



RING-FENCING IN THE ELECTRICITY AND GAS INDUSTRIES ISSUES PAPER

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PREFACE

Fundamental marketplace changes are underway in the electricity and gas markets in Victoria. Competition among service providers is intensifying as the market in Victoria moves towards Full Retail Competition (“FRC”) for all electricity and gas customers. In preparation for FRC, some market participants have already taken actions to create separate distribution and retailing functions, such as implementing new accounting processes, forming new affiliated retailers and forming brand new retailers that are physically and corporately separate from all distributors. They have also, in some cases, formed multi-utilities by combining electricity and gas distribution operations.

These evolving market structures, while generally more efficient, may still have the effect of preventing or dissuading entry and undermining effective competition in a highly competitive retail energy market, or of decreasing the efficiency of distribution price regulation. As a result, effective competition and regulation may be undermined, which may in turn increase costs to consumers.

The Office of the Regulator-General (the “Office”) is concerned to address these competition issues. Key objectives of the Office, pursuant to the *Office of the Regulator-General Act 1994* are to promote competitive market conduct, to prevent use of monopoly or market power and to ensure that consumers benefit from competition and efficiency.

The Office has consequently commenced a review of the existing ring-fencing arrangements between the distribution and retail arms of Victoria’s energy businesses and of the options for varying those arrangements. This Issues Paper addresses the relationships that both single-sector distributors and multi-utility (electricity and gas) distributors have with their affiliated electricity and gas retailers. It considers possible ways in which distributor-retailers might behave that might reduce the efficiency of distribution price regulation or might result in anti-competitive advantages for an affiliated retailer. It also presents a series of options to be considered for new regulations to address such behaviour.

Public input is sought on the issues identified for comment in the paper. Public response will provide an important basis for the Office’s further consideration of the options and approaches to ring-fencing for the integrated electricity and gas businesses. The Office will publish a Position Paper detailing its views on these issues later this year, for additional public consultation.

The Office invites all interested parties to comment on the issues raised in this Issues Paper. Submissions must be provided to the Office, both in writing and in electronic format, by the close of business, **Friday 8 September 2000**. Further information regarding submissions is contained in Part 6 of this paper.



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Regulator-General

KEY TERMS

<i>Affiliated (associated) companies</i>	Companies or business units related through common ownership.
<i>Affiliated retailer</i>	Electricity or gas retailer that is related to a distributor through common ownership. Affiliated retailers may be first-tier or second-tier retailers.
<i>Contestable customer</i>	A customer with the ability to switch energy retailer (all electricity and gas customers after the introduction of FRC in each market).
<i>Distribution business</i>	One of the eight businesses formed providing electricity and/or gas distribution services in Victoria. In most cases these businesses are also retailing energy.
<i>Distributor</i>	A provider of electricity or gas distribution services, regulated under the terms of a Distribution Licence issued by the Office.
<i>Dual-fuel retailer</i>	An energy retailer offering both electricity and gas to the same customer base, or overlapping customer bases. A dual-fuel retailer may also be a first-tier retailer of one or both energy products. Pulse Energy is proposed to be a dual-fuel retailer.
<i>Electricity generator/gas producer</i>	An electricity generation or gas production company that sells energy to a retailer, through a wholesale market.
<i>First-tier retailer/host retailer/incumbent</i>	In any given geographic area, the electricity or gas retailer that sells to franchise customers before the implementation of FRC. After implementation of FRC, this is the retailer with default obligations.
<i>Full retail competition (FRC)</i>	Availability of customer choice of retailer for all electricity or gas customers in Victoria, by making all customers contestable.
<i>Multi-utility</i>	A distribution business licensed for distribution service in both the electricity and gas industries. A multi-utility is essentially a combination of single-sector distributors.
<i>Offer</i>	A price and service combination marketed to a contestable customer base by a retailer.
<i>Retailer</i>	A company that obtains energy supply from an electricity generator or a gas supplier and sells the energy to end use customers, regulated under the terms of a Retail Licence issued by the Office. The energy is delivered to customers through a distribution system.

<i>Second-tier retailer</i>	An electricity or gas retailer operating in an area where it is not the first-tier retailer for that particular fuel. A retailer may be a first-tier retailer in one area, and a second-tier retailer in another. Even in the same geographic area, a retailer may be the first-tier retailer of electricity and a second-tier retailer of gas, or vice versa.
<i>Single-sector distributor</i>	A distribution business licensed for distribution service in only one energy sector (electricity or gas but not both).
<i>Tariff</i>	Regulated prices for services provided by a distributor or retailer.

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EXECUTIVE SUMMARY

In this paper, the Office examines the existing structural arrangements of Victoria's electricity and gas distributors and retailers. It considers how likely they are to have the effect of preventing or dissuading entry and undermining effective competition in a highly competitive retail energy market, or of decreasing the efficiency of distribution price regulation. The paper considers various aspects of corporate integration or affiliation between electricity and gas distributors and retailers, including the establishment of multi-utility businesses and dual-fuel retailers.

Ring-fencing addresses competitive policy issues through the application and enforcement of regulatory measures. This paper identifies the primary areas where the Office believes that ring-fencing may be necessary and presents a series of ring-fencing options to consider for new regulation to address those areas.

The paper seeks public comment on a range of ring-fencing issues. It also provides guidance on the Office's preliminary views regarding the way in which ring-fencing measures would contribute to the Office's objectives under the *Office of the Regulator-General Act 1994* (the "ORG Act"), the *Electricity Industry Act 1993* (the "Electricity Act") and the *Gas Industry Act 1994* (the "Gas Act").

The topics on which the Office is seeking comment in this paper include the following:

- the identification of the possible ways in which distributor-retailers might behave that might reduce the efficiency of distribution price regulation or might result in anti-competitive advantages for an affiliated retailer;
- opportunities that may exist for misallocation of costs between distributor and retailer activities, and for self-dealing under the existing business structures; and
- differences in the ring-fencing regimes between the electricity and gas industries, and the extent of the need for uniformity.

Part 5 of the paper brings together analysis earlier in the paper and provides a set of options for ring-fencing measures that can be considered for practical application in Victoria. Its aim is to focus readers and respondents on what they believe to be the practical issues that need to be addressed in the Victorian electricity and gas industries and how they differ between these two energy markets.

The table below details, for easy reference, each topic where the Office is seeking comment in the paper, the Office's preliminary position in relation to it, and the issues that will require further consideration.

Overview of issues

Table 1: Summary of the Office's Position and of Issues on which the Office Seeks Views

TOPIC	THE OFFICE'S PRELIMINARY POSITION	ISSUES ON WHICH THE OFFICE SEEKS VIEWS	SECTION
Multi-utility businesses	The positions adopted in this paper regarding multi-utility businesses primarily address issues that arise when a distribution business operates in both the electricity and gas markets.	<ul style="list-style-type: none"> • Other types of multi-utility companies likely to emerge in the Victorian market that may require additional consideration by the Office. 	2
Aspects of behaviour to be addressed by ring-fencing	<p>There are four possible ways in which distributor-retailers might behave so as to reduce the efficiency of distribution price regulation or result in anti-competitive advantages for an affiliated retailer. These are as follows:</p> <ul style="list-style-type: none"> • cross subsidisation by a distributor of affiliated retailer activities; • giving an affiliated retailer preferential access to distributor services; • joint marketing between a distributor and a retailer; and • giving an affiliated retailer access to information held by a distributor. 	<ul style="list-style-type: none"> • The identification of the aspects of behaviour where distributor/retailer relationships can reduce the efficiency of distribution price regulation or might result in anti-competitive advantages for an affiliated retailer. 	3
Cross subsidisation	<p>Cross subsidisation in the form of inappropriate cost shifting is possible between electricity and gas distribution and retailing activities, because although the costs of the retail business have largely been identified and removed from each distributor's cost base, some activities are performed for both the distribution and retail businesses.</p> <p>Ring-fencing measures that are intended to address potential for cross subsidisation need to focus on:</p> <ul style="list-style-type: none"> • ensuring appropriate identification and ongoing allocation of costs; • the definition and appropriate transfer pricing of distribution activities; and • the ability to ensure that appropriate transfer pricing is used in practice. 	<ul style="list-style-type: none"> • Opportunities for cross subsidisation. • The extent to which the physical separation in the gas industry prevents cross subsidisation occurring, in contrast to the electricity industry where physical separation is not required. 	3.1

TOPIC	THE OFFICE'S PRELIMINARY POSITION	ISSUES ON WHICH THE OFFICE SEEKS VIEWS	SECTION
Preferential access to distributor services	<p>A distributor may be in a position to offer an affiliated retailer preferential access to essential services. Such preferential access may give the affiliated retailer cost or service advantage over competitors in acquiring and serving their customers. It is the affiliated host retailer that is likely to be able to gain advantage in this case, since that is the retailer operating in the distributor's area of operation.</p> <p>Ring-fencing measures that are intended to address potential for affiliated retailers to obtain preferential access to distributor services need to focus on:</p> <ul style="list-style-type: none"> ensuring appropriate identification of the distributor services that should be made available to all retailers in a non-discriminatory manner; the definition of systems, processes and procedures through which distributors provide these services, to ensure that they support non-discriminatory service provision; and the ability to ensure that appropriate non-discriminatory access is afforded to all retailers in practice. <p>In addition, appropriate cost allocation and transfer pricing should be ensured.</p>	<ul style="list-style-type: none"> Identification of the essential services provided by a distributor. The essential services that are most likely to be provided preferentially. 	3.2
Joint marketing	<p>Joint marketing occurs where a distributor uses its resources to assist a retailer in its marketing, providing that retailer with marketing advantage that is not available to other retailers.</p> <p>Ring-fencing measures that are intended to address potential for an affiliated retailer to gain anti-competitive advantage from joint marketing with a distributor need to focus on:</p> <ul style="list-style-type: none"> ensuring appropriate identification of the situations that might arise where a retailer might gain an anti-competitive advantage in marketing through association with a distributor; the definition of practices such that the distributor will not afford anti-competitive marketing advantages to an affiliated retailer; and the ability to ensure that anti-competitive marketing advantages are not afforded to affiliated retailers in practice. 	<ul style="list-style-type: none"> The specific types of activity that should be considered to be joint marketing. Identification of the interactions that a distributor's employees have with customers that should be addressed. Identification of customer correspondence from distributors that should be addressed. Differences between the electricity and gas industries. 	3.3

