



Determination

Ring-fencing Guideline cost pass through

Evoenergy

February 2019

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Contents

Overview	1
1 Determination	3
2 Evoenergy's application.....	4
3 Relevant regulatory requirements	6
3.1. Assessment approach.....	6
3.2. Relevant factors	7
3.3. Timing matters	7
3.4. What we considered in making this determination.....	8
4 Reasons for determination	9
4.1. Occurrence of pass through event.....	9
4.1.1 Service standard event.....	10
4.1.2 Positive change event	14
4.1.3 Timing of Evoenergy's application	14
4.2. Assessment of the pass through amount	14
4.2.1 Matters and proposals set out by Evoenergy.....	15
4.2.2 The increase in costs incurred by Evoenergy	15
4.2.3 Actions to reduce the magnitude of the pass through amount	16
4.2.4 Time cost of money.....	17
4.2.5 Recovery of costs solely a consequence of the pass through event.....	18
4.2.6 Whether the costs have been factored into the annual revenue requirement	18
4.2.7 Whether the costs are subject of a previous pass through determination.....	19
4.2.8 Any other factors we consider relevant.....	19
4.3. Calculation of the approved pass through amount	19

Overview

On 7 December 2018, Evoenergy submitted a cost pass through application to the Australian Energy Regulator (AER). The application related to costs incurred as a consequence of the publication of the AER's Ring Fencing Guideline (Guideline) on 30 November 2016. In particular these costs arose in giving effect to the Guideline's obligation for Distribution Network Service Providers (DNSPs) to use independent and separate branding for network services from contestable services.

The role of the AER, as the economic regulator of DNSPs in the National Electricity Market (NEM), is to assess Evoenergy's application against the cost pass through requirements in chapter 6 of the National Electricity Rules (NER). Specifically, if a positive change event occurs, we must determine the required pass through amount and how much of that amount should be passed through to network users in each regulatory year. This decision addresses those requirements, which are set out in clause 6.6.1 of the NER.

We have determined that Evoenergy's pass through application satisfies the requirements of a pass through event, specifically a service standard event. In particular, giving effect to new obligations under the Guideline materially increased the costs to Evoenergy of providing direct control services. The activity that gave rise to the majority of these costs was the rebranding of the Evoenergy's distribution business (from ActewAGL to Evoenergy), undertaken largely in 2017-18.

Based on our assessment of the relevant factors listed in clause 6.6.1(j) of the NER, we conclude the approved pass through amount for Evoenergy is \$2.05 million (\$2018-19), as at 30 June 2019 and including the time cost of money.

Evoenergy can recover this amount from customers through higher network charges in the 2019-20 and 2020-21 regulatory years, within the next regulatory control period, as set out in Table 1.

Table 1: Approved positive pass through amounts (\$2018-19)¹

	2019-20	2020-21	2021-22	2022-23	2023-24	Total
Approved pass through amounts	1,027,476	1,027,476	0	0	0	2,054,952

Source: AER Analysis.

¹ The time cost of money will be determined at the time of the annual pricing proposal, in accordance with the WACC we determine in our final decision for Evoenergy's 2019-24 distribution determination in April 2019.

Structure of determination

This determination is structured as follows:

- Chapter 1 – sets out our determination on Evoenergy's pass through application
- Chapter 2 – sets out Evoenergy's pass through application
- Chapter 3 – sets out the relevant regulatory framework and our assessment approach
- Chapter 4 – sets out our reasons for our determination.

1 Determination

We consider that Evoenergy's pass through application of 7 December 2018² establishes that a pass through event has occurred, being a service standard event and a positive change event as defined under the NER.

The AER's Ring-fencing Guideline³ published on 30 November 2016 gave rise to a service standard event, which caused Evoenergy to incur material costs of compliance. We are satisfied that the costs Evoenergy incurred in giving effect to the relevant provisions under the Guideline are prudent and efficient.

We have approved a pass through amount of \$2.05 million (\$2018-19), including the time cost of money. We determine that this amount will be recovered by Evoenergy in the 2019-20 and 2020-21 regulatory years in two equal amounts, within the 2019–24 regulatory control period. This is because it is too late for Evoenergy to recover its compliance costs within the 2014–19 regulatory control period.

We note that we have also approved two other pass through applications submitted by Evoenergy on 7 December 2018.⁴ The sum of all the approved pass through amounts is \$8.42 million (\$2018-19). If this amount is recovered in 2019-20, it is likely to result in a material increase in Evoenergy's 2019-20 revenue requirement. Given the potential volatility in Evoenergy's revenue, our preferable approach is to allow Evoenergy to recover the approved pass through amounts in two equal instalments (with adjustment for the time cost of money) for all three pass through applications over the regulatory years 2019-20 and 2020-21. We consider this approach will minimise volatility in Evoenergy's revenue requirements while still allowing it to recover its efficient costs in a timely manner.

