appropriate basis for setting prices for regulated services and that an integrated business competes on an equal footing in contestable markets with its competitors.

In what ways could Western Power, or another integrated business, cross-subsidise its related businesses?

Is there evidence of cross-subsidisation between Western Power's Networks business unit and other businesses?

5.3.2 DISCRIMINATORY ACCESS TO SERVICES

An electricity network business provides a range of services to generators, retailers and end users, including entry, exit, use of system, common and ancillary services. Many of these services can only be provided by the monopoly network service provider, and are referred to in the Access Code as "covered services", however, some other services can be provided by competing suppliers – these are "excluded services" for the purposes of the Access Code.

If a network business is able to discriminate between Users in the price and other terms and conditions on which it provides its "covered services" then it may choose to provide more favourable terms and conditions to its related User than to other Users and so advantage the related User in competing to supply customers. Similarly, if a network business is able to discriminate between end users in the price and other terms and conditions of its supply then it may choose to provide more favourable terms and conditions to customers serviced by its related retail business than those serviced by other retailers. Disadvantaged Users are not able to arrange to be provided the "covered services" by an alternative supplier because, by their nature, they can only be provided by the monopoly network business.

Ringfencing arrangements can therefore be used to prevent a monopoly network business discriminating between Users and to require that it make its services available to all Users on comparable terms and conditions.

It is noted that a network business could potentially discriminate against either generators or retailers in providing their network services. Given that Western Power is an integrated provider with generation, network and retail businesses, and has responsibility for system management, establishing effective ringfencing arrangements that prevent discrimination

against third party generators could potentially be a more significant issue in Western Australia than in the National Electricity Market, which contains an independent system operator.

In what ways could Western Power or another integrated service provider discriminate between Users in the provision of network services (or have in the past)?

5.3.3 DISCRIMINATORY SHARING OF INFORMATION

An integrated service provider, such as Western Power, generates or obtains a wide range of information in the normal course of providing its regulated and contestable services, including information about end users' supply and consumption. Where it is a single legal entity, privacy laws may not constrain the integrated service provider's ability to exchange information within its organisation and between personnel responsible for regulated and contestable activities.

Allowing an affiliated other business to have access to information held by the network business may give the other business an unfair advantage over its competitors in supplying customers by, for example, providing advance notice of when new contestable users are to connect to the network or when existing contestable users require an expansion to their service.

Ringfencing can be used to limit the ability for an integrated service provider to share confidential information within its organisation, including between regulated network and contestable activities, such as electricity retailing and generation.

Furthermore, where it is appropriate for a regulated network business to provide non-confidential information to an affiliated other business, ringfencing arrangements can require the network business to make this information available to all competing businesses on the same terms and conditions.

In what ways could Western Power, or another integrated service provider, discriminate between Users in the provision of information or inappropriately use confidential customer information (or have in the past)?

5.3.4 JOINT MARKETING

It is a legitimate business practice for network service providers and electricity retailers and generators to market their products and services to their customers. For example:

- network services providers may promote the safety, reliability and quality of their supply network; and
- retailers and generators may package retail and generation products and services and promote them to customers in competition with those of their competitors.

However, arrangements which provide a User with preferential or exclusive rights to joint marketing or products with an associated network service provider, including exclusive network tariff arrangements, have the potential to reduce competition in upstream and downstream markets by unfairly advantaging the User against its competitors. This can happen, for example, by:

- network companies offering special tariff arrangements to related other businesses which their competitors cannot access; or
- network companies incurring the costs for advertising or specific types of branding development at the request or instruction of the related other business.

In order to limit the scope for adverse effects from joint marketing, some jurisdictions:

- prevent joint marketing by related networks and other businesses;
- require related networks and other businesses not to share marketing staff;
- require related network and other businesses to be separately branded, as common branding has the potential to confuse customers about who is providing what products and services;
- require network and other businesses to advise their customers about whether or not they can choose their supplier of a particular good and service; and
- prevent retailers marketing their products and services on the basis of network (rather than retail) performance, such as the safety, reliability and quality of electricity supply.

Do Western Power's marketing practices reduce competition in contestable electricity markets?

What types of joint marketing activities should ringfencing arrangements seek to control?

5.4 RINGFENCING OBJECTIVES IN THE ACCESS CODE

The ringfencing objectives are central to the ringfencing arrangements in Chapter 13 of the Access Code.

Section 13.1 requires that, except where the Authority grants an exemption, service providers must comply with the ringfencing objectives in respect of a covered network and the Authority's principal responsibility in the Chapter is to ensure that the objectives are promoted.

The ringfencing objectives are set out in section 13.11 of the Access Code:

The ringfencing objectives, in relation to a covered network, are that:

- (a) the ringfenced business must not carry on a related business; and*
- (b) subject to section 13.11(d), only marketing staff of the ringfenced business may have access to or possession of, or make use of, commercially sensitive information; and*
- (c) subject to section 13.11(d), and any written law including this Code, and except to the extent that the information comes into the public domain otherwise than by disclosure by the service provider, commercially sensitive information:*
 - (i) must be used only for the purpose for which that information was developed or provided; or*
 - (ii) must not be disclosed to any person (including any servant, consultant, independent contractor or agent of any associate of the ringfenced*

- business) without the prior consent of the person who provided it or to whom it relates; and*
- (d) commercially sensitive information may be disclosed to and used by the service provider's senior staff but:*
- (i) only to the minimum extent necessary from time to time for good corporate governance; and*
 - (ii) where possible only in summary or aggregated form or otherwise in a form that minimises the disclosure of any commercially sensitive or confidential details; and*
 - (iii) for use only in relation to the ringfenced business and only for the purpose for which it was developed or provided,*
- (e) any goods or services that the ringfenced business provides to, or receives from, any associate of the ringfenced business must be provided or received on terms that would be reasonable if the parties were dealing at arm's length; and*
- (f) any goods or services that the ringfenced business provides to, or receives from, a third party operating in competition with an associate of the ringfenced business must be provided or received on a basis that does not competitively or financially disadvantage the third party, relative to the associate; and*
- (g) the service provider's accounts and records relating to its covered network must be kept in a way that:*
- (i) provides a comprehensive view of the ringfenced business' legal and equitable rights and liabilities to the covered network; and*
 - (ii) provides a true and fair view of:*
 - A. the network business as distinct from any other business carried on by the service provider or any associate of the service provider; and*
 - B. income derived from, and expenditure relating to, the covered network; and*
 - C. the service provider's assets and liabilities so far as they relate to the covered network; and*
 - (iii) provides sufficient information to enable the price control and pricing methods, and these ringfencing objectives and any applicable ringfencing rules, to be applied in a reasonable manner; and*
 - (iv) enables all revenue received by the service provider from the provision of goods or services to an associate of the ringfenced business to be separately identified; and*
 - (v) enables all expenditure by the service provider on goods or services provided by an associate of the ringfenced business to be separately identified; and*
- (h) the service provider, when entering into service agreements, including asset management agreements, ensures that the terms and conditions of each*

agreement facilitates the implementation of these ringfencing objectives and any ringfencing rules.

5.5 MAKING RINGFENCING RULES UNDER THE ACCESS CODE

The Access Code gives the Authority broad powers to make ringfencing rules to promote the ringfencing objectives. Section 13.14 of the Access Code provides that:

The Authority:

(a) may at any time; and

(b) must for a covered network if it determines that the ringfencing objectives are not being achieved for the covered network,

draft and approve ringfencing rules, for the purpose of ensuring that the ringfencing objectives are achieved.

Additionally, section 13.15 allows service providers to submit proposed ringfencing rules to the Authority for its approval.

The Authority has determined it will consider whether it is necessary to develop ringfencing rules, given the integrated nature of Western Power.

The Access Code provides a broad scope for ringfencing rules. Section 13.23 provides that the ringfencing rules that apply to an integrated provider, such as Western Power, may:

(a) add to the ringfencing objectives for the integrated provider; and

(b) deal with any matter the Authority considers necessary or convenient to:

(i) achieve the Access Code objective or the ringfencing objectives; or

(ii) maintain the confidence of those who generate, transport or consume electricity that the Access Code objective or the ringfencing objectives are being achieved;

and

(c) without limiting section 13.23(b), require the physical separation of all or part of the network business' offices, equipment or marketing staff from those of any other business.