TOPIC	THE OFFICE'S PRELIMINARY POSITION	ISSUES ON WHICH THE OFFICE SEEKS VIEWS	SECTION
<p>Access to information</p>	<p>Anti-competitive advantages are afforded to a retailer when that retailer has access to information that is in the control of the distributor, where that information is not available at all to other retailers, or is not available to them in an easily accessible form or in a timely manner.</p> <p>Ring-fencing measures that are intended to address potential for an affiliated retailer to gain anti-competitive advantage from preferential access to information held by a distributor need to focus on:</p> <ul style="list-style-type: none"> • ensuring appropriate identification of the situations that might arise where a retailer might gain an anti-competitive advantage through preferential access to information held by a distributor; • the definition of practices such that the distributor will not afford such preferential access to an affiliated retailer; and • the ability to ensure that preferential access is not afforded to affiliated retailers in practice. 	<ul style="list-style-type: none"> • Types of information that can/cannot be shared between a distributor and affiliated retailer. • Types of information that should be available equally to all retailers. • Differences between the electricity and gas industries. 	<p>3.4</p>
<p>Ring-fencing methods</p>	<p>Structural separation methods are ownership separation, financial separation, legal separation and physical separation.</p> <p>Affiliate relationship rules and guidelines have the objective of achieving:</p> <ul style="list-style-type: none"> • equal provision by distributors of services to all retailers and their customers through open, neutral processes and systems; and • regulation of interactions between a distributor and affiliated retailer. 	<ul style="list-style-type: none"> • The Office's identification of methods of structural separation and categories of rules and guidelines. • Other methods of separation and other areas where rules and guidelines might apply. 	<p>4</p>
<p>Structural ring-fencing options</p>	<p>There are several structural ring-fencing options to consider. There may be a rationale for different structural ring-fencing approaches in the electricity and gas industries.</p>	<ul style="list-style-type: none"> • How the structural electricity and gas models that are currently in place work in practice, and whether either or both form suitable models for multi-utility businesses. • Whether there is a need for uniformity between electricity and gas industry structural requirements. • Other options for structural ring-fencing that should be considered. 	<p>5</p>

TOPIC	THE OFFICE'S PRELIMINARY POSITION	ISSUES ON WHICH THE OFFICE SEEKS VIEWS	SECTION
Options for ring-fencing rules and guidelines	Alongside the chosen structural ring-fencing measures to be in place in Victoria, rules and guidelines will also be required.	<ul style="list-style-type: none"> • How the existing rules and guidelines work in practice. • Areas where rules and guidelines might be required. • The extent of any need for uniformity of rules and guidelines between electricity and gas businesses. 	5

1 INTRODUCTION

In this paper, the Office examines the existing structural arrangements of Victoria's electricity and gas distributors and retailers. It considers how likely they are to have the effect of preventing or dissuading entry and undermining effective competition in a highly competitive retail energy market, or of decreasing the efficiency of distribution price regulation. The paper considers various aspects of corporate integration or affiliation between electricity and gas distributors and retailers, including the establishment of multi-utility businesses and dual-fuel retailers.

The paper seeks comment from interested parties on the need for and nature of appropriate ring-fencing arrangements between the distribution and retail arms of these Victorian energy businesses, in order to eliminate or substantially reduce potentially adverse effects on retail competition and to improve the efficiency of distribution price regulation. The paper:

- identifies the primary reasons for believing that these structural arrangements may result in a substantial measure of market failure in fully competitive retail energy markets or may decrease the effectiveness of network business regulation;
- sets out the primary areas where appropriate ring-fencing measures would enhance competitive outcomes in the retail market; and
- presents for public comment a series of ring-fencing options intended to address these reasons for concern and thus to enhance competitive outcomes in the market.

The Office has not formed a firm view as to the materiality of the competition concerns identified in the paper or the combination of ring-fencing measures that would be most appropriate to reduce or eliminate those concerns. The purpose of the paper is to expose the ring-fencing issues to public comment and debate, as a basis for the development of an appropriate ring-fencing framework by the Office.

This introductory section begins by stating the policy background to Victoria's energy market reforms and the more general regulatory objectives of the Office. This is followed by an explanation of the need for an integrated approach to ring-fencing in the Victorian electricity and gas distribution and retail markets, and the setting out of the objectives of such an integrated approach. The section concludes by outlining the structure of the rest of this paper.

1.1 Policy Background to the Energy Market Reform

The Victorian government's utility reforms have been part of a broader agenda being pursued by Australian governments with the objective of establishing interconnected, efficient and competitive national markets for utility services. The impetus of the National Competition Policy came from the Hilmer Report and the subsequent *Competition Principles Agreement* adopted by the Council of Australian Governments in 1994. National Competition Policy set the agenda for structural, competition and regulatory reforms in the electricity, gas, water and road transport industries. The overriding priority for these reforms has been the development of the most competitive markets possible where competition is feasible, and to apply efficient incentive-based regulation to the monopoly network market sectors where

competition is not feasible. The objective of these reforms has been to ensure the long-term efficiency and viability of the restructured industries and to ensure that the resulting benefits flow through to customers in the form of lower prices and higher standards of service.

1.2 Regulatory Objectives of the Office

The Office must be guided by its statutory objectives. It is required to exercise its powers to achieve its objectives under the ORG Act, the Electricity Act and the Gas Act.¹

Those objectives require the Office to ensure that the benefits of competition and improved efficiency in the electricity and gas industries are passed through to customers. The Office's underlying goal in setting regulatory policy is to protect the interests of customers by setting regulations that ultimately contribute to effective competition, efficient prices, better quality and service innovation.

It follows that the Office has a legitimate concern about the potential use of distributor market power in ways that may advantage distributors and affiliated retailers to the detriment of the development of competition, and ultimately reduce the benefits that the energy industry restructuring and reforms can bring to customers.

Achieving all of its objectives simultaneously is a difficult challenge, which requires the Office to exercise judgement in striking a balance between competitive goals and interests. When considering regulatory actions to redress the potential for market failure, the Office is conscious that the promotion of effective competition is a means towards the end of promoting efficiency in the delivery and pricing of energy services to the ultimate benefit of customers and the community. The Office does not intend to propose regulation with the singular goal of facilitating competitive entry, irrespective of the social costs and benefits that may involve. Policies designed to facilitate competitive entry and effective competition must be weighed against the possibility that they will reduce customer benefits by eliminating existing economic efficiencies and/or imposing additional compliance costs.

1 The Office's objectives under the ORG Act are:

- to promote competitive market conduct;
- to prevent misuse of monopoly or market power;
- to facilitate entry into the relevant market;
- to facilitate efficiency in regulated industries; and
- to ensure that users and consumers benefit from competition and efficiency.

The Office's objectives, as stated in the Electricity Act, are:

- to promote competition in the generation, supply and sale of electricity;
- to ensure the maintenance of an efficient and economic system for the generation, transmission, distribution, supply and sale of electricity;
- to protect the interests of consumers with respect to electricity prices and the safety, reliability and quality of electricity supply; and
- to facilitate the maintenance of a financially viable electricity supply industry.

The Office's objectives, as stated in the Gas Act, are:

- to facilitate and promote open, efficient and competitive markets for and in relation to gas and to safeguard against misuse of monopoly power;
- to protect the interests of consumers with respect to gas prices and the reliability and quality of gas supply; and
- to facilitate the maintenance of a financially viable gas supply industry.

Where there is evidence that structural change in the electricity or gas industry is necessary in order to create a sustainable competitive environment for the long term, the Office's objectives require it to act in order to promote competition, even if short-term efficiencies may be said to be lost.

1.3 The Need for an Integrated Approach to Ring-fencing

The privatisation of Victorian government-owned electricity and gas businesses, and the structural changes that took place at that time, introduced a competitive framework into those industries in Victoria. However, there is still potential for the monopoly market power of distributors to be detrimental to competition. The Office, which has an important role in the effective implementation of the Victorian Government's utility reforms, is concerned to address these market power issues, and in particular energy distributor market power issues that may affect the retail electricity and gas markets, which are the focus of this paper.

The introduction of competition into the Victorian electricity and gas markets has required the *financial separation* of electricity and gas distribution and retailing activities, and the further *legal separation* of gas distribution and retailing activities. However, in both these markets, these somewhat separated businesses can still exist under the same corporate umbrella, allowing the two entities to continue to maintain certain aspects of the relationship that they had as one integrated business. This relationship, or affiliation, may give affiliated retailers a competitive advantage that negatively affects the development of competition in the market, and ultimately reduces the benefits that energy industry restructuring and reform can bring to customers. A distributor's affiliation with other businesses may also reduce the transparency of costs that the distributor incurs in carrying out its regulatory functions as a distributor, and thus increase the complexity and reduce the efficiency of price regulation of the distributor's activities.

Ring-fencing addresses this competitive policy issue, through the application and enforcement of regulatory measures affecting the relationship between distribution and retail business activities.