In making this determination we have considered the factors set out in clause 6.6.1(j) of the NER.

² Evoenergy, *Ring-fencing cost pass through application*, 7 December 2018.

³ AER, *Ring-fencing Guideline (electricity distribution)*, 30 November 2016; AER, *Ring-fencing Guideline Version 2*, 17 October 2017.

⁴ AER, *AER determination - Power of Choice reforms cost pass through - Evoenergy*, February 2019; AER, *AER determination - Vegetation management cost pass through - Evoenergy*, February 2019.

2 Evoenergy's application

On 7 December 2018, Evoenergy submitted a pass through application to the AER for the costs it incurred to comply with the AER's Electricity Distribution Ring-fencing Guideline.

The AER was required to make the Guideline following a rule change in 2015 by the Australian Energy Market Commission (AEMC) as part of its Power of Choice (PoC) review (AEMC Rule Change).⁵ The amendments to the NER stipulated that the AER must develop and publish a guideline by 1 December 2016.⁶ The AER published the Guideline on 30 November 2016,⁷ and an amended Guideline on 17 October 2017.⁸

Evoenergy states that the Guideline is more onerous than the Ring-Fencing Guidelines for Electricity and Gas Network Service Operators in the ACT (ACT Guideline) that it has replaced,⁹ and it caused significant changes to the manner in which Evoenergy is required to provide direct control services such as differentiating its branding from ActewAGL Retail and implementing changes to the organisational structure.¹⁰

Evoenergy considers that the publication of the Guideline changes its regulatory obligations and requirements in respect of ring-fencing and constitutes a pass through event, in the form of a service standard event or, in the alternative, a regulatory change event.¹¹

Evoenergy submits that it incurred material incremental costs to comply with the new regulatory obligations imposed by the Guideline, and that these unplanned and unforeseeable costs were not included in the AER's determination of Evoenergy's revenue allowance for the 2014–19 regulatory control period.¹²

Evoenergy is seeking approval for a positive pass through amount of \$2.05 million (\$2018-19), including the time cost of money, as calculated in Table 2 below, to be recovered in the 2019–24 regulatory control period.

⁵ National Electricity Amendment (Expanding Competition in metering and related services) Rule 2015 No.12.

⁶ NER, clauses 6.17.2 and 11.86.8.

⁷ AER, *Ring-fencing Guideline (electricity distribution)*, 30 November 2016.

⁸ AER, *Ring-fencing Guideline Version 2*, 17 October 2017.

⁹ Independent Competition and Regulatory Commission, *Ring-Fencing Guidelines for Electricity and Gas Network Service Operators in the ACT*, November 2002. <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/jurisdictional-ring-fencing-guidelines>

¹⁰ Evoenergy, *Ring-fencing cost pass through application*, 7 December 2018, pp.6-7.

¹¹ Evoenergy, *Ring-fencing cost pass through application*, 7 December 2018, p.4.

¹² Evoenergy, *Ring-fencing cost pass through application*, 7 December 2018, p.4.

Table 2 - Evoenergy pass through amounts calculation (\$million, nominal)

\$million, nominal	2014-15	2015-16	2016-17	2017-18	2018-19
Annual revenue requirement (ARR)	155.75	148.68	153.84	160.37	164.38
ARR+ Pass through costs			154.00	161.99	164.53
Pass through amount (difference)			0.17	1.62	0.15
Cumulative pass-through amount, including time cost of money			0.17	1.80	2.05

Source: Evoenergy ring-fencing pass through application - Attachment 4 RF Final Decision post tax revenue model.

3 Relevant regulatory requirements

The pass through mechanism recognises that an efficient revenue allowance cannot account for certain types of matters that are uncertain and outside the control of the business, and which cannot be prevented or mitigated by prudent operational risk management. A cost pass through enables a network service provider to recover (or pass through) the costs of defined unpredictable, high cost events that are not factored into our revenue determination.

The NER includes the following prescribed pass through events for all DNSPs:

- a regulatory change event
- a service standard event
- a tax change event
- a retailer insolvency event
- any other event specified in a determination as a pass through event (nominated pass through event).

This decision relates to a service standard event. Our discretion in assessing pass through events is limited in the NER under clause 6.6.1(j), which is outlined in section 3.2 and addressed in our assessment in section 4.2 of this decision.