Furthermore:

- section 13.16 provides that the ringfencing rules may cover any class of covered networks, including within a specified geographic area or interconnected system, and may specify exemptions; and
- sections 13.25 and 13.26 can require a service provider to procure an associate to comply with the ringfencing objectives, any ringfencing rules or any ringfencing compliance procedures.

However, section 13.17 requires that a ringfencing rule cannot require a contravention of a written law or a statutory instrument.

Section 13.19 provides that, subject to correcting clerical or accidental mistakes, the Authority must consult with the public in accordance with Appendix 7 of the Access Code

before it approves, revokes or varies ringfencing rules (which it may otherwise do at any time). Section 13.20 requires that the Authority must place any approved, revoked or varied ringfencing rules on a public register. Section 13.27 states that rules take effect immediately or at a time specified by the Authority. However, section 13.28 provides that if no timeframe is specified then the approval, revocation or variation takes effect 3 months after they are placed on the public register.

Section 6 of this paper considers in detail the nature of the ringfencing rules that the Authority may consider introducing to promote the ringfencing objectives, including the need for any further objectives to complement those provided for in section 13.11 of the Access Code.

5.6 COSTS OF RINGFENCING

While ringfencing arrangements are principally focussed on providing benefits to end users by promoting competition in contestable markets and improving the regulation of a monopoly business, these arrangements impose costs on the regulated business. These may include:

- set-up costs – these are the initial costs associated with separating an integrated business and establishing internal procedures to comply with ringfencing obligations;
- operating costs – these are the on-going compliance and monitoring costs and any loss of economies of scale or scope as a result of the constraints that the ringfencing arrangements impose on the regulated business. This could include costs as a result of any need to separate different parts of a business' operations; and
- constraints on future decisions – these costs may relate to limits on a service provider's ability to choose how it structures and operates its business and on the products and services that it can provide.⁷

Regulators need to take care to ensure that the benefits of imposing ringfencing arrangements on a business exceed their associated costs, while recognising that the most effective outcomes that achieve the greatest benefits may impose higher costs on business than the available alternatives.

A balance therefore needs to be struck between the likely costs and benefits in deciding on an appropriate set of ringfencing arrangements which achieve the desired objectives. This assessment needs to be considered not only in establishing general ringfencing provisions but in deciding whether a specific exemption should be granted to these provisions. Indeed, section 13.31 of the Access Code states, in part, that:

the Authority may grant an exemption from a provision of the ringfencing objectives or ringfencing rules in respect of a covered network if the Authority determines in all the circumstances that the disadvantages of requiring the service provider to comply with the provision are likely to exceed the advantages.

However, section 13.29 prevents any such exemption being granted to Western Power.

What are the costs of ringfencing that the Authority should consider in developing ringfencing rules?

⁷ IPART, September 2000, page 4.

6 POTENTIAL RINGFENCING RULES

This section examines potential ringfencing rules that could be applied to promote the Access Code’s ringfencing objectives and to address the types of anti-competitive behaviour that are identified in section 5.3 of this paper. In particular, it examines:

- the parties to whom ringfencing arrangements apply – this is important because the Access Code limits the potential parties to whom ringfencing arrangements can apply to service providers of covered networks and their associates;
- arrangements for separating integrated businesses – this is important where Western Power is concerned as the Authority can potentially decide the extent of the separation required between its covered networks and other parts of its business;
- non-discrimination in the provision of goods and services – this is important because the Access Code requires the Authority to ensure services are not provided on a discriminatory basis;
- regulatory accounting and cost allocation arrangements – this is important because the Authority must decide what rules to apply to the allocation of costs and the development of accounts for an integrated provider’s regulated and non-regulated services;
- information management – this is important because the Authority must choose the rules to apply in relation to the provision of information to the Authority and the disclosure of information between businesses;
- arrangements for monitoring and reporting compliance with the ringfencing rules – this is important because the Authority will design rules in relation to compliance monitoring; and
- how the Access Code, and the Authority, would deal with potential breaches of ringfencing obligations – this is important to ensure that market participants have confidence that any contraventions of the ringfencing arrangements are appropriately addressed.

6.1 APPLICATION OF RINGFENCING ARRANGEMENTS

In drafting ringfencing rules there is a need to consider which service providers the rules will apply to, how an “associate” of a service provider may be covered by the rules and when an exemption may be granted to the rules.

Covered Networks

Section 13.1 of the Access Code provides that:

Except to the extent that the Authority grants an exemption under section 13.31, a service provider must, in relation to a covered network:

- (a) comply with the ringfencing objectives; and*
- (b) if ringfencing rules apply to the covered network, comply with the ringfencing rules.*

Section 13.3 of the Access Code provides that a “service provider” may be the network business of an integrated provider, such as Western Power’s network business, or a standalone network business of any other service provider.

Section 3.1 of the Access Code provides that:

The portions of the SWIS which are owned by Western Power Corporation are a covered network from the Code commencement date, unless coverage has subsequently been revoked under section 3.30.

As already noted, the Access Code commencement date was 30 November 2004 and coverage of the parts of the SWIS owned by Western Power has not been revoked under section 3.30.

Section 3.2 of the Access Code also allows other networks to become covered in the future and states that:

A network other than the covered network that is covered under section 3.1 may become covered after the Code commencement date where a person make [sic] a coverage application in respect of the network and the Minister decides under section 3.3(a) that the network should be covered.

To date, no other networks have been covered under section 3.2 and, as a result, Western Power's network in the SWIS is currently the only covered network under the Access Code.

An issue arises for the Authority as to whether there is a need to ringfence the distribution and transmission network activities provided within Western Power's SWIS, given the significant differences in the nature of the two activities. This was alluded to by the Western Australian Electricity Reform Task Force in 2002 when it noted:

While owning and operating transmission and distribution networks are natural monopoly activities, the nature of the two businesses is considerably different. The high voltage transmission network is concerned with the activity of generators and the impact on system-wide stability, whereas the distribution network is focused on continuity of supply and dealing with a large number of customer connection points. Each function is concerned with system-wide considerations but with varying degrees of tolerance in performance standards.⁸

In its Final Report, the Task Force concluded that:

Although the Task Force does not consider that legal separation of the transmission and distribution activities is required, it does consider that for regulatory purposes it would be necessary to separately identify the assets and operating costs of the two business areas. This is a matter that could be addressed under the State Network's access arrangement to be developed under the Electricity Access Code.⁹

The Access Code distinguishes between the "distribution system", which it defines as "any apparatus, equipment, plant or buildings used, or to be used, for, or in connection with, the transportation of electricity at nominal voltages less than 66kV" and the "transmission system", which relates to nominal voltages of 66kV or more. However, Chapters 5 and 6 of

⁸ Electricity Reform Task Force, "Discussion Paper on the Reform of the Electricity Supply Industry in Western Australia", April 2002, volume 1, chapter 2, page 24.

⁹ Electricity Reform Task Force, "Electricity Reform in Western Australia – A Framework for the Future", October 2002, page 7.

the Access Code, which deal with the content of access arrangements and the nature of price control arrangements do not deal with these two matters separately. Furthermore, the ringfencing provisions in Chapter 13 refer to the “covered network” and the “network business” and make no distinction between transmission and distribution activities.

This is in contrast to the distinction between network services in the National Electricity Market, where:

- separate businesses provide transmission and distribution services in each jurisdiction;
- different regulatory arrangements apply to transmission and distribution businesses under the *National Electricity Code*; and
- different regulators regulate transmission and distribution services, with each applying their own ringfencing arrangements, albeit based on common provisions in section 6.20 of the *National Electricity Code*.

The approach in the Access Code is similar to the arrangements in the Northern Territory where Power and Water Corporation provides all of the electricity network services and its network is regulated as an integrated system, with no distinction made between transmission and distribution. However, it is noted that there are very few assets in the Northern Territory that would be classified as “transmission assets” for the purposes of the Access Code’s definition.

Whether or not Western Power’s transmission and distribution network activities ought to be ringfenced is ultimately impacted upon by a decision to distinguish between the two activities its access arrangement, particularly whether the Authority will regulate transmission and distribution prices separately or on a “bundled” basis.