Dynamic changes to the industry and corporate structures are already moving in a direction that is consistent with the objectives of ring-fencing. For example, some market participants have taken actions to create separate distribution and retailing functions, such as implementing new accounting processes, forming new affiliated retailers and forming brand new retailers that are physically and corporately separate from all distributors. However, there is still potential for affiliated retailers to obtain anti-competitive advantages in the market, where associations with a distributor remain. This paper seeks to identify the specific aspects of distributor behaviour that might result in anti-competitive advantages for an affiliated retailer, in that they cause significant entry barriers or would distort competition between retailers in the market.

Affiliated retailers also may have some inherent competitive advantages, such as:

- economies of scope and scale through affiliation with a distributor;
- a host retailer starting FRC with all the newly contestable customers;

- customer inertia – the tendency of consumers, especially small users, to stay with their current supplier even when there are apparent economic and/or service quality benefits associated with competitive offers; and
- sharing of a brand name with a distributor, with an established reputation in Victoria.

The presence of these inherent advantages adds to the need to address potential anti-competitive distributor behaviour.

General competition law is premised on the assumption that a workable competitive market is already in place and that the purpose of the regulatory regime is to maintain effective competition. It has been recognised by Australian governments that the structural features of the utility markets, and particularly the presence of natural monopoly conditions in the network services sector, are such as to warrant direct regulatory measures in addition to the protections of competition law.

In considering ring-fencing issues, the Office has taken a preventative “ex-ante” view as opposed to a reactive “ex-post” view. The ex-ante view identifies the potential that specific circumstances could arise and result in market failure and, ultimately, diminished benefits for customers. An ex-ante approach to regulatory intervention therefore seeks to reduce the risk of future anti-competitive behaviour. Ex-ante reforms provide all market participants with more certainty. Incumbents are more certain about what they can/cannot do. New entrants are better able to evaluate whether to enter the market. Ex-ante measures go to the root of competitive problems and try to change incentives – hence reducing risk of future anti-competitive behaviour. They are also generally simpler and easier to enforce.

In this paper, the Office therefore will consider ring-fencing measures where necessary to ensure the development of effective competition, which may include preventative as well as prescriptive measures.

The energy industry has other features that could impede the emergence of effective retail competition, including the scope for vertical leverage of network monopoly power into the retail sector and the dependency of competitors on access to the incumbent’s distribution infrastructure. These features are not addressed directly by competition law and both the National Electricity and Gas Codes recognise that additional ring-fencing arrangements are warranted to deal with them.

To date, the Office has not developed an integrated ring-fencing approach for the Victorian electricity and gas industries. The industries were structured differently and so required separate regulations. Thus, current accounting and legal separation requirements differ. However, existing regulatory instruments were not designed to address the convergence of activities in the newly formed multi-utility businesses and dual-fuel retailers. The current uncoordinated regulatory approach may therefore not be sufficient without additional separation requirements.

The implementation of FRC in the electricity and gas markets brings with it more issues that suggest the need for an integrated ring-fencing approach. The existing contestable market appears to be highly competitive for large usage customers. However, this does not guarantee that competition for small customers will be as effective. Residential and small-business customers are likely to see smaller reductions in energy bills offered to them by competing retailers. These customers

are also the most likely to display inertia. Marketing costs to the mass-market can be high relative to the size of the customers' energy bills. An affiliated retailer's advantage that is not material in the market for larger customers can become material in the mass-market.

The different pace at which contestability is being introduced in the electricity and gas industries further complicates these competition issues. For example, the supply of a contestable energy source such as electricity and a non-contestable energy source such as gas in a single package by a company may pre-empt entry of competing providers into the market once the non-contestable service becomes contestable.

The Office's Industry Guidelines have been published separately for the electricity and gas industries and were developed at an earlier time to reflect the industry structure and regulatory priorities that applied then. Although some aspects of ring-fencing were addressed in these Guidelines, a more integrated and comprehensive approach is now warranted.

1.4 Objectives of an Integrated Approach to Ring-fencing

There are two complementary goals and reinforcing effects of ring-fencing:

1. improvement in the provision of effective retail competition, by prevention of the exercise of leverage by the monopoly service provider into the contestable sector; and
2. improvement in the efficiency of monopoly service provider regulation, by prevention of shifting of contestable costs into the regulated sector.

Ring-fencing therefore assists the Office in its objectives in relation to both the implementation of FRC and the ongoing regulation of distribution services where there is not effective competition. Ring-fencing measures that prevent cost shifting address both of the above goals simultaneously. Measures that prevent the exercise of leverage that does not directly shift costs are designed to enhance retail competition by preventing misuse of monopoly power in the retail market.

1.5 Structure of this Paper

The rest of this paper is structured as follows:

- Part 2 reviews the current structure of Victorian electricity and gas distributors and retailers and the regulatory framework in place. These existing structures form the basis for the evaluation of the need for additional regulation to address ring-fencing issues.
- Part 3 considers possible ways in which distributor-retailers might behave that may reduce the efficiency of distribution price regulation or result in anti-competitive advantages for an affiliated retailer. In each case, it discusses how the behaviour might arise, the ways in which it could have an adverse effect and how the behaviour might be facilitated in the absence of appropriate ring-fencing measures.
- Part 4 discusses ring-fencing measures, which are in the form of structural separation requirements or rules and guidelines to which businesses must adhere.

- The purpose of Part 5 is to focus readers and respondents on what they believe to be the practical issues that need to be addressed in the Victorian electricity and gas industries and how they differ between these two energy markets. Table 9 in section 5.3 provides a focus for respondents to this Issues Paper, as it brings together analysis earlier in the paper to provide a set of options for ring-fencing measures that can be considered for practical application in Victoria.

2 THE VICTORIAN CONTEXT

This section reviews the current structure of Victorian electricity and gas distributors and retailers and the regulatory framework in place. These existing structures form the basis for the evaluation of the need for additional regulation to address ring-fencing issues.

This paper addresses the relationships that both single-sector distributors and multi-utility distributors have with their affiliated electricity and gas retailers. Almost all of the licensed distributors in the Victorian market have affiliated entities licensed to retail both electricity and gas (dual fuel retailers), be they single or multiple sector distributors. The emergence of dual fuel retailers in the market brings additional issues related to the market power they may have inherited due to their relationship with a distributor, through a common brand name, or a large market share of contestable customers.

The emergence of multi-utility distributor-retailers has extended the scope for the leverage of the market power of price-regulated distribution businesses into contestable electricity and gas retail markets. Accordingly there is a need to extend, similarly, the review of ring-fencing arrangements with respect to single-sector distributors that are licensed to operate in either the electricity or gas retail market, to accommodate issues raised by the multi-utility form of business that operates in a more integrated energy market.

The Office supports the formation of multi-utilities in the Victorian market. Multi-utilities can harvest the benefits from the convergence of energy market distribution and retail operations. Convergence of distribution operations can result in efficiency improvements from economies of scale, scope and density that can be passed through to customers in the form of lower prices and higher standards of service. Efficiency improvements from convergence may be achievable in functions such as meter reading, fleet operations and customer service. These efficiency improvements can also contribute to more robust competition in the market.

The positions adopted in this paper regarding multi-utility businesses primarily address issues that arise when a distribution business operates in both the electricity and gas markets. The Office welcomes input as to other types of multi-utility companies that need to be considered in formulating its views. What other types of multi-utility companies are likely to emerge in the Victorian market that may require additional consideration by the Office?

2.1 Electricity and Gas Distributors and Retailers

Twelve ultimate parent entities, including two state governments, have emerged with ownership interests in electricity and gas distributors and retailers in Victoria.

2.1.1 Multi-utility Distribution Companies

As shown in table 2 below, there are two distribution companies that have both electricity and gas distribution operations:

- a) Energy Partnership/United Energy with United Energy electricity distribution and Multinet Partnership gas distribution; and

b) TXU with Eastern Energy electricity distribution and TXU Networks gas distribution.

Both of these distribution companies have formed associate companies to perform operational activities, and are also licensed to market both electricity and gas under the same name. For example, TXU’s distribution companies are collectively called “TXU Networks” and electricity and gas are marketed under the common brand name “TXU”.

Pulse Energy has been established as a single, legally separate company to market both electricity and gas. Pulse Energy will still be affiliated with United Energy electricity distribution and Multinet Partnership gas distribution through Energy Partnership’s share holding in Pulse Energy.

Table 2

VICTORIAN ELECTRICITY AND GAS INDUSTRIES MULTI-UTILITY DISTRIBUTION COMPANIES				
	Distribution Licences		Retail Licences	
	Electricity	Gas	Electricity	Gas
Energy Partnership - Formed associate operational services provider	United Energy	Multinet Partnership	Ikon Energy United Energy*	Ikon Energy* Pulse Energy proposal
TXU - Formed associate operational services provider – Global Customer Systems - Providing distribution services under the name TXU Networks - Marketing energy under the brand name TXU	Eastern Energy	TXU Networks (Gas)	Eastern Energy* Kinetik Energy	Kinetik Energy*
* first-tier retailers				

2.1.2 Single-sector Distribution Companies

The trends towards dual fuel retailing and the formation of affiliated operational companies are evident within other distribution companies as well. As shown in table 3 below, three of the four distribution companies that are licensed to distribute only one energy product also hold licences to market both electricity and gas, or are affiliated with such licensees. Origin Energy has formed an associate company to perform operational activities.

Table 3

VICTORIAN ELECTRICITY AND GAS INDUSTRIES SINGLE-SECTOR DISTRIBUTION COMPANIES				
	Distribution Licences		Retail Licences	
	Electricity	Gas	Electricity	Gas
American Electric Power (AEP)	CitiPower		CitiPower*	CitiPower
AGL	AGL Electricity		AGL Electricity* ETSA Power ACTEW Energy	AGL Energy
Origin Energy - Formed associate operational services provider - Origin Energy Asset Management - Marketing gas under the brand name Origin		Envestra (Origin is a shareholder in Envestra, and Origin Energy Asset Management operates and maintains Envestra's distribution network.)	Boral Energy Electricity Boral Energy (Vic)	Boral Energy* Boral Energy (Vic)
Scottish Power	Powercor		Powercor*	
* first-tier retailers				

2.1.3 Independent Second-tier Retailers

There are six ultimate parent entities with ownership interests in eleven companies holding second-tier retail electricity and gas licences that are not affiliated with a distributor in Victoria.