3.1 Assessment approach

When assessing Evoenergy's positive pass through application, we must determine whether a 'positive change event' has occurred.

A positive change event for a DNSP is defined under chapter 10 of the NER as:

a pass through event which entails the DNSP incurring materially higher costs in providing direct control services than it would have incurred but for that event, [...]

This assessment is done with reference to the NER and the current AER determination applicable to the Evoenergy, which is our remade 2014–19 distribution determination for Evoenergy.¹³ As part of this process, we also determine the materiality of the proposed pass through amount.

Clause 6.6.1(d) of the NER provides that if the AER determines that a positive change event has occurred, the AER must determine:

- the approved pass through amount; and
- the amount that should be passed through to Distribution Network Users in the regulatory year in which, and each regulatory year after that in which, the positive change event occurred, taking into account the matters referred to in clause 6.6.1(j) of the NER.

¹³ AER, *Final decision Evoenergy 2014–19 distribution determination*, 15 November 2018.

3.2 Relevant factors

As required under clause 6.6.1(j) of the NER, in assessing Evoenergy's application and making this decision, we must take into account the following relevant factors:

- 1) The matters and proposals set out in any statement given to the AER by Evoenergy;
- 2) The increase in costs in the provision of direct control services;
- 3) The efficiency of Evoenergy's decisions and actions in relation to the risk of the positive change event, including whether Evoenergy failed to take any action that could reasonably be taken to reduce the magnitude of the eligible pass through amount and whether Evoenergy took or omitted to take any action that increased the magnitude of the amount;
- 4) The time cost of money based on the allowed rate of return;
- 5) The need to ensure that Evoenergy only recovers any actual or likely incremental costs that are solely as a consequence of the pass through event;
- 6) Whether the costs have already been or will be factored into the calculation of Evoenergy's annual revenue requirement in an existing or future distribution determination;
- 7) The extent to which costs are the subject of a previous pass through determination made by the AER; and
- 8) Any other factors the AER considers relevant.

3.3 Timing matters

Clause 6.6.1(c) of the NER requires that to seek the AER's approval to pass through a positive pass through amount, a DNSP must submit to the AER a written statement specifying a range of details relating to the event within 90 business days of the relevant positive change event occurring. Thus, in the normal course of events, our assessment will involve consideration of two dates, and the period of time between them, namely:

- The date on which the pass through event could be said to have occurred
- The date on which the pass through application was received
- The number of days between these events.

We must also comply with the timing limit specified under clause 6.6.1(e) of the NER in making this determination, being 40 business days from the date of Evoenergy's cost pass through application.

However, it is permissible under the NER to extend the time limits that apply to the DNSP or the AER.¹⁴

¹⁴ NER, clause 6.6.1, paragraphs (k), (k1)-(k6).

3.4 What we considered in making this determination

We have made our determination in accordance with clause 6.6.1 of the NER. In forming our determination, we have:

- considered the application and supporting information we received from Evoenergy
- consulted further with Evoenergy in the form of meetings and information requests
- where the material Evoenergy submitted was unclear or incomplete, sought clarification from Evoenergy and had regard to its responses.
- undertaken our own analysis to verify and understand the information provided by Evoenergy
- consulted with the AER's Consumer Challenge Panel (CCP)
- applied the relevant factors set out in clause 6.6.1(j) of the NER to explain our decision
- had regard to past AER decisions, where relevant.

4 Reasons for determination

We are satisfied that Evoenergy's pass through application establishes that the regulatory obligations introduced by the Guideline constitute a pass through event, in the form of a positive change and service standard event. We consider that complying with the Guideline materially increased Evoenergy's costs in providing direct control services in the current regulatory control period. This section details our reasons in making this determination.

4.1 Occurrence of pass through event

The first step in our assessment is to determine whether a pass through event has occurred. A pass through event is defined in clause 6.6.1(a1) of the NER as one of the following events:

- (1) a regulatory change event;
- (2) a service standard event;
- (3) a tax change event;
- (4) a retailer insolvency event; and
- (5) any other event specified in a distribution determination as a pass through event for the determination.

Evoenergy submitted that the pass through event qualifies as a 'service standard event' or, in the alternative, a 'regulatory change event'.¹⁵

In relation to DNSPs, the NER defines a service standard event as:¹⁶

A legislative or administrative act or decision that:

(a) has the effect of:

- (i) substantially varying, during the course of a regulatory control period, the manner in which ... a DNSP is required to provide a direct control service;
- (ii) imposing, removing or varying, during the course of a regulatory control period, minimum service standards applicable to ... direct control services; or
- (iii) altering, during the course of a regulatory control period, the nature or scope of the direct control services, provided by the service provider; and

(b) materially increases ...the costs to the service provider of providing ... direct control services.