For the purposes of this paper, no distinction has been made between Western Power’s distribution and transmission activities in considering its network activities. However, this will be considered further by the Authority as part of the broader development of the new economic regulatory arrangements for the SWIS.

Should the Authority require ringfencing between Western Power’s transmission and distribution activities?

Putting aside the potential segregation of transmission and distribution operations, and assuming that the networks business is to be treated as one entity, there are four options available to the Authority in drafting the ringfencing rules. Ringfencing rules could:

- apply only to Western Power’s SWIS network, that is the rules should relate to the specifics of the SWIS system; or
- apply to Western Power generally so that if another of its networks, such as in the NWIS, was to be covered in the future the rules would also apply. In this way, the rules would be general in nature, but still specific to Western Power, and would not require amendment if a new network was covered; or
- general in scope, so that the rules could be applied to any covered network, whether they are owned by Western Power or some other party. The rules would therefore be more general than the previous two examples; or
- partly general in scope and partly specific to Western Power’s network in the SWIS.

There are several important considerations in deciding which might be the best option to adopt:

- the Authority seeks to promote consistent and fair regulatory arrangements that do not discriminate between regulated businesses, where appropriate to do so. This would suggest that the ringfencing rules should be drafted to be as general in scope as possible so that they apply to the service provider of any covered network;
- Western Power may be subject to structural reform in the future. This would also suggest that the rules should be drafted to be as general in scope as possible so that they can accommodate any future structural arrangements with as little modification as possible;
- the Authority may, subject to consulting publicly, approve, revoke or vary ringfencing rules at any time to accommodate the specific needs of a newly covered network. This would suggest that ringfencing rules should initially be drafted to be general in scope, recognising that they can be modified in the future to accommodate specific needs; and
- Western Power’s SWIS network is by far the largest network in Western Australia and it is likely to face unique issues as a large integrated service provider that will not be relevant to other service providers. This would suggest that there should be scope to tailor certain ringfencing rules to meet the specific needs of particular covered networks.

Consideration should be given to whether proposed ringfencing rules should be drafted to be general in scope where possible, but that there is also provision for specific rules to be made to apply to particular networks to meet their unique requirements.

Should ringfencing rules be drafted to be general in scope but to have the provision for specific rules?

Associates

Section 13.25 of the Access Code allows the ringfencing arrangements in Chapter 13 to be extended beyond a service provider to apply to its associates. The section states that:

Ringfencing rules which apply to a covered network may require a service provider to procure an associate of the ringfenced business to comply with any one or more of:

- (a) the ringfencing objectives;*
- (b) any applicable ringfencing rules; and*
- (c) the ringfencing compliance procedures.*

The Access Code defines the term “associate” as follows:

“Associate”, in relation to a person and subject to section 13.2, has the meaning it would have under Division 2 of Part 1.2 of the Corporations Act 2001 of the Commonwealth if sections 13, 14, 16(2) and 17 of that Act were repealed, except that a person will not be considered to be an associate of a service provider solely because that person proposes to enter, or has entered, into a contract, arrangement or understanding with the service provider for the provision of a covered service.

The Access Code definition gives the following examples of persons who are associates of a body corporate under the *Corporations Act 2001* (Commonwealth):

- *a director or secretary of the body corporate;*
- *a related body corporate of the body corporate; and*
- *another body corporate that can control or influence the composition of the board or the conduct of the affairs of the body corporate.*

Section 13.2 of the Access Code expands on the above definition and provides that:

If the service provider for a covered network is an integrated provider, a reference in this Chapter 13 to an “associate” of the service provider or of its network business includes any other business of the service provider.

Section 13.26 specifically deals with those associates that undertake activities under service agreements for a ringfenced business, including under asset management agreements. It allows the Authority, without limiting its powers under section 13.25, to require the service provider to procure its associates to keep separate accounts for the activities they provide to the service provider, to allocate shared costs transparently and to provide the accounts to the Authority upon request.

For the purposes of Chapter 13 of the Access Code, Western Power’s network business’ “associates” would therefore include its generation, retail and corporate businesses, its company directors and secretary and any other body corporate that otherwise falls within the definition of “associate” under the Access Code. A person is not an “associate” where the relationship derives from the proper performance of the functions attaching to a professional capacity or a business relationship.

Who are Western Power’s network business’ “associates” for the purposes of Chapter 13 of the Access Code?

Section 13.25 gives the Authority discretion in deciding whether or not to require the service provider of the covered network to procure an associate to comply with the ringfencing arrangements. However, the Access Code gives no specific direction for when the Authority should do this.

It is considered that the Authority could assess, on a case by case basis, whether to require a service provider of the covered network to procure an “associate” to comply with the ringfencing arrangements in accordance with clause 13.25 of the Access Code. This assessment could be undertaken on the basis of whether the ringfencing objectives are not being, or are unlikely to be, achieved for the covered network.

What matters should the Authority have regard to in considering whether to extend ringfencing arrangements to an “associate”?

Which of Western Power’s network business’ “associates” should be subject to some or all of the ringfencing arrangements?

6.2 SEPARATING AN INTEGRATED BUSINESS

Section 13.11(a) of the Access Code sets a ringfencing objective that “the ringfenced business must not carry on a related business”, where a “related business” is defined to mean:

the business of generating, purchasing or selling electricity, but does not include purchasing or selling electricity to the extent necessary:

- (a) for the safe and reliable operation of a covered network; or*
- (b) to enable a service provider to provide balancing and ancillary services in connection with a covered network; or*
- (c) to comply with an obligation under Part 9 of the Act.¹⁰*

However, the Access Code also recognises that there are “integrated providers” which undertake multiple business activities, and which the Access Code defines to mean:

- (a) Western Power; and*
- (b) a service provider which, under section 13.11, has been given an exemption from section 13.11(a).*

The Access Code recognises that an “integrated provider” has both:

- a “network business”, which is defined as “the part of the integrated provider’s business and functions which are responsible for the operation and maintenance of a covered network and the provision of covered services by means of the covered network”; and
- an “other business” or businesses, which is defined as “the part of parts of an integrated provider’s business which are not the network business, and include any part or parts of the integrated provider’s business and functions which acquire covered services from the network business”.

Western Power, for example, is therefore an “integrated provider” with both a “network business” and “other businesses”, being its retail, generation and corporate businesses.

The Authority therefore needs to consider how ringfencing rules should be used to promote the objective in section 13.11(a) that “the ringfenced business must not carry on a related business”, while recognising that the “ringfenced business” can be an “integrated business” with both a “network business” and “other businesses”.

One means of doing this is to provide for the separation of the integrated business. This could involve imposing arrangements to separate an integrated business’ operations, but doing so does not obviate the need for other ringfencing arrangements.

In considering this, the NSW Distribution Boundary Review Committee expressed the view that:

The commercial incentives for preferential dealing, information sharing, transfer pricing and distortions in cost allocation will be the same irrespective of whether the regulated and non-regulated businesses are carried out within the same organisation or by related but legally separated corporations.

¹⁰ This refers to an obligation which may arise under the Wholesale Electricity Market Rules.

Neither is the ability to engage in uncompetitive conduct likely to be reduced to any material extent that such behaviour may be detected from the financial statements of the legal entity.¹¹

Ownership and legal separation

Ownership separation would require the separate businesses of an integrated provider to be broken up and sold so that the monopoly network and other businesses are owned by different parties. Legal separation would require the separate businesses of an integrated provider to be broken up into different legal entities, although they could continue to have a common owner.

The Electricity Reform Task Force recommended that Western Power be legally separated.¹²

The Access Code does not confer upon the Authority the power to require either ownership or legal separation of Western Power. Consequently, these options are not considered further.

Operational separation

Operational separation, in the absence of ownership or legal separation, involves separating the operations of different functions or internal businesses of an integrated provider, such as Western Power's networks, generation, retail and corporate businesses. It could entail such matters as requiring:

- *Separation of activities* – ringfencing arrangements should clearly separate responsibility for activities undertaken by a network service provider from those undertaken by other businesses of an integrated provider. Most activities can be readily attributed either to the generation, networks or retail businesses, however, others could potentially be undertaken by more than one business and there is therefore a need to allocate responsibility for them. For example, the following activities could be undertaken by either a retailer or a distributor:
 - customer fault calls;
 - enquiries or complaints regarding the network;
 - connection, disconnection and reconnection;
 - customer transfers;
 - metering; and
 - managing information relating to the above.