As shown in table 4 below, two of these parent entities are government. The New South Wales and Queensland Governments together own seven of the licensed second-tier retailers. Of these, two are licensed for dual fuel retailing. The remaining five government-owned companies have licences for electricity retailing only.

Table 4

VICTORIAN ELECTRICITY AND GAS INDUSTRIES INDEPENDENT SECOND-TIER ELECTRICITY AND GAS RETAILERS		
	Retail Licences	
	Electricity	Gas
New South Wales Government	Energy Australia Great Southern Energy Integral Energy Australia NorthPower Advance Energy	Energy Australia
Queensland Government	Ergon Energy Energex	Energex

As shown in table 5 below, three of the four non-government entities are international energy companies: Enron, PowerGen and Exxon. Enron and PowerGen are licensed for retail electricity sales, while Exxon is licensed for retail gas sales.

Table 5

VICTORIAN ELECTRICITY AND GAS INDUSTRIES INDEPENDENT SECOND-TIER SINGLE FUEL RETAILERS		
	Retail Licences	
	Electricity	Gas
Enron	Enron Australia	
Exxon		Eso Australia
PowerGen	Yallourn Energy	
(Independent)	Australian Energy Services	

2.2 Regulatory Framework

A utility reform agenda has been implemented within the Victorian electricity and gas industries through the passage of and amendments to the Electricity Act and the Gas Act, which are the principal Acts governing those industries. The reform process for the Victorian electricity and gas industries began with the restructuring and privatising of the government-owned electricity and gas businesses. New market and corporate structures were put in place in each industry, which essentially separated generation/supply, transmission, distribution and retail activities. Different considerations and timeframes have resulted in different initial regulatory frameworks in the two energy markets.

As noted above, the initial structural, ownership and corporate organisational arrangements established by the government at the time of the electricity and gas reforms have now changed commercially as a result of merger and acquisition activity, corporate restructuring and organisational changes within the relevant businesses.

2.2.1 Statutory Powers of the Office

Through its statutory powers, the Office has broad scope to devise and impose ring-fencing requirements. The source of these powers is the ORG Act, which refers to the general authority of the Office to achieve its objectives and perform its functions. The ORG Act then refers to other “relevant legislation” that also confers powers on the Office, namely the Victorian Electricity and Gas Acts. The Office’s objectives under these three Acts were listed in a footnote in section 1.2 above.

The Victorian Electricity and Gas Acts make it an offence to distribute or retail electricity and gas, respectively, without a licence issued by the Office.² The licences require electricity and gas distributors and retailers to comply with applicable laws, rules, codes, tariff orders and service standards. The Office is able to issue new licences on such terms and conditions as it deems necessary and transfer, vary or revoke existing licences. Licence conditions can be enforced through complaint procedures, penalties and securing undertakings and ultimately the revocation of licences.

A key element of electricity and gas distribution licences is the requirement that customers and retailers can connect and use the distribution network on “fair and reasonable” terms. Fair and reasonable terms are defined variously in the different electricity and gas regulatory instruments.

² Section 159 of the Electricity Act and section 48B of the Gas Act respectively.

In addition, Section 12 of the ORG Act allows the Office to publish statements and guidelines relating to the performance of its functions and the exercise of its powers. The Office has issued a series of guidelines for each of the electricity and gas industries.

2.2.2 National Regulatory Requirements

The National Electricity Code

The *National Electricity Code* is a component of the National Electricity Law that is set out in a Schedule to the *National Electricity (South Australia) Act 1996*. Victoria adopted the National Electricity Law (and therefore, the *National Electricity Code*) in the *National Electricity (Victoria) Act 1997*.

The *National Electricity Code* provides the regulatory regime for the National Electricity Market (NEM), and, in section 6.20, provides for the development of ring-fencing guidelines for transmission and distribution network service providers. Victoria is part of the NEM, a wholesale market for the generation and purchase of electricity, with open access to transmission and distribution networks for generators, retailers and customers. The National Electricity Market Management Company Limited (NEMMCO) operates and administers the NEM in accordance with the *National Electricity Code*. The National Electricity Code Administrator Limited (NECA) supervises, administers and enforces the *National Electricity Code*. While the *National Electricity Code* does not expressly confer power on NEMMCO, NECA or the Office to develop ring-fencing guidelines for the Victorian electricity market, the ring-fencing provisions contained in the *National Electricity Code* are still relevant for the Office's consideration.

The Australian Competition and Consumer Commission (ACCC) has released a draft Statement of Principles for the Regulation of (Electricity) Transmission Revenues under the National Electricity Code. It details the ACCC's draft approach to a range of issues including information requirements and ring-fencing. This Statement of Principles is based primarily on *National Gas Code* provisions, with some key differences relating to ring-fencing requirements:

- detailed requirements relating to accounting separation and information flows;
- comprehensive coverage of account keeping, record keeping and cost allocation; and
- less attention to non-price issues such as treatment of confidential information, use of employees, and other forms of distributor/affiliated retailer interactions.

The National Gas Code

The *National Gas Code* provides for ring-fencing rules in the gas industry. It is the principal instrument for the regulation of access to gas distribution pipelines and is set out in Schedule 2 of the *Gas Pipelines Access (South Australia) Act 1997* (adopted in Victoria by the *Gas Pipelines Access (Victoria) Act 1998*).

The gas ring-fencing framework instituted under the *National Gas Code* and given statutory force in Victoria by the *Gas Pipelines Access (Victoria) Act 1998*, goes further than the reforms of the electricity industry in that it requires corporate separation of the distribution and retail functions.

Section 4 of the *National Gas Code* contains express provisions regarding ring-fencing³. It sets out minimum ring-fencing obligations for service providers to segregate their distribution services. As a minimum, the *National Gas Code* provides that a gas distributor must:

- be a separate legal entity incorporated under the Corporations Law;
- not carry on a “related business” (essentially a business of producing, purchasing or selling natural gas);
- establish and maintain a separate set of accounts in respect of the services it provides;
- establish and maintain a separate set of accounts for the entire business;
- have a fair and reasonable methodology for allocation of costs;
- comply with provisions to ensure that confidential information provided by, or obtained about, customers is used only for the purposes for which it was provided and is not disclosed without consent; and
- ensure marketing staff are not shared with a related business.

There is also a procedure for new ring fencing rules to be adopted should they be considered necessary, and provisions to ensure compliance with the rules in place.

2.2.3 *Victorian Electricity Industry Regulatory Framework*

The Electricity Act required distribution and retailing activities to be disaggregated into five regionally based distribution companies, each with its own retail arm. Thus, each of these five distribution/retail businesses operates as a distribution monopoly and a competitive energy retailer. The Electricity Act also introduced a timetable for the development of competition in retail electricity supply, with the implementation of FRC scheduled for 1 January 2001.

Current regulation for Victorian electricity distribution and retail businesses requires separate licensing, but not legal separation, of distribution and retailing activities. Until 1 January 2001, electricity prices are regulated by the Electricity Industry Tariff Order (“Electricity Tariff Order”). Network prices for all customers (covering the transmission and distribution of electricity) are also subject to the Electricity Tariff Order. The Electricity Tariff Order facilitates the purchase of electricity in the wholesale market by independent retailers, by requiring delivery across a distribution company’s network under the same regulated maximum tariffs at which the distribution company charges its retail arm for delivering electricity to its customers.

2.2.4 *Victorian Gas Industry Regulatory Framework*

The effect of the passage of the Gas Act in Victoria was to separate the monopoly functions of transmission and distribution from the competitive functions of buying and selling (retailing) of gas. This structural separation goes further than what was applied in the electricity industry. The key structural changes include the unbundling of the distribution operations and physical separation of the retail operations previously performed by Gascor into three “stapled” gas business, each

³ Under section 2 of the *National Gas Code*, the Office is required to approve access arrangements submitted by gas distribution companies, which can be part of the framework for dealings between gas distribution companies and downstream gas retailers.

comprising a gas distributor and a gas retailer. These gas retailers act as agents for Gascor for all non-contestable customers within a defined area of operation. As the gas market is deregulated, customers will progressively be able to move from their incumbent retailer (acting as an agent for Gascor) to any retailer of choice, with all customers expected to have their choice of retailer by 1 September 2001.

Unlike the electricity industry, the three gas distributors are not wholly aligned with the initial retail areas. Each gas distributor has two retailers serving its franchise customers. In the period before 1 September 2001, each gas distributor is therefore required to provide the use of its network on an open access basis to the two gas retailers acting as their agent. Following the progressive introduction of contestability into the retail gas market, gas distributors will be required to provide open access to their pipeline systems on a non-discriminatory basis, allow any licensed gas retailer to sell gas to those contestable customers, and allow customers to purchase gas directly from a producer. For current non-contestable customers there is price protection through legislative capping of tariffs pursuant to the Victorian Gas Industry Tariff Order (“Gas Tariff Order”). Charges for connection to, and use of the transmission system are also regulated by the Gas Tariff Order.

2.2.5 Victorian Electricity and Gas Industry Codes and Guidelines

In Victoria, there are several codes and guidelines in place for electricity and gas distributors and retailers. Although not always specifically developed for the purpose, some of those codes and guidelines address some ring-fencing issues, and these are listed in table 6 below. When considering the need for additional ring-fencing requirements, the sufficiency of these existing codes and guidelines must be addressed.