The NER defines a regulatory change event as:¹⁷

A change in a regulatory obligation or requirement that:

- (a) falls within no other category of pass through event; and
- (b) occurs during the course of a regulatory control period; and

¹⁵ Evoenergy, *Ring-fencing cost pass through application*, 7 December 2018, p. 7.

¹⁶ NER, Chapter 10 Glossary.

¹⁷ NER, Chapter 10 Glossary.

(c) substantially affects the manner in which ... the DNSP provides direct control services ...; and

(d) materially increases or materially decreases the costs of providing those services.

4.1.1 Service standard event

To find a service standard event, we must be satisfied that there was a legislative or administrative act or decision and at least one of sub-paragraphs (a)(i), (a)(ii) or (a)(iii) of the service standard event definition is satisfied, together with sub-paragraph (b).

For the reasons set out below, we are satisfied that the pass through event meets the definition of a service standard event. Having found that the event in question is a service standard event, we have not considered further in this decision whether the pass through event also meets the definition of a regulatory change event.

Evoenergy submits that the Guideline is a service standard event as per paragraph (a)(i), on the basis that it was an administrative act/decision and that “new obligations under the guidelines necessitated far-reaching and fundamental practical changes to the way the business structures and organises its activities involved in the provision and marketing of direct control services, and how its staff conduct themselves on a day to day basis.”¹⁸

The AER was required to develop and publish the Guideline under the NER. We consider that the publication of the Guideline was a legislative or administrative act or decision.

4.1.1.1 Sub-paragraph (a)(i) – has the effect of substantially varying the manner in which Evoenergy is required to provide a direct control service

Evoenergy states that the publication of the Guideline has the effect of substantially varying the manner in which Evoenergy is required to provide direct control services. Evoenergy noted that it was already subject to a range of separation requirements under its previous jurisdictional Guideline.¹⁹ However, Evoenergy submits that the AER’s Guideline introduced new obligations, including that:²⁰

- it must use independent and separate branding for network services from contestable services and must not engage in cross-promotional activities [Clause 4.2.3]
- it may provide distribution services and transmission services, but must not provide other services [Clause 3.1(b)]
- it must ensure staff involved in the provision or marketing of direct control services are not also involved in the provision or marketing of contestable electricity services by a related electricity service provider and are not located in any offices from which a related

¹⁸ Evoenergy, *Ring-fencing cost pass through application*, 7 December 2018, p. 12.

¹⁹ Independent Competition and Regulatory Commission, *Ring-Fencing Guidelines for Electricity and Gas Network Service Operators in the ACT*, November 2002. <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/jurisdictional-ring-fencing-guidelines>

²⁰ Evoenergy, *Ring-fencing cost pass through application*, 7 December 2018, pp. 8-9.

electricity service provider provides contestable electricity services [Clauses 4.2.1 and 4.2.2].

Evoenergy submits that to achieve compliance with these new obligations, ActewAGL Distribution was required to, inter alia, implement the new brand, Evoenergy, for the provision of regulated electricity distribution network services.²¹

We note that the Guideline requires the separate branding of network and retail affiliates:

A DNSP must use branding for its direct control services that is independent and separate from the branding used by a related electricity service provider for contestable electricity services...²²

ActewAGL, as a parent company, owned and controlled both an electricity “network” business that provides direct control services (ActewAGL Distribution), and a related electricity retail business that provides contestable electricity services (ActewAGL Retail). Until the rebranding exercise, both ActewAGL Distribution and ActewAGL Retail bore the ActewAGL brand name and traded as ActewAGL. With the issuing of the Guideline a network and retail affiliate carrying the same brand name is not permitted. In cases like those facing ActewAGL, the Guideline requires that the associated network and retail affiliates must bear separate and independent brand names.

We note that the Guideline does not explicitly stipulate whether the distribution network business or the retail business must undergo rebranding. In response to our information request, Evoenergy submitted that because the Guideline requires the distribution business to ensure that it uses branding for its direct control services that is independent and separate from the branding used by its related contestable electricity businesses, the obligation falls on the distribution business.

To comply with the Guideline, it was open to ActewAGL as to which of its network and retail affiliates should undergo a rebranding exercise. In the present case, ActewAGL chose its network business.

We consider that the legal ownership of the 'ActewAGL' trademark by ActewAGL Retail practically meant that there were two choices available to the company in order to give effect to the Guideline’s requirement for separate branding of network and retail affiliates:

- ActewAGL Distribution rebrands (with ActewAGL Retail keeping the name ActewAGL)
- ActewAGL Distribution purchases the ActewAGL trademark from ActewAGL Retail, leaving ActewAGL Retail to rebrand.