Clarifying responsibility for undertaking specific functions and services is a fundamental first step in establishing effective ringfencing arrangements. To the extent that the separation of these responsibilities is not already well established, they could be clarified through specific ringfencing rules.

¹¹ Distribution Boundary Review Committee, Final Report, June 1998, page 68.

¹² Electricity Reform Task Force, "Electricity Reform in Western Australia – A Framework for the Future", October 2002.

What is an appropriate separation of the network and other activities of an integrated service provider?

- *Separate management teams* – ringfencing rules could be introduced to require the monopoly network business and the other businesses to have separate management teams. This could minimise information sharing across the business functions which could otherwise be used to provide competitive advantages to contestable activities, compared with their competitors. However, given that the integrated provider would otherwise continue as a single legal entity, this is unlikely either to be successful in achieving all of the ringfencing objectives or to engender public confidence if it is not supported by other ringfencing initiatives of the kind discussed below.

Should an integrated service provider be required to have separate management teams for its monopoly network business and its other businesses?

What are the consequences if an integrated service provider were not required to establish separate management teams?

- *Physical separation* – section 13.23(c) of the Access Code explicitly allows ringfencing rules to be applied to an integrated provider that “... require the physical separation of all or part of the network business’ offices ... from those of any other business”. Requiring an integrated provider physically to separate different functions or internal businesses has the potential to reduce the inappropriate sharing of commercially sensitive information, which might otherwise give a related business an unreasonable advantage over its competitors in supplying contestable services. Physical separation could involve either:
 - restricting access to different parts of a single building by introducing security measures; or
 - requiring that different functions or internal businesses of an integrated provider be located in different buildings, with access restricted to appropriately authorised personnel.

It is understood that Western Power currently has security measures which only allow authorised personnel to access the network business’ area within its Perth head office, although the company’s business groups share common premises.

Should Western Power or another integrated service provider be required to have separate offices for its monopoly network business and its other businesses?

What are the consequences if an integrated service provider were not required to establish separate office locations?

- *Separation of personnel* – section 13.11(c) of the Access Code provides, in part, that:

subject to section 13.11(d), only marketing staff of the ringfenced business may have access to or possession of, or make use of, commercially sensitive information

where “commercially sensitive information” is defined as:

all confidential or commercially sensitive information in relation to an applicant, user or consumer which is developed by or comes into the

possession of a service provider including a ringfenced business' past, present and future dealings with the applicant, user or consumer

and where “marketing staff” are defined as:

servants, consultants, independent contractors or agents directly involved in sales, sale provision or advertising (whether or not they are also involved in other functions) but does not include servants, consultants, independent contractors or agents:

(a) who are senior staff; or

(b) involved only in technical, administrative, accounting or service functions

and where “senior staff” are defined as:

servants, consultants, independent contractors or agents involved strategic decision making (sic), including directors and the executive officer or officers to whom marketing staff report either directly or indirectly.

Section 13.11(d) provides, in part, that:

Commercially sensitive information may be disclosed to and used by the service provider's senior staff but:

(a) only to the minimum extent necessary from time to time for good corporate governance; and

(b) where possible only in summary or aggregated form or otherwise in a form that minimises the disclosure of any commercially sensitive or confidential details; and

(c) for use only in relation to the ringfenced business and only for the purpose for which it was developed or provided.

Furthermore, section 13.23(c) allows ringfencing rules to be applied to an integrated provider which “... require the physical separation of ... marketing staff from those of any other business”.

Enforcing these Code restrictions has the potential to reduce the inappropriate sharing of commercially sensitive information within an integrated provider, which might otherwise give a related business an unreasonable advantage over its competitors in supplying contestable services to end users.

Other jurisdictions seek to achieve similar objectives by preventing individuals being employed by both a monopoly network business and a related business. For example, in Victoria:

A distributor must ensure that its distribution employees are not also staff of a retail business and, if a distribution employee becomes or is found to be an

employee of a retail business, procure the distribution employee's immediate removal from its distribution staff.¹³

However, a provision such as this is not feasible for an integrated provider, such as Western Power, where it is understood that all staff are employed by a single corporate entity. The alternative is to create arrangements within the integrated business that prevent the sharing of commercially sensitive information, other than for the limited purposes provided for by section 13.11(d). The Victorian ringfencing arrangements also include this type of provision by requiring that:

A distributor must ensure that any organisational unit marketing or providing the distributor's goods or services and any organisational unit within a retail business:

(a) operate independently; and

(b) have separate work areas with access controls that prevent staff of either organisational unit from entering into the work area of the other organisational unit.¹⁴

Ringfencing rules could therefore be introduced to complement the existing ringfencing objectives by requiring integrated providers to:

- operate their network marketing separately from the marketing activities of their other businesses;
- prevent marketing personnel working for a network business and other businesses of an integrated provider simultaneously;
- provide the Authority with an up-to-date list of the marketing staff working for each business; and
- disclose commercially sensitive information to senior staff only where they have a clear accountability within the network business that requires them to have access to the information, which may include for corporate governance purposes.

Potential rules regarding the use and sharing of commercially sensitive information are discussed further below.

Are the ringfencing rules above appropriate to introduce to separate an integrated service provider's personnel?

- *Separate branding and marketing* – common branding and public marketing of network and other activities, such as retailing, by an integrated provider has the potential to confuse customers about the identity of the provider of products and services and to limit customers' awareness of when they can choose their service provider. Because of the potential for this to reduce effective competition in contestable markets other jurisdictions require network and related other businesses to:

¹³ Essential Services Commission, "Electricity Industry Guideline No. 17 – Electricity Ring-fencing", October 2004, clause 4.2.

¹⁴ Essential Services Commission, (October 2004), clause 4.1.

- brand and market themselves in a way that minimises customers’ confusion;
- make clear to customers the scope of the services that they provide;
- indicate to customers if they have a choice of supplier for particular services;
- make clear who is responsible for what pages when the businesses share a website; and
- avoid imputing aspects of another business when marketing their own services – for example, a retailer may be prevented from marketing the safety, reliability or quality of network services as these are network, rather than retail, matters.

These provisions could be incorporated into ringfencing rules for integrated providers so as to limit the potential for them to inappropriately brand and market themselves and thereby inhibit effective competition in contestable markets.

Are ringfencing rules necessary to provide for the separate branding and marketing of an integrated service provider’s businesses?

In what ways do separate branding and marketing rules enhance competition in upstream and downstream markets?

- *Separate information systems* – an integrated provider’s information systems will hold large amounts of commercially sensitive, and other information in respect of each of its functions and businesses. Inappropriately sharing commercially sensitive network information with a related other business might give that other business an unfair advantage over its competitors in supplying contestable services.

In order to prevent this, and to ensure that only appropriately authorised personnel have access to, and can use, information relevant to their needs, a ringfencing rule could be introduced which imposes access controls on users of the information systems.

Are ringfencing rules necessary to provide for the separation of an integrated service provider’s information systems for its different businesses?

What specific rules should be introduced to ensure that information systems are not inappropriately accessed?

The above discussion has identified a range of options for separating the operations of an integrated business to address the four types of problems that were identified in section 5.3 as being the focus of ringfencing: cross-subsidisation between services; discriminatory access to services; discriminatory information sharing and joint marketing.

The following table illustrates which ringfencing options are likely to be effective in addressing the four potential problems.

Ringfencing option	Cross-subsidisation between services	Discriminatory access to services	Discriminatory information sharing	Joint marketing
Separate activities		✓	✓	✓
Separate management teams			✓	

Ringfencing option	Cross-subsidisation between services	Discriminatory access to services	Discriminatory information sharing	Joint marketing
Separate physical location			✓	
Separation of personnel			✓	
Branding and marketing		✓		
Separate information systems			✓	

Are ringfencing rules required to provide for the separation of any other matters relating to an integrated service provider's businesses?