Table 6

VICTORIAN ELECTRICITY AND GAS INDUSTRIES CODES AND GUIDELINES		
Regulatory Instrument	Market	Application
<i>Electricity Distribution Code (EDC)</i>	Electricity	Standards for distribution of electricity to customers.
<i>Electricity Supply and Sale Code (ESSC)</i>	Electricity	Standards for supply and sale of electricity to customers.
<i>Retail Tariff Metering Code (RTMC)</i>	Electricity	Electricity metering standards.
<i>Electricity Industry Guideline No. 1, Part 7</i>	Electricity	Use of customer information.
<i>Electricity Industry Guideline No. 1, Part 6</i>	Electricity	Connections services and electricity supply.
<i>Electricity Industry Guideline No. 2</i>	Electricity	Arms length dealings between tendering and construction arms in network augmentation.
<i>Electricity Industry Guideline No. 3</i>	Electricity	Accounting requirements.
<i>Electricity Industry Guideline No. 5</i>	Electricity	Fair and reasonable connection and use of system agreements.
<i>Electricity Industry Guideline No. 8</i>	Electricity	Information reporting requirements.
<i>Electricity Industry Guideline No. 9</i>	Electricity	Compliance audits.
<i>Market System Operations Rules (MSOR)</i>	Gas	Unbundled purchase of gas and operation of gas transmission systems.
<i>Gas Distribution System Code</i>	Gas	Minimum standards for use of gas distribution system.
<i>Gas Customer Service Code</i>	Gas	Minimum standards for supply of gas to customers.
<i>Gas Industry Guideline No. 6</i>	Gas	Access to contestable gas customers that are connected to transmission or distribution networks operated under MSOR.

3 ASPECTS OF BEHAVIOUR TO BE ADDRESSED BY RING-FENCING

As discussed in Part 1 above and illustrated in Part 2 above, Victorian electricity and gas distribution and retailing businesses can exist under the same corporate umbrella. Their relationship within this corporate umbrella may give affiliated retailers opportunities to gain competitive advantage that negatively affects the development of competition in the market, and ultimately reduces the benefits that industry restructuring can bring to customers. A distributor's affiliation with other businesses may also reduce the transparency of costs that the distributor incurs in carrying out its regulatory functions as a distributor, and thus increase the complexity and reduce the efficiency of price regulation of the distributor's activities. Ring-fencing addresses this competitive policy issue.

The Office considers that there are four possible ways in which distributor-retailers might behave so as to reduce the efficiency of distribution price regulation or result in anti-competitive advantages for an affiliated retailer. These are as follows:

- cross subsidisation by a distributor of affiliated retailer activities;
- giving an affiliated retailer preferential access to distributor services;
- joint marketing between a distributor and a retailer; and
- giving an affiliated retailer access to information held by a distributor.

This section of the paper now considers each of these in turn. It discusses how the behaviour might arise, the ways in which it could have an adverse effect and how the behaviour might be facilitated in the absence of appropriate ring-fencing measures.

Comment is sought on the identification of the aspects of behaviour where distributor/retailer relationships can reduce the efficiency of distribution price regulation or might result in anti-competitive advantages for an affiliated retailer. What other specific aspects of behaviour should be reviewed in this context?

3.1 Cross Subsidisation

Cross subsidisation in the form of inappropriate cost shifting is possible between electricity and gas distribution and retailing activities, because although the costs of the retail business have largely been identified and removed from each distributor's cost base, some activities are performed for both the distribution and retail businesses. For example, procurement services can be provided in electricity distribution businesses for both the distribution and retailing functions. Accounting requirements are in place to allocate the appropriate costs to the retail business. However, there might be incentive to allocate all (or an inappropriate proportion) of such costs to the distributor when possible.⁴ Similar cost allocation issues arise where a distributor is affiliated to other businesses, such as a distributor in another jurisdiction. As part of the 2001 Electricity Distribution Price Review (the "EDPR"), the Office is currently examining the Victorian electricity distributors' cost statements in order to reach a final view on what the cost allocations in these businesses should be for the purposes of the EDPR.

⁴ There is a distinction between taking appropriate advantage of economies arising from synergies in the distribution and retail businesses and inappropriate cost shifting between distribution and retailing activities.

Cost shifting is clearly of concern from the perspective of network regulation. The shifting of contestable costs into the regulatory sector decreases the efficiency of regulation of the distributor as a monopoly service provider. It may also have an effect on retail competition, because, if cross subsidisation does occur, a distributor may, as a result, be able to raise its revenues by recovering some affiliated retailer costs via its regulated tariffs. This type of cross subsidisation may give the affiliated retailer a cost advantage over its competitors. This has the potential to distort competition between retailers and to discourage market entry.

Therefore, if ring-fencing measures can decrease or alleviate the potential for cross subsidisation to occur, it should give benefits through improving both the effectiveness of retail competition and the efficiency of regulation of distribution activities. In all jurisdictions where price-regulated distribution activities are mingled with retailing or other contestable activities, rules for cost allocation methods have necessarily been put in place in order to enable effective and efficient regulation of the distribution business, even in the absence of full retail competition.

The potential for cross subsidisation to occur is strongly related to the strength and degree of separation between distributor and retailer. The stronger the separation, the lower the likelihood that cross subsidies will occur. Monitoring and policing is difficult when businesses share employees, especially common managers and common customer contact personnel. Legal separation (currently in place for gas distributors) may result in more stringent auditing of the allocation of costs between those two businesses. This suggests that there may, in Victoria at the moment, be larger issues with electricity distributors than with gas distributors, due to the lesser extent of structural separation in the electricity industry.

With convergence of electricity and gas distribution activities, systems and processes are merged. As a result, cost allocation and transfer pricing becomes more complex, especially if there are separate rules in place for electricity and gas distributors that are co-mingled. Further complexity arises where a Victorian electricity or gas distributor shares corporate resources with a business that is price-regulated in another jurisdiction. In such a case, in the absence of appropriate identification and allocation of costs in a manner that is consistent across jurisdictions, there is further complexity in relation to the calculation and allocation of costs. In that situation, possibilities exist for cost shifting across jurisdictions and the potential ability arises for a distributor to over-recover under a multiplicity of regulatory regimes.

In international jurisdictions, convergence with other business activities under the same corporate umbrella has also increased complexity. For example, in Britain, several electricity distribution businesses share systems and processes with water distribution activities. In other cases, telephone networks have been established alongside existing transmission and distribution infrastructure.

Ring-fencing measures that are intended to address potential for cross subsidisation need to focus on:

- ensuring appropriate identification and ongoing allocation of costs⁵;
- the definition and appropriate transfer pricing of distribution activities; and

5 Cost allocation is a key issue in setting regulated prices.

- the ability to ensure that appropriate transfer pricing is used in practice.

Comment is sought on cross subsidisation that may currently exist between distributors and retailers in the Victorian electricity and gas industries. What opportunities for cross subsidisation may currently exist in each industry? To what extent does the physical separation in the gas industry prevent cross subsidisation occurring, in contrast to the electricity industry where physical separation is not required?

3.2 Preferential Access to Distributor Services

Each electricity and gas distributor provides many services to retailers that enable them to market and sell electricity to customers situated in its area. These services can be described as “essential services”, either because the distributor has a natural monopoly in providing the service (e.g. network connections, distribution network maintenance and fault repair) or because competition in the service is being implemented but is not yet fully effective (e.g. metering services). In either case, retailers are likely to be relying on the provision of these services in order to enable them to compete effectively in the retail market. The ability of an affiliated retailer to obtain preferential access to essential services is clearly a competitive concern. It could cause significant entry barriers for other retailers and distort competition between retailers in the market.

What constitutes an essential service may vary between the electricity and gas markets, for reasons that include the different nature of the markets, different customer transfer arrangements and different metering arrangements. The categorisation of essential services will also vary at any given time because of the different timetables for implementing retail competition. It will also vary from time to time within each industry as competition in energy supply and in supporting services is introduced. Broadly, essential services may include:

- **Basic distribution service:** The delivery of energy to customers of retailers using the distributor’s network; maintaining the network; responding to notification of faults. Processing connection and disconnection requests. Retailer / distributor account management.
- **Supporting services:** Metering and data services.
- **Facilitating retail competition:** Facilitating customer transfers, including provision of essential information.

A distributor may be in a position to offer an affiliated retailer preferential access to services of this nature. Such preferential access may give the affiliated retailer cost or service advantage over competitors in acquiring and serving their customers. It is the affiliated host retailer that is likely to be able to gain advantage in this case, since that is the retailer operating in the distributor’s area of operation.

The incentive to give preferential access arises from the fact that the affiliated host retailer is under the same corporate umbrella as the distributor, and can occur in one of three ways:

1. **Lack of provision of services to competing retailers:** If a distributor were actively to withhold access to essential services from competing retailers, that

would be anti-competitive and would be clearly in breach of the distributor's licence obligations. It would be easily detected and addressed through regulatory enforcement.

2. *Active preferential treatment:* In a case where a service is not withheld from any retailer, but its provision to the host affiliated retailer were prioritised, this might be less easy to detect. An example might be prioritising special meter reads requested by the host retailer. When detected, active discrimination of this nature would again clearly put the distributor in breach of its licence obligations and regulatory enforcement would proceed.
3. *Circumstantial preferential treatment:* There may be cases where a distributor does not actively seek to give preferential treatment to its affiliated host retailer, but the nature of the organisation is such that the host retailer nevertheless does experience preferential access to services that other retailers cannot achieve. An example might arise if the host retailer could obtain information that assists in customer switching through direct access to the distributor's database, where other retailers may have to e-mail the request and await a response that arrives later.