A relevant factor when considering these two alternatives is which option would be more efficient, having regard to clause 6.6.1(j)(3) of the NER. This clause requires that the AER take into account whether Evoenergy failed to take any action that could reasonably be taken to reduce the magnitude of the eligible pass-through amount, or conversely took any action that has increased the magnitude of the pass-through amount.

²¹ Evoenergy, *Ring-fencing cost pass through application*, 7 December 2018, p. 10.

²² AER, *Ring-fencing Guideline Electricity Distribution - Version 2*, October 2017, Clause 4.2.3.

Evoenergy submits that it was not possible for ActewAGL Distribution to retain the ActewAGL brand for its direct control services and rebrand the contestable electricity services at the time of publication of the Guideline. This is because the 'ActewAGL' trademark is not owned by ActewAGL Distribution but, rather, by ActewAGL Retail, which intended to continue and has continued its use of that mark.²³

In response to our Information Request, Evoenergy elaborated that it:

gave consideration to re-branding its related businesses, in particular the energy retail business of ActewAGL Retail, which would involve the distribution business acquiring the name 'ActewAGL' from its owners, the partners of ActewAGL Retail. It quickly became clear that the likely costs, both direct and indirect, of doing so would significantly exceed the costs of rebranding the distribution business. These costs would have included the loss of goodwill in the name, which was of considerably greater value to a market-driven business than one not subject to competitive forces, and would form part of the cost to the distribution business of acquiring the name 'ActewAGL'. These costs would ultimately have been borne by the electricity consumers of the distribution business and achieved little or no additional benefit to those consumers.

We are satisfied that ActewAGL gave due consideration to its options and took the least cost option.

In the broader policy context, the requirement to have separate branding is to give effect to the objectives of ring fencing, which are to promote competition and prevent anti-competitive leveraging by minimising the opportunities for adverse cross-subsidisation, discrimination, and information sharing. In this light, it is reasonable that the cost of regulatory obligations to facilitate these objectives are borne by the beneficiaries, which are consumers.

Therefore we are satisfied that the link between the issuing of the Guideline and the rebranding of ActewAGL Distribution is a strong one.

The question then turns to whether the requirement to rebrand has the effect of substantially varying in the manner in which Evoenergy is required to provide a direct control service.

Evoenergy submitted that the rebranding project had such effect, which required the rebranding of assets, systems and information from across the organisation.²⁴ This included redesigning and rebranding: websites; vehicles; uniforms and personal protection equipment; building signage; zone substations; access cards; distribution assets; outward facing documents; and digital content. Evoenergy stated that it was also necessary to develop a communications plan around the name change to inform staff, customers, service providers and the general public. This involved a media statement from the CEO, media interviews, letters explaining the change sent to Government, industry, suppliers, retailers and all ACT households, as well as the deployment of content through social media, and radio and press advertisements.

In addition to rebranding, ActewAGL Distribution has undertaken a series of measures to comply with the functional separation obligations and restrictions on sharing and co-locating

²³ Evoenergy, *Ring-fencing cost pass through application*, 7 December 2018, p. 11.

²⁴ Evoenergy, *Ring-fencing cost pass through application*, 7 December 2018, p. 11.

staff under the Guideline, such as developing physical infrastructure, changing ICT systems, developing information sharing protocols and changing consumer engagement activities.²⁵

We are satisfied that these activities represent a substantial variation in the manner in which Evoenergy is required to provide a direct control service in this regulatory control period, and therefore satisfying the requirements of paragraph (a)(i) of the service standard event definition.

4.1.1.2 Sub-paragraph (b) – materiality

The NER defines “materially” as follows:

For the purposes of the application of clause 6.6.1, an event results in a Distribution Network Service Provider incurring materially higher or materially lower costs if the change in costs (as opposed to the revenue impact) that the Distribution Network Service Provider has incurred and is likely to incur in any regulatory year of a regulatory control period, as a result of that event, exceeds 1% of the annual revenue requirement for the Distribution Network Service Provider for that regulatory year.²⁶

Evoenergy has used the AER's Post-Tax Revenue Model (PTRM) to compare the annual revenue requirement with and without the pass through costs to assess materiality. This is consistent with our approach in assessing 'costs' in our previous pass through determinations.

Evoenergy submits that its ring-fencing compliance costs are material for the purpose of this pass through application. This is because the change in Evoenergy's required revenues represents 1.01 per cent of Evoenergy's annual revenue requirement in 2017-18 after taking into account the compliance costs, which exceeds the materiality threshold of 1 per cent.²⁷ This is shown in Table 3.