6.3 NON-DISCRIMINATION IN THE PROVISION OF GOODS AND SERVICES

Section 13.11(e), (f) and (h) of the Access Code establish ringfencing objectives to promote non-discrimination in the provision of goods and services involving a ringfenced business and an associate or third party. They provide that:

- (e) any goods or services that the ringfenced business provides to, or receives from, any associate must be provided or received on terms and that would be reasonable if the parties were dealing at arm's length;*
- (f) any goods or services that the ringfenced business provides to, or receives from, a third party operating in competition with an associate of the ringfenced business must be provided or received on a basis that does not competitively or financially disadvantage the third party, relative to the associate; and*
- (h) the service provider, when entering into service agreements, including asset management agreements, ensure that the terms and conditions of each agreement facilitates the implementation of these ringfencing objectives and any ringfencing rules.*

These three ringfencing objectives apply equally to a ringfenced business that is a standalone network service provider and to one that is part of an integrated provider. To support these objectives, the Access Code provides:

- section 13.4(c):
 - ...by 3 months after the access arrangement start date, the network business and the other business must record in writing the full terms and conditions of the arrangement by which the network business is to provide the covered services to the other business ("deemed access contract");*
- section 13.5:
 - Without limiting section 13.4 a service provider must, by 3 months after the access arrangement start date, record in writing the full terms and conditions of any contract, arrangement or understanding by which it provides covered services to an associate ("associate contract");*
- section 13.6 requires the service provider to advise the Authority within five days of any amendment, variation or termination of a deemed access contract or associate contract;

- section 13.7 requires the service provider to provide a copy of a deemed access contract or associate contract to the Authority in the time specified;
- section 13.8:
 - The Authority must, if it considers that an associate contract or a deemed access contract:*
 - (a) *is contrary to the Access Code objective; or*
 - (b) *may have been entered into for the purpose of preventing or hindering access by any person to services,*
 - require a service provider, by notice, to ensure that the ringfenced business provides covered services to the associate on terms and conditions which are not contrary to the Access Code objective and do not have the purpose of preventing or hindering access by any person to services, and may, without limiting the Authority's powers and subject to section 13.9, specify the terms and conditions for the provision of covered services by the ringfenced business to the associate.*
- section 13.9 provides that the Authority must limit any changes it requires to contracts to those necessary to ensure that their terms and conditions are consistent with the Access Code objective and do not prevent or hinder access by any person to services; and
- section 13.10:
 - The Authority may consult the public in accordance with Appendix 7 before imposing a requirement under section 13.8.*

These provisions provide a strong base for promoting non-discrimination in the provision of goods and services involving a ringfenced business and an associate or third party. However, they could be complemented by ringfencing rules which detail how they will be applied.

Possible rules could require a service provider to:

- supply the Authority with up-to-date copies of all deemed access contracts and associate contracts and to notify it of any contracts that have been terminated. This would avoid the need for the Authority to request the contracts from time to time and would ensure that it had the latest information to assess whether the Access Code objectives are being promoted appropriately;
- obtain the Authority's approval to any new, or amendment to any existing, deemed access contracts or associate contracts. This would allow the Authority to fulfil its obligation under section 13.8(a) of the Access Code to assess whether the contract's terms and conditions are consistent with the Access Code objective or whether the contract is intended to prevent or hinder access, and to determine the need for any changes to address any such shortcomings;
- provide covered services to its associates or an "other business" (in the case of integrated providers) only in accordance with the relevant associate contracts or deemed access contracts. This would ensure that the contracts that the Authority reviews reflect the terms and conditions that the service providers' customers actually receive;
- provide the Authority with a copy of any service contract between the service provider and end customers. This is likely to be necessary because in some cases, such as in the provision of connection or metering services, the network service provider directly services customers, without involving an associate or third party retailer. While this is

not explicitly provided for in Chapter 13 of the Access Code, it appears that this is because it has been assumed that there would always be a “linear” relationship between the network provider, the retailer and the customer, with the retailer always having the direct relationship with the customer. To address this limitation, the Authority may consider using its powers under section 13.23(a) to add to the ringfencing objectives to make it explicit that ringfenced businesses must not unreasonably discriminate between customers in the provision of their goods or services;

- avoid jointly marketing its services with an “other business” or an associate which would result in them having preferential or exclusive rights to joint marketing or products with an associated network service provider. This is considered necessary to promote fair competition in contestable markets and to avoid the possibility of, for example:
 - network companies offering special tariff deals to related businesses which other Users cannot access; or
 - network companies incurring the costs for advertising or specific types of branding development at the request or instruction of the related business.

The Authority may also consider it necessary to introduce additional ringfencing rules that:

- specify when deemed access contracts and associate contracts will be treated as confidential documents and when they will be treated as public documents and disclosed on the public register; and
- detail when the Authority will consult the public in accordance with Appendix 7 of the Access Code on amendments it may require to a deemed access contract or associate contract, as is provided for under section 13.10. To some extent, this will depend on whether the contracts are in the public domain.

Are the ringfencing rules and principles specified above appropriate to provide for non-discrimination in the provision of goods and services by an integrated service provider?

6.4 REGULATORY ACCOUNTING AND COST ALLOCATION

As already discussed, one of the main purposes of ringfencing is to improve the regulation of a monopoly business, including to ensure that a service provider’s regulated charges only recover those costs that are appropriately attributable to its network services and do not cross-subsidise the costs of other related business activities.

Failing to prevent cross-subsidisation could otherwise result in customers paying too much for their network services and the network business’ related businesses having an unfair advantage over their competitors in providing contestable services.

To address this issue, section 13.11(g) of the Access Code provides that:

the service provider’s accounts and records relating to its covered network must be kept in a way that:

- (i) provides a comprehensive view of the ringfenced business’ legal and equitable rights and liabilities to the covered network; and*
- (ii) provides a true and fair view of:*

- A. *the network business as distinct from any other business carried on by the service provider or any associate of the service provider; and*
 - B. *income derived from, and expenditure relating to, the covered network; and*
 - C. *the service provider's assets and liabilities so far as they relate to the covered network; and*
- (iii) *provides sufficient information to enable the price control and pricing methods, and these ringfencing objectives and any applicable ringfencing rules, to be applied in a reasonable manner; and*
- (iv) *enables all revenue received by the service provider from the provision of goods or services to an associate of the ringfenced business to be separately identified; and*
- (v) *enables all expenditure by the service provider on goods or services provided by an associate of the ringfenced business to be separately identified*

Supporting these objectives is a requirement under section 13.45 that:

The service provider of a covered network must comply with any request by the Authority or the arbitrator to inspect or make copies of the service provider's accounts and records for the covered network.

In addition, section 13.26 allows the Authority to extend the preparation of regulatory accounts to "associates" by requiring a service provider to:

...procure any associate of the ringfenced business that undertakes activities for the ringfenced business in relation to the network under service agreements, including asset management agreements:

- (a) *to establish and maintain a separate set of accounts in respect of the activities undertaken for the ringfenced business in relation to the network; and*
- (b) *to allocate any costs that are shared between an activity for which accounts are kept under section 13.26(a) and another activity according to a methodology for allocating costs that is transparent; and*
- (c) *to provide the accounts established and maintained under section 13.26(a) to the Authority at the Authority's request.*

In order to give practical effect to broadly similar ringfencing objectives to those in section 13.11 of the Access Code, regulators in other jurisdictions typically approve:

- regulatory accounting procedures, which detail how a regulated business should prepare its regulatory accounts for submission to the regulator; and
- cost allocation procedures, which detail how a regulated business should allocate its costs between its regulated and other activities for the purposes of preparing its regulatory accounts.

These procedures are then applied by regulated businesses in preparing their regulatory accounting statements for submission to the regulator. This information can be used by the regulator to:

- ensure revenues and expenses are appropriately allocated between a business' different activities;
- aid the economic regulation of a business;
- review a business' actual financial performance against its forecast;
- provide information for public reporting in order to promote transparency of a business' financial performance; and
- support other regulatory decisions as necessary.

There are two broad approaches that regulators have taken for developing these accounting and cost allocation procedures.

First, a regulator can prepare and issue the procedures itself, possibly following public consultation, and require the regulated business to comply. This approach is particularly appropriate where the regulator has a strong understanding, or experience, of the businesses it is regulating and a relatively clear view of the requirements it wishes to impose. Regulators in NSW, Victoria, Queensland, South Australia and Tasmania have all developed procedures on this basis.