Ring-fencing measures that are intended to address potential for affiliated retailers to obtain preferential access to distributor services need to focus on:

- ensuring appropriate identification of the distributor services that should be made available to all retailers in a non-discriminatory manner;
- the definition of systems, processes and procedures through which distributors provide these services, to ensure that they support non-discriminatory service provision; and
- the ability to ensure that appropriate non-discriminatory access is afforded to all retailers in practice.

In addition, appropriate cost allocation and transfer pricing should be ensured, as discussed in section 3.1 above.

Comment is sought with regard to access to essential services. What are the essential services provided by a distributor? Which essential services are most likely to be provided preferentially?

3.3 Joint Marketing

Joint marketing occurs where a distributor uses its resources to assist a retailer in its marketing, providing that retailer with marketing advantage that is not available to other retailers. Joint marketing could occur where, for example:

- a distributor encourages customers to choose an affiliated retailer; or
- a distributor makes available marketing information exclusively, or more easily accessible, with regard to an affiliated retailer; or
- a distributor and affiliated retailer jointly develop products that are not available to other retailers, or which are designed so as to be more advantageous to the affiliated retailer than to other retailers.

Examples of joint marketing activities that could deter competitive entry or distort competition include:

- tying the provision of network services to the purchase of a particular retailer's product;
- providing customers with referrals or advice on choice of retailer during regular service interactions by distributor employees with customers⁶;
- passing on to the retailer leads obtained during regular service interactions by distributor employees with customers;
- promoting a particular retailer in correspondence to customers;
- joint presentations; and
- joint advertising.

There are a number of reasons why a distributor might afford its host retailer with such an advantage:

- There is an incentive because the distributor and retailer operate under the same corporate umbrella.
- Where there is no physical separation between distributor and retailer, close proximity will facilitate joint product development, whereas it would be difficult for a distributor to undertake product development with other retailers with whom it has more distant relationships. The potential for joint marketing is greater where there is less physical separation, and consequently more interaction, between distribution and retail employees.
- The host retailer will commence FRC with a dominant share of the contestable customer market, due importantly to its endowment of the previously franchised less than 160 MWh per annum customers that will become contestable with the implementation of FRC. Thus, if a distributor wishes to develop a product, it may perceive advantages for itself in jointly developing it with a dominant retailer that has significant market share. This issue could arise even if there has been full separation of the host retailer from the distributor.

Inadvertent joint marketing could occur where distributor and retailer share the same brand name and customers are confused as a result into thinking that a particular aspect of distributor service is linked to obtaining energy from the retailer that shares the brand name.

Ring-fencing measures that are intended to address potential for an affiliated retailer to gain anti-competitive advantage from joint marketing with a distributor need to focus on:

- ensuring appropriate identification of the situations that might arise where a retailer might gain an anti-competitive advantage in marketing through association with a distributor;
- the definition of practices such that the distributor will not afford anti-competitive marketing advantages to an affiliated retailer; and

⁶ The issue of provision of other types of information is addressed in section 3.4 below.

- the ability to ensure that anti-competitive marketing advantages are not afforded to affiliated retailers in practice.

The nature of the relationship between distributors and customers will also determine the extent to which distributors will build direct relationships with customers and the extent to which distributors will market directly to customers. In the gas industry, customers have relationships with retailers and not directly with distributors. A distributor is seen as being a service provider to a customer's retailer, enabling the retailer to deliver energy to the customer. An alternative model, which may be used in the electricity industry, regards a customer as having two relationships:

- a relationship with a retailer for the purchase of energy; and
- a relationship with a distributor for distribution service and for connection to the distributor's network.

This alternative model may give the distributor reason to market to customers. If, for example, a customer is to telephone his distributor rather than his retailer in the case of a power failure, then distributors may need to have means of informing customers of numbers to call and of the service they might expect to receive.

Comment is sought with regard to joint marketing between distributors and their affiliated retailers. What specific types of activities should be considered to be joint marketing? What are the interactions that a distributor's employees have with customers that should be addressed? What customer correspondence from distributors should be addressed? Are there differences between the electricity and gas industries in this regard?

3.4 Access to Information

Anti-competitive advantages are afforded to a retailer when that retailer has access to information that is in the control of the distributor, where that information is not available at all to other retailers, or is not available to them in an easily accessible form or in a timely manner.

Besides marketing leads and other marketing information referred to in the section above, information in this category could include the following:

- **Customer-specific information:** This may include usage data, or customer switching history.⁷
- **General customer information:** This may include forward looking scenario modelling, forecasting of demand growth trends, economic trends, demographic trends, and other such work carried out for, or by, the distributor for network planning related reasons, which would also be of advantage for retailers to have.
- **Distribution system information:** The affiliated retailer may have preferential access to information, such as where the distributor is going to make network improvements, new connections or advance information on planned outages. Network reliability information or other network operational data could

⁷ The Office will shortly release a consultation paper on the subject of Confidentiality and Explicit Informed Consent in relation to FRC in electricity supply and will similarly be addressing confidentiality of customer data in relation to gas supply at a later date.

provide advantages to retailers as it could be used to identify customer segments that are more likely to purchase selected products and services (e.g. back-up generation, power quality equipment, etc.).

- **Other industry information:** The distributor may be privy to other industry information that is confidential to itself and to other market participants, or otherwise not readily available. Having access to that information could confer a retailer with anti-competitive advantages. The information might, for example, be with regard to market shares between retailers, or retailers' financial data. It might relate to operational difficulties that retailers are having with billing systems or customer transfer systems, or other performance measures.

An affiliated retailer may obtain anti-competitive advantage through access to systems, facilities or employees of the distributor. Multi-utilities can provide valuable marketing information to an affiliated retailer of a complementary product. Joint or co-ordinated development of new products, such as sophisticated demand management systems, referred to in the section above, would also entail the sharing of information by a distributor with an affiliated retailer.

The more interaction there is between distributor and retailer systems, processes, facilities and employees, the stronger the likelihood that anti-competitive advantages of this nature will ensue.

Ring-fencing measures that are intended to address potential for an affiliated retailer to gain anti-competitive advantage from preferential access to information held by a distributor need to focus on:

- ensuring appropriate identification of the situations that might arise where a retailer might gain an anti-competitive advantage through preferential access to information held by a distributor;
- the definition of practices such that the distributor will not afford such preferential access to an affiliated retailer; and
- the ability to ensure that preferential access is not afforded to affiliated retailers in practice.

Distributors and retailers will also need to comply with any other guidelines issued by the Office with regard to confidentiality of customer information. Where information is not confidential, distributors will need to consider how they might make it available to all market participants on a non-discriminatory basis.

As discussed in section 3.3 above, the nature of the relationship between distributors and customers will also determine the extent to which distributors will have requirements for access to customer-specific data in order to facilitate the customer interactions in which they are involved.

Comment is sought on sharing of information between distributors and their affiliated retailers. What specific types of information should be considered? What types of information should be available equally to all retailers? Are there differences between the electricity and gas industries in this regard?

4 RING-FENCING METHODS

Ring-fencing involves regulatory intervention to require specified forms of separation between the activities of a distributor and an affiliated retailer. Ring-fencing arrangements are implemented through the application and enforcement of measures affecting the relationship between distribution and retail business activities.

Where there is an established need for regulatory intervention in the electricity and gas industries, two levels of ring-fencing can be considered. The *first level of ring-fencing* would involve forms of structural separation of the activities of the distributor from those of its affiliated retailer, and would include measures that are focused primarily on the control of opportunities for cross-subsidisation. The *second level of ring-fencing* would involve specific requirements and/or guidelines to limit behaviour in the company that would substantially lessen competition in the retail market.

4.1 Structural Separation

The extent of structural separation of the activities of the distributor from its affiliated retailer will impact the degree of additional ring-fencing requirements needed. In general, the lesser the extent of structural separation, the more rules and guidelines will be necessary. With greater structural separation, some issues become less relevant, and those rules and guidelines that are necessary may be easier to prescribe, monitor and enforce. However, it is important to realise that greater structural separation may result in diminished economies of scale or scope that are inherent in an integrated distribution and retail business.

Possible approaches to structural separation methods include *ownership separation, financial separation, legal separation* and *physical separation*.

4.1.1 Ownership Separation

While ownership separation, involving divestiture of retail activities, is the most comprehensive form of structural ring-fencing, it is also an extreme form of intervention in relation to existing property rights and corporate ownership arrangements.

Ownership separation has been adopted by a number of jurisdictions in the context of industry restructuring and corporatisation and privatisation of previously government-owned utility businesses. In particular, it has been used to separate gas production and electricity generation from the natural monopoly networks and in some cases to separate distribution from retail.

Ownership separation is usually applied where it is judged that a less rigid form of separation would not sufficiently mitigate existing market power. It is much less common to require divestiture of privately owned contestable businesses from affiliated regulated network businesses as a structural ring-fencing measure on competitive grounds. However, New Zealand provides an example of a jurisdiction where this has recently occurred.

The Office's current position is that divestiture of retail activities is not necessary to enable effective competition in energy retailing. It notes, however, that a number of Australian energy businesses are increasingly adopting corporate structures that

involve the separation of distribution and retailing activities. Some (eg Boral/Envestra) have moved to separate ownership structures for the separated business units. Such commercial developments are likely to be complementary to the objectives of ring-fencing and will reduce the need for second level ring-fencing measures where separate ownership structures are adopted as a commercial strategy.

4.1.2 Financial Separation

Financial separation requires separate accounting for distributor and retailer activities, but requires minimal separation of personnel, systems, facilities and information. This form of separation, which is required to distinguish the costs for distribution activities from retail activities, has been implemented by Victorian electricity and gas distribution businesses.