Table 3 - Materiality of Evoenergy's compliance costs with new ring-fencing obligations (\$million, nominal)

\$million, nominal	2014-15	2015-16	2016-17	2017-18	2018-19
Annual revenue requirement (ARR) (unsmoothed)	155.75	148.68	153.84	160.37	164.38
Pass through amount	0.00	0.00	0.17	1.62	0.15
Materiality threshold (1%)			0.11	1.01	0.09

Source: Evoenergy Ring-fencing pass through application - Attachment 4 - PTRM.

We find that Evoenergy has correctly calculated the pass through amount as passing the materiality threshold.

²⁵ Evoenergy, *Ring-fencing cost pass through application*, 7 December 2018, p. 11.

²⁶ NER, Chapter 10 Glossary.

²⁷ Evoenergy, *Ring-fencing cost pass through application*, 7 December 2018, p. 15.

4.1.2 Positive change event

If we are satisfied that a pass through event has occurred, we must determine whether the pass through event qualifies as a 'positive change event'. That is, whether Evoenergy incurs materially higher costs in providing direct control services than it would have incurred but for the pass through event.

As discussed in section 4.1.1 above, we consider that a pass through event has occurred, in the form of a service standard event. We agree with Evoenergy that this pass through event materially increased its costs in providing direct control services, with its costs exceeding 1 per cent of the annual revenue requirement for Evoenergy for 2017-18. Therefore, the pass through event in question constitutes a positive change event.

4.1.3 Timing of Evoenergy's application

Clause 6.6.1(c) of the NER requires DNSPs to submit a pass through application to us within 90 business days of the positive change event occurring. Evoenergy submits that the positive change event occurred on 30 November 2016, the date the Guideline was published.

On 10 April 2018, in response to Evoenergy's request, we extended the fixed time limit for Evoenergy to submit its pass through application in respect of the publication of the Guideline to 90 business days after publication of our remade final decision on Evoenergy's 2014–19 distribution determination.²⁸ This is because at the time of the positive change event, the AER was remaking Evoenergy's 2014–19 distribution determination which precluded Evoenergy from submitting a cost pass through application without knowing what its annual revenue requirement would be.²⁹

We published our remade final decision for Evoenergy's 2014–19 distribution determination on 15 November 2018. We received Evoenergy's pass through application 16 business days later, on 7 December 2018. Evoenergy has therefore submitted the application within the allowable timeframe.

4.2 Assessment of the pass through amount

Clause 6.6.1(c)(3) of the NER requires Evoenergy to specify the eligible pass through amount. The 'eligible pass through amount' is defined in the NER to mean 'the increase in costs in the provision of direct control services that, as a result of that positive change event, the DNSP has incurred and is likely to incur (as opposed to the revenue impact of that event)' until the end of the regulatory control period in which the positive change event occurred. Evoenergy submits that it has incorporated only incremental costs in the eligible

²⁸ NER, cl. 6.6.1(k); AER, *Letter to Evoenergy*, dated 10 April 2018. This is the second time the AER had extended the time limit for Evoenergy to submit its pass through application with respect to the Ring-fencing Guideline.

²⁹ Following its review of the AER's final decision made in April 2015 with respect to Evoenergy's 2015–19 distribution determination, the Australian Competition Tribunal remitted the decision to the AER to be remade in accordance with the Tribunal's directions.

pass through amount consistent with the NER. This is further discussed in section 4.2.5 below.³⁰

Clause 6.6.1(c)(4) of the NER requires Evoenergy to specify the positive pass through amount that Evoenergy proposes in relation to the positive change event. The positive pass through amount is defined as an amount not exceeding the eligible pass through amount. Evoenergy proposes a positive pass through amount of \$2.05 million (\$2018-19, including the time cost of money).

In considering Evoenergy's pass through application and the proposed pass through amount, we took into account those factors set out in clause 6.6.1(j) of the NER. We discuss each of these factors below.

4.2.1 Matters and proposals set out by Evoenergy

We reviewed Evoenergy's application and supporting information, including responses to our information requests. We have made our determination based on the matters and proposals set out by Evoenergy.

4.2.2 The increase in costs incurred by Evoenergy

Clause 6.6.1(j)(5) of the NER requires the AER, in determining the approved pass through amount and the amount to be passed through to users in each regulatory year, to take into account the need to ensure the DNSP only recovers any actual or likely increment in costs that is solely as a consequence of the positive change event.

Table 4 shows the opex amounts incurred by Evoenergy in the 2014–19 regulatory control period to comply with the new ring-fencing requirements, as submitted by Evoenergy.