The main advantage of this approach is that it allows the regulator to set the detail of the procedures itself in order to address what it considers to be the most important issues and to ensure that it obtains information in a form and level of detail that fully meets its needs.

However, this approach can be more difficult for a regulator to apply when it is new to regulating an industry and does not have the depth of knowledge and experience about a business' operations, or the detailed division of activities across an integrated provider, that comes with time. It may therefore not be able to prepare and issue procedures that effectively address the specific needs of the industry it is responsible for regulating.

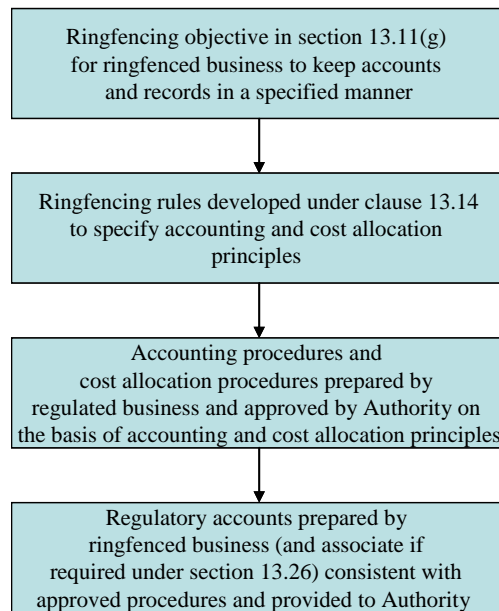
The alternative approach is for a regulator to develop a set of principles that it considers should be reflected into accounting and cost allocation procedures and to require the regulated business to prepare and submit to the regulator proposed arrangements that are consistent with the prescribed principles. This is the approach that the Northern Territory Utilities Commission has undertaken in regulating the Power and Water Corporation, the Northern Territory's vertically integrated monopoly electricity service provider.

The main advantage of this approach is that it still allows the regulator to retain control of the procedures by prescribing the principles and approving their final form, but it also draws on the service provider's detailed knowledge of its own business in the initial drafting of the procedures. Of course, there is the potential for the service provider to draft procedures that suit its own ends, rather than the regulator's needs. However, the service provider would be required to demonstrate that what it proposes is consistent with the prescribed principles and the regulator retains the right to amend the service provider's proposals, or to draft its own procedures.

In the Authority’s view, this latter approach is particularly suited to it, given the agency only recently became responsible for regulating the electricity industry and in the first instance the procedures would only apply to one business – Western Power.

The Authority can therefore specify in ringfencing rules the cost allocation and regulatory accounting principles that it wants the network business to reflect into detailed procedures. A service provider could prepare the initial version of the procedures for submission to the Authority for approval. The service provider would be required to comply with the procedures following their approval by the Authority.

The following diagram represents the relationship under this approach between the ringfencing objectives, ringfencing rules, accounting and cost allocation principles, accounting and cost allocation procedures and the business’ regulatory accounts.



Is this approach for developing regulatory accounting and cost allocation procedures appropriate?

The following subsections discuss the nature of the accounting and cost allocation principles that could be prescribed by the Authority under this approach.

Accounting Principles

The regulatory accounting principles should detail the basis on which a service provider must draft accounting procedures which, when the procedures are in turn approved by the Authority, the service provider would be required to use to prepare its annual regulatory accounting statements.

The Authority could consider reflecting the following principles, which draw heavily on the accounting principles in Schedule 2 of the *Northern Territory Electricity Ring-fencing Code*, into ringfencing rules. The accounting principles may provide that a ringfenced business must:

- prepare annual historic regulatory accounting statements, comprising a balance sheet, profit and loss report and a cashflow statement, for each ringfenced business and, in the case of integrated businesses, for the entire business of the integrated provider;
- prepare regulatory accounting statements, the structure of which must be consistent with the reporting templates detailed in the Utility Regulators' Forum discussion paper "*National regulatory reporting for electricity distribution and retailing businesses*"¹⁵;
- prepare its regulatory accounting statements:
 - in a manner that promotes the ringfencing objectives in section 13.11 of the Access Code, in particular section 13.11(g);
 - using accounting policies, procedures and assumptions that have a rational and recognisable economic basis;
 - based on financial information that is material, relevant, reliable and verifiable and so accurately reflects the substance of the underlying transactions or events of the business – where the substance and form of a transaction differ, the substance should be reported;
 - on a consistent and comparable basis, to the greatest extent possible, for each year of a regulatory period and provide a clear reconciliation of any changes in the policies, procedures or assumptions used since the first year of the regulatory period so that the Authority can make comparisons between years; in accordance with Australian Accounting Standards, wherever possible;
 - on a consistent basis, where applicable, across each business of an integrated provider for a financial year;
 - based on the financial statements from the business' statutory accounts, so that the regulatory accounting statements can be verified from the statutory accounts; and
 - in accordance with any cost allocation procedures approved by the Authority;
- have its regulatory accounting statements certified by an appropriately qualified, independent and objective auditor approved by the Authority;
- submit the regulatory accounting statements, together with copies of relevant policies, procedures or assumptions used in their preparation, to the Authority by the date prescribed by the Authority;
- make its directors responsible for the accuracy of the information contained in the regulatory accounting statements provided to the Authority;
- provide the Authority with a breakdown of the revenue received from, and expenditure paid to, its associates together with any supporting information required by the Authority;

¹⁵ Available at <http://www.accc.gov.au/content/index.phtml/itemId/332190/fromItemId/3894>

- specify certain other information that the Authority may want to require the ringfenced business to provide for the purposes of regulating revenues and prices – the nature of this information would need to be determined following a more detailed consideration; and
- procure any “associates” that are nominated by the Authority under section 13.26 of the Access Code to comply with the accounting procedures approved by the Authority, including to submit accounts to the Authority in accordance with section 13.26(a) to (c).

The accounting principles may also:

- detail the basis on which the Authority will approve the accounting procedures, such as if they comply with the accounting principles and effectively promote the ringfencing objectives and the objects of the Access Code;
- require the ringfenced business to prepare forecast regulatory accounting statements when requested to do so by the Authority;
- detail when the accounting procedures come into effect;
- detail where copies of the accounting procedures can be obtained;
- specify that information provided under the accounting procedures will be treated confidentially by the Authority (although, consistent with section 13.22 of the Access Code, neither the accounting principles nor the accounting procedures themselves would be confidential documents);
- detail the basis by which the accounting procedures can be added to, amended or varied over time;
- detail when service providers, other than Western Power, can apply for an exemption from all or part of the accounting principles; and
- provide that nothing in the accounting principles or related accounting procedures detracts from any obligation that a regulated business has under the Access Code or another relevant regulatory instrument.

Do the accounting principles above provide an appropriate basis for developing the accounting procedures?

What additional principles, if any, should be included?

Cost Allocation Principles

The cost allocation principles should detail the basis on which a service provider must prepare cost allocation procedures which, when the procedures are in turn approved by the Authority, the service provider should use to allocate costs across its business for the purpose of preparing its annual regulatory accounting statements.

The Authority may consider reflecting the following principles, which draw heavily on the accounting principles in Schedule 2 of the *Northern Territory Electricity Ring-fencing Code*, into ringfencing rules. The accounting principles may provide that a ringfenced business must:

- apply the cost allocation procedures when preparing its regulatory accounting statements;
- allocate costs legitimately incurred in the conduct of its business:

- in a manner that promotes the ringfencing objectives in section 13.11 of the Access Code, in particular section 13.11(g);
 - using accounting policies, procedures and assumptions that have a rational and recognisable economic basis;
 - so that items which are directly attributable to the network business are allocated to the network business;
 - so that items which are not directly attributable either to the network business or other business' of an integrated provider are allocated on a causation basis – costs may not be allocated based on an avoidable cost approach;
 - so that non-material items which cannot be directly attributed to a particular business and which cannot reasonably be allocated on a causation basis are attributed on a defensible, non-causal basis;
 - on a consistent basis, to the greatest extent possible, for each year of a regulatory period and provide a clear reconciliation of any changes in the policies, procedures or assumptions used since the first year of the regulatory period so that the Authority can make comparisons between years; and
- provide the regulator with a documented explanation of all costs that are not directly attributable and have been allocated on a causal or non-causal basis, including the split between a network business and other business' and a justification for the basis of the allocation.