It has been suggested that accounting separation on its own is unlikely to be a sufficient form of ring-fencing:

“It is sometimes suggested that the degree of separation required is merely “accounting” separation, so that the financial relationships between two parts of a business become more transparent. While separation of this kind may place some practical constraints on cross-subsidisation, and facilitate regulation of the natural monopoly element, it will not be sufficient to remove potential incentives to misuse control over access to a vertically integrated element.”⁸

4.1.3 Legal Separation

Legal separation requires financial separation and the formation of different corporate business entities for distributor and retailer activities. Legal separation facilitates a clear audit trail for identifying cross subsidies and greater transparency of activities to enable compliance monitoring. Legal separation could require the transfer of property between different corporate business entities, but would not require the owners to divest assets to entirely new owners. Implementing legal separation can result in significant corporate reorganisation. Legal separation is currently required for gas distribution businesses, but not for electricity distribution businesses.⁹

4.1.4 Physical Separation

Physical separation requires distribution and retail operational activities to be carried out in different locations, using separate or partitioned systems. Complete physical separation prohibits sharing of facilities, equipment, information systems, employees and resources. Strict physical separation can impact the ability to achieve economies of scale, as well as create potentially unfair advantages for independent competitors from other jurisdictions that have not been required to implement physical separation. However, the extent of physical separation between distributor and retailer activities has a large impact on the potential for distributor/retailer

8 Report by the Independent Committee of Inquiry, National Competition Policy, Canberra, August 1993, p. 220.

9 In Britain, the Monopolies and Mergers Commission recommended in August 1993 that British Gas' transportation and storage business and trading business should be organised and operated as separate units. British Gas completed its restructuring in this manner in 1995. Subsequently, in 1997, British Gas split into two separately owned businesses: BG plc, whose Transco division comprises a gas transportation business, and Centrica plc, which is a retailer. The Utilities Bill currently before the UK Parliament introduces separate licensing of electricity distribution and retailing activities and prohibits distribution and retail licences being held by the same legal person in Great Britain.

relationships to create barriers to entry or distort competition. Physical separation is currently required for gas distribution businesses, but not for electricity distribution businesses.

4.2 Rules and Guidelines

As discussed above, rules and guidelines to limit behaviour that would substantially lessen competition in the retail market can be regarded as the *second level of ring-fencing* measures that can be implemented. The extent of implementation of the *first level of ring-fencing* measures – structural separation of the activities of the distributor from its affiliated retailer – will impact the degree of additional ring-fencing requirements needed. In general, the lesser the extent of structural separation, the more rules and guidelines will be necessary.

Affiliate relationship rules and guidelines generally have the objective of achieving:

- a) equal provision by distributors of services to all retailers and their customers through open, neutral processes and systems.

Section 3.2 above described how preferential access to distributor services could give an affiliated retailer anti-competitive advantages over other retailers. To the extent that rules and guidelines are used in order to address potential for affiliated retailers to obtain preferential access to distributor services, they need, as discussed above, to focus on:

- ensuring appropriate identification of the distributor services that should be made available to all retailers in a non-discriminatory manner;
- the definition of systems, processes and procedures through which distributors provide these services to ensure that they support non-discriminatory service provision; and
- the ability to ensure that appropriate non-discriminatory access is afforded to all retailers in practice.

In addition, appropriate cost allocation and transfer pricing should be ensured, as discussed in section 3.1 above.

- b) regulation of interactions between a distributor and affiliated retailer.

Sections 3.3 and 3.4 above described how joint market activities and issues with regard to access to information could give a retailer that is affiliated to a distributor anti-competitive advantages over other retailers. To the extent that rules and guidelines are used in order to address potential for affiliated retailers to gain competitive advantage in this manner, they need, as discussed above, to focus on:

- ensuring appropriate identification of the situations that might arise where a retailer might gain an anti-competitive advantage in this manner;
- the definition of practices such that the distributor will not afford such anti-competitive advantages to the retailer; and
- the ability to ensure that anti-competitive advantages are not afforded to affiliated retailers in practice.

Each of these objectives effectively comprises a category of affiliate relationship rules and guidelines, these being:

- rules and guidelines that prescribe equal provision by distributors of services to all retailers and their customers through open, neutral processes and systems; and
- rules and guidelines that regulate the conduct of interactions between a distributor and affiliated retailer.

This section has described four ways a distribution business could be structurally separated (first-level ring-fencing measures), and two categories of rules and guidelines that can be applied in addition to structural separation (second-level ring-fencing methods). Comment is sought on this identification of the two levels and types of methods. What other methods of structural separation might be considered for implementation in Victoria? What are other areas where rules and guidelines might apply?

5 RING-FENCING EVALUATION CRITERIA AND OPTIONS

Previous sections of this Issues Paper have considered the aspects of behaviour that ring-fencing is intended to address and the methods of ring-fencing that are available. Comments have been sought on each of these topics. The purpose of this Part 5 is to focus readers and respondents on what they believe to be the practical issues that need to be addressed in the Victorian electricity and gas industries and how they differ between these two energy markets. Responses to the issues identified for comment in the paper will provide an important basis for the Office's further consideration of the options and approaches to ring-fencing for the integrated electricity and gas businesses. The Office will publish a Position Paper detailing its views on these issues later this year, for additional public consultation.

Section 5.1 presents the Office's criteria for evaluating different ring-fencing options. Section 5.2 outlines the current ring-fencing requirements in place in the electricity and gas industries. Section 5.3 presents a series of "first level" structural requirement options, and a listing of "second level" rules and guidelines for combination with the structural "first level" option chosen. The chosen options will be implemented as a combination of first level and second level measures. In general, the stricter the first level measures are, the less strict the complementary second level requirements are likely to need to be. Strict first level measures combined with strict second level measures may constitute over-regulation. Weak first level measures, combined with weak second level measures, are likely to be ineffective at delivering benefits.

5.1 Office's Evaluation Criteria

The Office's key criterion for determining the need for regulatory intervention to address affiliated retailer competitive advantages is that the intervention delivers net benefits¹⁰.

As discussed in Part 1 above, in considering the need for ring-fencing measures, the Office has taken a preventative "ex-ante" view as opposed to a reactive "ex-post" view. The ex-ante view identifies the potential that specific circumstances could arise and result in market failure and, ultimately, diminished benefits for customers. An ex-ante approach to regulatory intervention does not require anti-competitive behaviour to have already occurred; it seeks instead to reduce the risk of future anti-competitive behaviour.

The Office therefore intends to propose for implementation ring-fencing measures where necessary to ensure the development of effective competition, which may include preventative measures.

The aim of the Office is to ensure long-term workable and effective competition, that alleviates barriers to entry where practicable, and delivers economically sustainable benefits to consumers in terms of price, quality of service and innovation.

In order to assess that net benefits will result from regulatory intervention, the Office must consider the effectiveness of measures to promote competition against the costs incurred in implementing the measures. The costs incurred in

¹⁰ While the primary objective is to ensure that Victorian electricity and gas customers receive net benefits as a result of ring-fencing arrangements adopted, the Office's analysis of the available options will have regard to the wider public benefits and costs involved, including implications for efficient resource use, business viability, competition and consumer choice.

implementing the measures include both initial set-up costs (e.g., business reorganisation) and ongoing operational costs (e.g., monitoring costs, losses of economies of scale and scope). Ideally, regulatory intervention should be highly effective, and capable of being implemented at low cost. In practice, trade-offs will be required, as the most effective measures may be more difficult/costly to implement.

Benefits and costs are, however, not necessarily directly measurable in financial terms. Many of the parameters that contribute to benefits and costs and thus to the assessment of whether net benefits will result will have to be evaluated using judgement. Parameters that would be particularly difficult to quantify include:

- complexity for market participants and for customers;
- consistency between electricity and gas in Victoria; and
- consistency with arrangements in other jurisdictions.

Issues with regard to complexity and consistency are considered below.

Improvements in competitiveness of the market (and hence in the efficiency of prices and service delivery) are also difficult to measure in financial terms.

The Office does not intend to rank parameters in terms of their importance, but rather to assess the extent to which each may / may not be significant in terms of the net benefits that may accrue in respect of each ring-fencing package of measures that is considered for implementation.

5.1.1 *Complexity*

Different ring-fencing approaches will have varying levels of complexity for customers, regulators, distribution companies and other market participants.

For example, corporate separation can be very complex for the distribution business at the outset, but requires less ongoing regulatory oversight and is less complex for customers to understand. Requiring a separation approach of only accounting separation may be less complex for the distribution business to implement than full separation, but it is likely to require more complex ongoing monitoring by regulators. Formal structural separation requirements may therefore be of limited value without practical operational separation between businesses, systems, information systems and staff.

Rules and guidelines may be of different levels of complexity, depending on their design.

5.1.2 *Consistency*

The Office proposes to seek regulatory consistency for Victorian multi-utilities where possible. The co-ordination of the two existing sets of requirements for electricity and gas and a future regime of multi-utility ring-fencing is an important matter. An inappropriate “fit” between regimes can result in confusion and unnecessary costs on businesses, thus jeopardising welfare gains from industry reform and defeating the Office’s objectives of facilitating efficiency and competition.

A national market is developing, and many utilities are now national in scope. Account needs to be taken of the fact that having different regimes across jurisdictions may lead to inefficiencies and undue burdens. Disincentives to operate

across jurisdictions may result from the increased cost of compliance with varying legal structures and regulatory requirements. There will thus be a need for the Office to consider the cross-jurisdictional effects of measures that it considers.

A need for consistency was also identified in section 3.1 above, which discussed the circumstance of a Victorian electricity or gas distributor that shares corporate resources with a business that is price-regulated in another jurisdiction. In such a case, in the absence of appropriate identification and allocation of costs in a manner that is consistent across jurisdictions, possibilities exist for cost shifting across jurisdictions and the potential ability arises for a distributor to over-recover under a multiplicity of regulatory regimes.

5.2 Current Ring-fencing Requirements

Table 7 below illustrates the structural ring-fencing requirements that currently apply to distributors and affiliated retailers in the Victorian electricity and gas industries.