Table 4: Evoenergy compliance costs with new ring-fencing obligations (\$, nominal)

\$, nominal	2016-17	2017-18	2018-19	Total
Incremental Opex	161,255	1,551,724	139,800	1,852,779

Source: Evoenergy Ring-fencing cost pass through application.

Table 5 below provides a breakdown of the costs included in the eligible pass through amount.

³⁰ Evoenergy, *Ring-fencing cost pass through application*, 7 December 2018, p. 16.

Table 5: Evoenergy cost breakdown of project costs for compliance with the new ring-fencing obligations (\$, nominal)

\$, nominal	2016-17	2017-18	2018-19
Rebranding			
Website		\$334,657	
Communications		\$327,476	
Personal protective equipment and uniforms		\$266,913	
Additional resources		\$219,291	
Signage and collateral rebranding		\$169,517	
Stationery and promotional items		\$48,883	
Creative design		\$28,860	
Industry memberships		\$7,068	
Project management & legal	\$161,255	\$149,058	\$139,800
Total	\$161,255	\$1,551,724	\$139,800

Source: Evoenergy Ring-fencing pass through application.

With the exception of forecast expenditure for 2018-19, the costs in Table 5 were captured and extracted from Evoenergy's corporate accounting system, Oracle. Evoenergy had tracked individual expenditure tasks for the ring-fencing compliance project in Oracle throughout the life of the project.³¹ Evoenergy provided an extract from Oracle on a confidential basis to substantiate its compliance costs, which we took into account in our assessment of this pass through application.

4.2.3 Actions to reduce the magnitude of the pass through amount

We consider that, as an event, the issuing of the Guideline by the AER in November 2016 and its associated obligations was exogenous for Evoenergy. We are satisfied that the occurrence of the obligation to effect separate branding of network and related contestable services businesses, and its attendant costs, was not a risk which Evoenergy would have been able to mitigate prior to the event.

³¹ Evoenergy, *Ring-fencing cost pass through application*, 7 December 2018, p. 18.

Evoenergy submits that, once the event occurred, it took steps (actions, and the avoidance of actions) that would have mitigated the cost impact. Evoenergy states that it carried out the following:³²

- implemented required activities by engaging external service providers using cost-effective competitive tendering and procurement processes (on which it provided more detail in response to our information request);
- undertook steps that have reduced the magnitude of the costs, including seeking a waiver for the gas business to avoid significant costs to consumers that would not have delivered a commensurate benefit;³³
- undertook an initial detailed assessment of the change in requirements for ring-fencing resulting from the introduction of the Guideline to identify areas of compliance and avoid any duplication or unnecessary expenditure.

As discussed in section 4.1.1.1, we are satisfied that when deciding which of its network or retail business it should rebrand, ActewAGL gave due consideration to its options and took the least cost option.

We have assessed efficiency primarily by consideration of the efficiency and prudence properties of the DNSP's processes and actions in effecting obligations arising from the pass through event. We consider Evoenergy's actions to be consistent with those of a prudent and efficient operator who was seeking to mitigate the cost impact of the positive change event. We reached this conclusion on the basis that:

- Evoenergy adopted processes that would have helped to ensure the scope of activities was appropriately constrained to that necessary to give effect to the relevant obligations, such as the internal review it carried to identify additional requirements to those in the previous jurisdictional ring-fencing guideline; and
- in incurring the costs of those activities, Evoenergy adopted competitive tendering processes when engaging external service providers, noting that these costs comprise the bulk of the costs included in this pass through application.

4.2.4 Time cost of money

Clause 6.6.1(j)(4) of the NER requires us to take into account the time cost of money based on the weighted average cost of capital (WACC) for the DNSP. Evoenergy has included the time cost of money in its proposed pass through amount.

The time cost of money included in the proposed pass through amount is \$0.12 million (\$2018-19) and it is based on the applicable WACC set out in our remade final decision for Evoenergy 2014–19 distribution determination.³⁴ We are satisfied that Evoenergy has

³² Evoenergy, *Ring-fencing cost pass through application*, 7 December 2018, pp. 18-19.

³³ AER, Decision - DNSP applications for waivers from the Electricity Distribution Ring-fencing Guideline, December 2017, pp.74 - 76.

³⁴ AER, *Final decision Evoenergy PTRM - Distribution*, November 2018; AER, *Final decision Evoenergy PTRM - Transmission*, November 2018.

calculated the time cost of money consistent with our approach in previous determinations and it should be included in the approved pass through amount.