The cost allocation principles may also:

- detail the basis on which the Authority will approve the cost allocation procedures, such as if they comply with the cost allocation principles and effectively promote the ringfencing objectives and objects of the Access Code;
- detail when the cost allocation procedures come into effect;
- detail where copies of the cost allocation procedures can be obtained;
- specify that information provided under the cost allocation procedures will be treated confidentially by the Authority (although, consistent with section 13.22 of the Access Code, neither the cost allocation principles nor cost allocation procedures would be confidential documents);
- detail the basis by which the cost allocation procedures can be added to, amended or varied over time;
- detail when service providers, other than Western Power, can apply for an exemption from all or part of the cost allocation principles; and
- provide that nothing in the cost allocation principles or related cost allocation procedures detracts from any obligation that a regulated business has under the Access Code or another relevant regulatory instrument.

Do the cost allocation principles above provide an appropriate basis for developing the cost allocation procedures?

What additional principles, if any, should be included?

6.5 INFORMATION MANAGEMENT

One of the key purposes of ringfencing is to promote competition in contestable markets by preventing a monopoly service provider preferentially dealing with a related business, including by providing preferential access to information which can advantage the related business over its competitors. Ringfencing arrangements can be used to control a service provider's:

- treatment of confidential information;
- disclosure of information to associates and third parties; and
- provision of information to the regulator.

Section 13.11(b) to (d) of the Access Code sets the following ringfencing objectives to control a service provider's use of commercially sensitive information:

- (b) subject to section 13.11(d), only marketing staff of the ringfenced business may have access to or possession of, or make use of, commercially sensitive information; and*
- (c) subject to section 13.11(d), and any written law including this Code, and except to the extent that the information comes into the public domain otherwise than by disclosure by the service provider, commercially sensitive information:*
 - (i) must be used only for the purpose for which that information was developed or provided; or*
 - (ii) must not be disclosed to any person (including any servant, consultant, independent contractor or agent of any associate of the ringfenced business) without the prior consent of the person who provided it or to whom it relates; and*
- (d) commercially sensitive information may be disclosed to and used by the service provider's senior staff but:*
 - (i) only to the minimum extent necessary from time to time for good corporate governance; and*
 - (ii) where possible only in summary or aggregated form or otherwise in a form that minimises the disclosure of any commercially sensitive or confidential details; and*
 - (iii) for use only in relation to the ringfenced business and only for the purpose for which it was developed or provided,*

The Authority can choose, as regulators in other jurisdictions have done, to approve information procedures in order to give practical effect to these objectives.

As with the regulatory accounting and cost allocation procedures, information procedures could be prepared and issued by the Authority, following public consultation, or developed by the regulated business, based on an approved set of principles, and submitted to the Authority for review, amendment as required and approval.

Given that the Authority only recently became responsible for regulating the electricity industry and in the first instance any information procedures would only apply to Western Power, the Authority has a preference to adopt the latter approach.

As with the proposed regulatory accounting and cost allocation procedures, the Authority could develop ringfencing rules that detail the principles that it would like to see reflected into the procedures and require Western Power to prepare an initial draft that promotes both the prescribed principles and the ringfencing objectives in section 13.11 of the Access Code.

Is this approach for developing information procedures appropriate?

The Authority may consider reflecting the following principles, which draw heavily on the information principles in Schedule 2 of the *Northern Territory Electricity Ring-fencing Code*, into ringfencing rules. These principles may provide that the information procedures must detail how a service provider will identify, handle, store, share and publish commercially sensitive information, including information which has the potential to affect materially the commercial interests of a competitor of an associate of the service provider, so that:

- it can only be accessed and used by marketing staff of the ringfenced business;
- it is only used for the purpose for which it was developed or provided;
- it is only shared to the minimum extent necessary from time to time for good corporate governance and with the prior consent of the person who provided it or to whom it relates;
- it is only shared, where possible, in summary or aggregated form or otherwise in a form that minimises the disclosure of any commercially sensitive or confidential details;
- it is only used in relation to the ringfenced business and only for the purpose for which it was developed or provided; and
- its disclosure to an associate does not give that associate an advantage over its competitors in a contestable market.

The principles may also provide that the information procedures must require the service provider to:

- make information provided to an associate available to competitors of the associate, whether the information is commercially sensitive information or not;
- provide information to the Authority in response to any reasonable request made by it from time to time; and
- make its directors responsible for the accuracy of the information provided to the Authority.

These principles may require that the provisions of section 2.2(1) of the *Electricity Industry Customer Transfer Code 2004* are extended to an integrated provider, such as Western Power. Section 2.2(1) requires a network operator to treat related businesses on an arms-

length basis and not to provide any benefit to those related businesses unless the network operator also makes that benefit available to other Users.¹⁶

The principles may also:

- detail the basis on which the Authority will approve the information procedures, such as if they comply with the information principles and effectively promote the ringfencing objectives and the objects of the Access Code;
- detail when the information procedures come into effect;
- detail where copies of the information procedures can be obtained;
- specify that commercially sensitive information provided under the information procedures will be treated confidentially by the Authority (although, consistent with section 13.22 of the Access Code, neither the information principles nor information procedures would be confidential documents);
- detail the basis by which the information procedures can be added to, amended or varied over time;
- detail when service providers, other than Western Power, can apply for an exemption from all or part of the information principles;
- provide that nothing in the information principles or related information procedures detracts from any obligation that a regulated business has under the Access Code or another relevant regulatory instrument.

Do the information principles above provide an appropriate basis for developing the information management procedures?

What additional principles, if any, should be included?

Should these information principles be extended to Western Power, in light of sections 2.2(1) and (2) of the Electricity Industry Customer Transfer Code 2004?

6.6 COMPLIANCE MONITORING AND REPORTING

As noted, section 13.1 of the Access Code provides that:

Except to the extent that the Authority grants an exemption under section 13.31, a service provider must, in relation to a covered network:

(a) comply with the ringfencing objectives; and

(b) if ringfencing rules apply to the covered network, comply with the ringfencing rules.

Sections 13.37 to 13.41 of the Access Code deal with monitoring and reporting of a service provider's compliance with these obligations:

¹⁶ Under section 2.2(2) of the Transfer Code, Western Power would not be required to treat related retailers on an "arms-length, commercial" basis unless required to do so in some other statutory instrument.

13.37 *A service provider must:*

- (a) *establish, maintain and implement effective procedures (“ringfencing compliance procedures”) to ensure and monitor its compliance with section 13.1; and*
- (b) *when requested by the Authority, provide a copy of its ringfencing compliance procedures to the Authority; and*
- (c) *at reasonable intervals determined by the Authority from time to time, assess its compliance with, and the effectiveness of, its ringfencing compliance procedures, and its compliance with section 13.1, and provide a report to the Authority regarding the assessment.*

13.38 *The Authority must place the service provider’s ringfencing compliance procedures on the public register.*

13.39 *No act or omission by the Authority concerning the adequacy or effectiveness of a service provider’s ringfencing compliance procedures affects the service provider’s obligations under section 13.1.*

13.40 *Nothing in any ringfencing compliance procedures limits section 13.1 or 13.14.*

13.41 *The Authority may from time to time publish guidelines setting out model ringfencing compliance procedures and model reporting procedures in relation to ringfencing compliance procedures.*

The Authority could choose to include principles in ringfencing rules which provide direction to the service provider about what must be included in compliance and reporting procedures.

These principles could include requirements that the procedures:

- cover all of the service provider’s obligations under Chapter 13 of the Access Code (not just the ringfencing objectives and ringfencing rules it is required to comply with under section 13.1);
- be submitted to the Authority for approval within a prescribed period, and the Authority may require changes to be made to the proposed procedures prior to approval and from time to time after their approval as deemed necessary by the Authority;
- require the service provider to submit annual reports to the Authority, in a form specified by the Authority, of compliance with those procedures;
- require the service provider, when requested by the Authority, to engage an independent auditor approved by the Authority to audit the service provider’s compliance with its compliance procedures and require the audit report to be provided to the Authority;
- make the service provider’s directors responsible for the accuracy of the information provided to the Authority under the compliance and reporting procedures;
- require the service provider to have a dedicated compliance committee and compliance officer that is responsible for ensuring that the compliance and reporting procedures are applied;
- comply with Australian Standard AS3806-1998 – “Compliance Programs” – which provides guidance on the development of effective compliance systems; and

- detail where copies of the compliance and reporting procedures can be obtained.