Table 7

VICTORIAN ELECTRICITY AND GAS INDUSTRIES STRUCTURAL RING-FENCING REQUIREMENTS FOR DISTRIBUTORS AND AFFILIATED RETAILERS		
Structural Ring-fencing Requirements	Electricity Industry	Gas Industry
Ownership	Common ownership	Common ownership
Financial Structure - cross subsidisation	Different accounting treatment of costs and reporting	Different charts of accounts and reporting
Legal Structure - corporate decision-making	Single corporation Same Board of Directors	Separate corporations
Physical Separation - sharing resources and information - access to customers	Shared facilities and systems Affiliated "host" retailer has all contestable customers at outset	Separate facilities and systems Affiliated "host" retailer has all contestable customers at outset

Table 8 below illustrates the ring-fencing rules and guidelines that currently apply to distributors and affiliated retailers in the Victorian electricity and gas industries.

Table 8

VICTORIAN ELECTRICITY AND GAS INDUSTRIES RING-FENCING RULES AND GUIDELINES FOR DISTRIBUTORS AND AFFILIATED RETAILERS		
Ring-Fencing Rules and Guidelines	Electricity Industry	Gas Industry
Accounting	Cost allocation methods Reporting and auditing requirements	Cost allocation methods Reporting and auditing requirements
Access to Essential Services	Open access systems requirements	Open access systems requirements
Sharing of Information	Some requirements in place	Some requirements in place
Joint Marketing Activities	Not precluded	Cannot share marketing staff

The primary differences in the current ring-fencing requirements for the electricity and gas industries are the:

- extent of legal separation;
- extent of physical separation of facilities and systems; and
- controls on joint marketing activities.

There may be other differences, which have not resulted from regulatory requirements. These will factor into the evaluation of options for additional ring-fencing.

5.3 Ring-fencing Options

In this section, the Office presents, for consultation, a series of “level one” structural requirement options and a listing of “level two” rules and guidelines for combination with the chosen structural option. For the purposes of this Issues Paper, level one and level two options are presented separately. The Office intends to present a combination of level one and two requirements in a Position Paper to be published later this year for further public consultation.

To develop the options for additional ring-fencing in the electricity and gas industries in Victoria, the Office has considered:

- the objectives for ring-fencing prescribed in Part 1 of this paper;
- the industry and regulatory frameworks in Victoria that are set out in Part 2;
- the competition and regulatory concerns discussed in Part 3; and
- potential remedies set out in Part 4.

The results are summarised in table 9 below. This table provides a focus for respondents to this Issues Paper, as it brings together analysis earlier in the paper to provide a set of options for ring-fencing measures that can be considered for practical application in Victoria.

Table 9

VICTORIAN ELECTRICITY AND GAS INDUSTRIES AFFILIATED RETAILER ADVANTAGES AND POTENTIAL RING-FENCING MEASURES		
Issue	Objectives	Potential Regulatory Measures
Cross subsidisation	<ul style="list-style-type: none"> Ensuring appropriate identification and ongoing allocation of costs The definition and appropriate transfer pricing of distributor activities The ability to ensure that appropriate transfer pricing is used in practice 	<p><u>Structural – Level One</u></p> <ul style="list-style-type: none"> Definition of retail activities, to enable their separation Accounting separation of distribution and retail activities Legal separation of distribution and retail activities Physical separation of processes, facilities and systems <p><u>Rules and Guidelines – Level Two</u></p> <ul style="list-style-type: none"> Procedural requirements for accounting for shared resources Transparency of transactions, to facilitate monitoring Standardised set of cost allocation and transfer pricing rules
Preferential access to distributor services	<ul style="list-style-type: none"> Ensuring appropriate identification of the distributor services that should be made available to all retailers in a non-discriminatory manner The definition of systems, processes and procedures through which distributors provide these services, to ensure that they support non-discriminatory service provision The ability to ensure that appropriate non-discriminatory access is afforded to all retailers in practice 	<p><u>Structural – Level One</u></p> <ul style="list-style-type: none"> Definition of essential services, both natural monopolies and services where competition is not yet fully effective Setting of tariffs and standards of service requirements for essential services Accounting separation of distribution and retail activities Legal separation of distribution and retail activities Physical separation of processes, facilities and systems <p><u>Rules and Guidelines – Level Two</u></p> <ul style="list-style-type: none"> Non-discriminatory provision of access to interfaces (systems, technology, people) Employee training and communication requirements, to incentivise compliance Transparency of transactions, to facilitate monitoring
Joint marketing	<ul style="list-style-type: none"> Ensuring appropriate identification of the situations that might arise where a retailer might gain an anti-competitive advantage in marketing through association with a distributor The definition of practices such that the distributor will not afford anti-competitive marketing advantages to an affiliated retailer The ability to ensure that anti-competitive marketing advantages are not afforded to affiliated retailers in practice 	<p><u>Structural – Level One</u></p> <ul style="list-style-type: none"> Legal separation of distribution and retail activities Physical separation of processes, facilities and systems, and particularly management, planning and research and development activities <p><u>Rules and Guidelines – Level Two</u></p> <ul style="list-style-type: none"> Restrictions on product development, marketing and advertising, to avoid affiliated retailer biases Requirements to focus on all retailers' positions when developing products, marketing and advertising Requirements for customer communication to explain the different roles of distributor and retailer, which may be particularly important where customer confusion could result from the distributor and retailer sharing the same brand name Employee training and communication requirements, to incentivise compliance Transparency of product development and marketing activities, to facilitate monitoring

VICTORIAN ELECTRICITY AND GAS INDUSTRIES AFFILIATED RETAILER ADVANTAGES AND POTENTIAL RING-FENCING MEASURES cont'd		
Issue	Objectives	Potential Regulatory Measures
Access to information	<ul style="list-style-type: none"> Ensuring appropriate identification of the situations that might arise where a retailer might gain an anti-competitive advantage through preferential access to information held by a distributor The definition of practices such that the distributor will not afford such preferential access to an affiliated retailer The ability to ensure that preferential access is not afforded to affiliated retailers in practice 	<p><u>Structural – Level One</u></p> <ul style="list-style-type: none"> Legal separation of distribution and retail activities Physical separation of processes, facilities and systems <p><u>Rules and Guidelines – Level Two</u></p> <ul style="list-style-type: none"> Procedural restrictions on information access within distributor-retailer organisations, supported through systems access and security definitions Procedural restrictions on the use that can be made of information inadvertently received through unofficial channels Requirements for definition and classification of information available to the distributor to categorise it as information that should be confidential to the distributor or available to all retailers/customers Requirements for enabling timely availability to all retailers, or to customers of all retailers, of information to which non-discriminatory access should be afforded Requirements for customer communication to explain the different roles of distributor and retailer, which may be particularly important where customer confusion could result from the distributor and retailer sharing the same brand name Employee training and communication requirements, to incentivise compliance Transparency of information access systems and processes, to facilitate monitoring

Several of the potential regulatory measures that are shown in table 9 above are aimed at contributing to the objective of clearly identifying and ensuring effective accounting separation and transfer pricing of essential services. These are:

- definition of retail activities;
- accounting separation of distribution and retail activities;
- procedural requirements for accounting for shared resources;
- transparency of transactions; and
- standardised set of cost allocation and transfer pricing rules for both electricity and gas distributors.

The Office has regulatory instruments in place, described in section 2.2 above, which begin to address this objective. In developing a comprehensive ring-fencing regime for both the electricity and gas industries, the Office must evaluate the sufficiency of the instruments already in place, and consider any changes that might be necessary.

Other potential regulatory measures of a structural nature would entail physical separation and/or legal separation of distribution and retail activities through separation of systems, processes, facilities, employees and resources.

Comment is sought on how the structural electricity and gas models that are currently in place work in practice, and whether either or both form suitable models for multi-utility businesses.

Should electricity distribution businesses be further ring-fenced through legal separation, physical separation, or some combination of legal and physical separation?

Should the legal structure required for the gas distribution businesses be changed to allow some degree of resource sharing, or not require corporate separation?

Is there a need for uniformity in the ring-fencing structure used within the Victorian electricity and gas distribution businesses?

What other options for structural ring-fencing for the Victorian electricity and gas distribution businesses should be considered?

Alongside the chosen structural ring-fencing measures to be in place in Victoria, rules and guidelines will also be required. Table 9 above shows the potential rules and guidelines that the Office intends to consider in order to meet its objectives in instituting an integrated ring-fencing approach for Victoria's electricity and gas industries. In developing this approach, the Office must evaluate the sufficiency of the rules and guidelines already in place, and consider any changes that might be necessary.

Comment is sought on how the rules and guidelines that are currently in place work in practice, and on the potential rules and guidelines that are shown in table 9 above.

Are there other areas where rules and guidelines might be required?

Respondents should consider the relationship between the need for rules and guidelines and the structural ring-fencing requirements that might apply to Victoria's electricity and gas distributors and retailers.

What need is there for uniformity of rules and guidelines between electricity and gas businesses, taking into account the formation of multi-utility businesses and dual-fuel retailers in Victoria?

6 SUBMISSIONS

Submissions must be provided to the Office, both in writing and in electronic format, by the close of business, **Friday 8 September 2000**.

Submissions and inquiries should be directed to:

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In general, all submissions will be treated as in the public domain and placed on both the Office's Public Register and the Office's web-site, located at www.reggen.vic.gov.au. Where confidentiality is sought for all or part of the contents of a submission, these parts should be indicated clearly. However, where the Regulator-General considers that the release of this information would not be unduly harmful to the legitimate business interests of any party, the contents of the submission may be disclosed. The party making the submission will, of course, be provided the option of revising or withdrawing the submission prior to its disclosure.