4.2.5 Recovery of costs solely a consequence of the pass through event

Evoenergy states that the eligible pass through amount incorporated only incremental costs consistent with the NER to capture the total cost of compliance. Evoenergy explains that it undertook change management processes within a dedicated ring-fencing compliance project and categorised all costs in determining the eligible pass through amount to ensure only incremental costs were included.³⁵ Evoenergy submits that internal resources that were not fully allocated to implementing compliance activities, such as part time work on the project and allocated overheads, are not included in the eligible pass through amount.³⁶

Evoenergy states that it employed its accounting system, Oracle, to clearly record and track the costs incurred by creation of a separate project code in Oracle. This system differentiated between the expenditure incurred for activity types and business as usual (BAU) expenditure, and particularly between costs of the broader ring fencing compliance project and the rebranding activity. Evoenergy submits that BAU resources that were engaged to provide input to the ring-fencing compliance project were funded by the 2014–19 expenditure allowance, including staff members of the project board, internal legal and IT services, and administrative support services.

In response to our information request, Evoenergy confirmed that the financial managers responsible for the ring-fencing project reviewed each transaction recorded against the ring-fencing codes to ensure coding was undertaken correctly within the Oracle system. It explained that while Oracle automatically allocates corporate overheads to every project code, the ring-fencing costs used in Evoenergy's pass through application was amended to exclude these costs.

We are satisfied that Evoenergy's proposed pass through amount only includes incremental costs that are solely attributed to the implementation of the obligations arising out of the Guideline. In particular, we note the adoption of what appears to be good practice in governance and project management, the recording of costs against a defined project cost code, and the exclusion of corporate overheads from that code. This provides confidence that the cost increment arose solely as a consequence of the pass through event.

4.2.6 Whether the costs have been factored into the annual revenue requirement

In our remade final decision for Evoenergy's 2014–19 distribution determination, we determined that Evoenergy's forecast operating expenditure was \$290.82 million (real, \$2018-19). This forecast does not include any allowance for the costs of compliance with the Guideline. Consequently, the current revenue allowance of Evoenergy does not factor in any allowance for these costs.

³⁵ Evoenergy, *Ring-fencing cost pass through application*, 7 December 2018, p.18.

³⁶ Evoenergy, *Ring-fencing cost pass through application*, 7 December 2018, p.16.

4.2.7 Whether the costs are subject of a previous pass through determination

Evoenergy's proposed pass through amount is not part of a previous pass through determination by us under clause 6.6.1 of the NER.

4.2.8 Any other factors we consider relevant

There are no other factors we consider relevant in making our determination on the pass through amount.

4.3 Calculation of the approved pass through amount

The approved pass through amount is 2.05 million (\$2018-19) as at 30 June 2019. This amount means the building block revenue components resulting from the application of the pass through opex amount in the PTRM. It has been calculated as the sum of the annual differences in the annual revenues under the PTRM with and without the costs of the pass through, including the time cost of money. The calculations are set out in the PTRM submitted by Evoenergy along with its cost pass through application, which is published on our website.³⁷

The time cost of money included in the approved pass through amount is \$0.12 million (\$2018-19) and it is based on the applicable WACC set out in our remade final decision for Evoenergy 2014–19 distribution determination.³⁸

We determine that the approved pass through amount will be recovered by Evoenergy in the 2019-20 and 2020-21 regulatory years in two equal amounts, within the 2019–24 regulatory control period. This is because it is too late for Evoenergy to recover its compliance costs within the 2014–19 regulatory control period.

We note that we have also approved two other pass through applications submitted by Evoenergy on 7 December 2018.³⁹ The sum of all the approved pass through amounts is \$8.42 million (\$2018-19). If this amount is recovered in 2019-20, it is likely to result in a material increase in Evoenergy's 2019-20 revenue requirement. Given the potential volatility in Evoenergy's revenue, our preferable approach is to allow Evoenergy to recover the approved pass through amounts in two equal instalments (with adjustment for the time cost of money) for all three pass through applications over the regulatory years 2019-20 and 2020-21. We consider this approach will minimise volatility in Evoenergy's revenue requirements while still allowing it to recover its efficient costs in a timely manner.

³⁷ Evoenergy *Ring-fencing cost pass through application - Attachment 4 - PTRM*, 7 December 2018.

³⁸ AER, *Final decision Evoenergy PTRM - Distribution*, November 2018; AER, *Final decision Evoenergy PTRM - Transmission*, November 2018.

³⁹ AER, *AER determination - Power of Choice reforms cost pass through - Evoenergy*, February 2019; AER, *AER determination - Vegetation management cost pass through - Evoenergy*, February 2019.