The compliance and reporting principles may also:

- detail the basis on which the Authority will approve the compliance and reporting procedures, such as if they comply with the compliance and reporting principles and effectively promote the ringfencing objectives detailed in the Access Code;
- confirm that, consistent with section 13.22 of the Access Code, the compliance and reporting procedures are not confidential material;
- specify that commercially sensitive information provided under the compliance and reporting procedures will be treated confidentially by the Authority;
- detail the basis by which the compliance and reporting procedures can be added to, amended or varied over time;
- detail when service providers, other than Western Power, can apply for an exemption from all or part of the compliance and reporting principles; and
- provide that nothing in the compliance and reporting principles or procedures detracts from any obligation that a regulated business has under the Access Code or another relevant regulatory instrument.

Do the compliance monitoring and reporting principles above provide an appropriate basis for developing the compliance monitoring and reporting procedures?

What additional principles, if any, should be included?

6.7 BREACHES OF RINGFENCING ARRANGEMENTS

Sections 13.42 to 13.44 of the Access Code deal with the service provider breaching the ringfencing objectives and ringfencing rules that it is required to comply with under section 13.1:

13.42 A service provider must report to the Authority details of any breach of section 13.1 immediately upon becoming aware of the breach.

13.43 A person who considers that a service provider has breached section 13.1 may provide details of the breach to the Authority.

13.44 On receipt of details under sections 13.42 or 13.43 the Authority must, and any other time of its own initiative the Authority may, consider whether to make a determination under section 13.14(b).¹⁷

However, Chapter 13 of the Access Code imposes further obligations on a service provider than the requirement in section 13.1 to comply with the ringfencing objectives and ringfencing rules. For example, sections 13.4 to 13.7 impose obligations in relation to establishing and amending “deemed access contracts” and “associate contracts”.

The Authority may therefore consider introducing ringfencing rules which:

¹⁷ A determination under section 13.14(b) refers to the Authority drafting and approving ringfencing rules.

- require a service provider to report to the Authority details of any breach of an obligation under Chapter 13, not just a breach of section 13.1, immediately it becomes aware of the breach as a reasonable and prudent service provider;
- enable a person who considers that a service provider has breached any of its obligations under Chapter 13, not just section 13.1, to provide details of the breach to the Authority; and
- require a person who alleges that a service provider has made a breach of its obligations under Chapter 13 to provide the Authority with details of:
 - the nature of the breach;
 - the impact or effect of the breach; and
 - evidence that supports or substantiates the allegation; and
- extends the Authority’s obligations under section 13.44 to breaches, or alleged breaches, of any part of Chapter 13, not just section 13.1.

It is noted that, while the Access Code does not specify penalties for breaching the Access Code, section 118 of the *Electricity Industry Act 2004* does make provision for regulations to be established for enforcing, and penalising contraventions of, the Access Code. However, no such regulations have yet been established.

Are the principles above necessary to ensure that breaches of the ringfencing arrangements are appropriately managed?

What additional principles should be introduced?

6.8 TIMEFRAME FOR INTRODUCING RINGFENCING RULES

Sections 13.27 and 13.28 of the Access Code deal with the timeframe for the commencement of the ringfencing rules and provide that:

13.27 An approval, variation or revocation of the ringfencing rules may be expressed to take effect immediately or at one or more specified times.

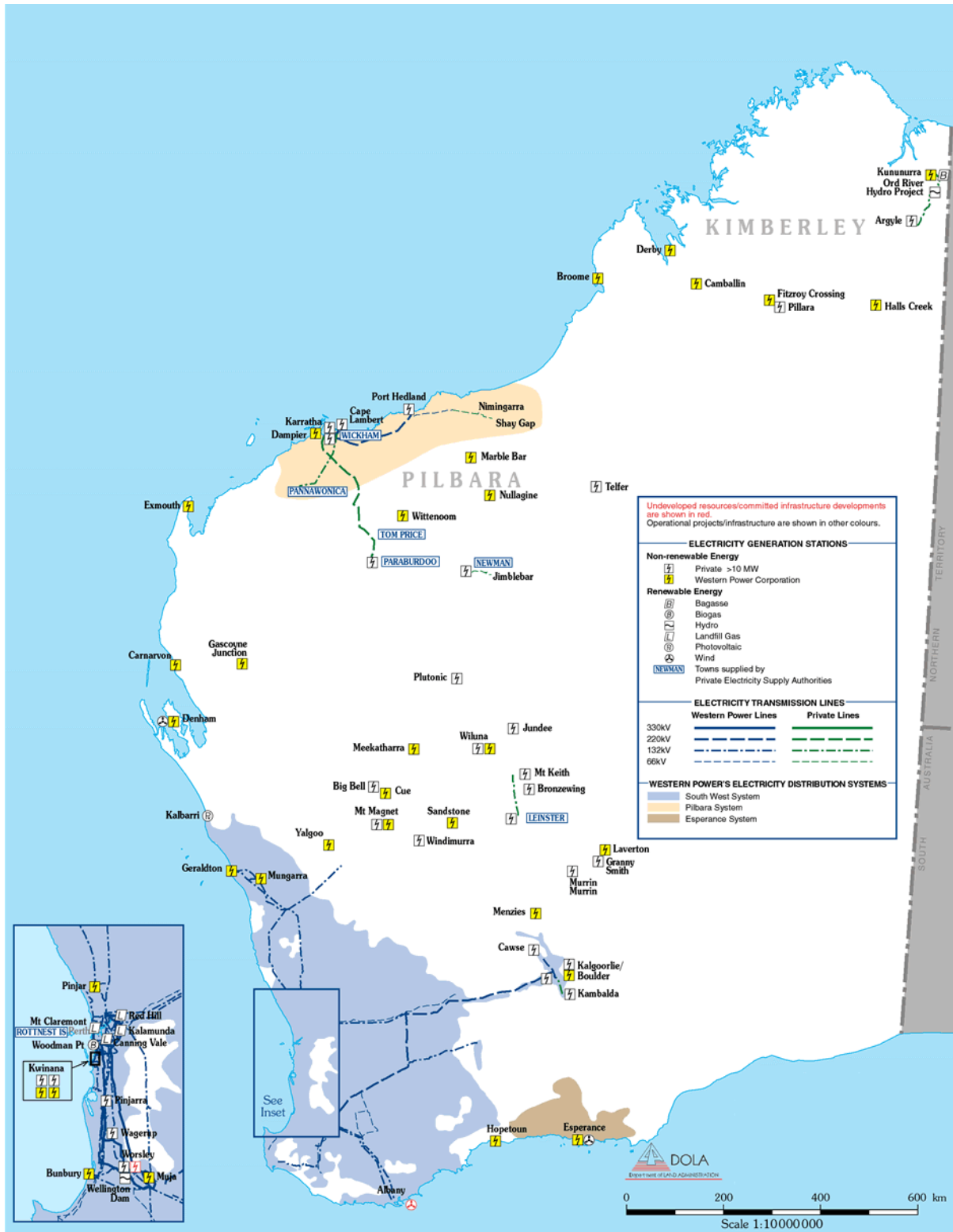
13.28 If no time is specified, an approval, variation or revocation of the ringfencing rules takes effect 3 months after it is placed on the public register.

The Access Code therefore gives considerable discretion to the Authority to decide when ringfencing rules will commence.

Determining the appropriate commencement date will require a “rule-by-rule” assessment by the Authority as it is likely that some rules, such as preparing regulatory accounting statements, could take effect immediately while others, such as any requirement to separate an integrated service provider’s activities as discussed in section 6.2, may require a considerable lead time.

What matters should the Authority consider in deciding whether particular rules should commence immediately, within 3 months of being placed on the public register or at some other specified date?

APPENDIX 1 - MAP OF WESTERN AUSTRALIAN ELECTRICITY SUPPLY NETWORK 18



¹⁸ Electricity Reform Task Force, "The Electricity Supply Industry of Western Australia - A Background Paper on the Reform Process", November 2001, page 33.