Ring-Fencing Guideline
Electricity Distribution

Mt Baw Baw waiver application

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Chapter 1 Waiver Application

Introduction

AusNet Electricity Services Pty Ltd (**AES**) submits a waiver application in accordance with Section 5 of the Electricity Distribution Ring-fencing Guideline (the Guideline) for the provision of services to the Alpine Resorts Commission (**ARC**). The ARC and AES have a Power Reticulation Agreement dating from 1997 for AES to build, own, operate and supply LPG and electrical energy at Mt Baw Baw in Eastern Victoria. AES is not permitted to provide these services at Mt Baw Baw in accordance with the requirements of the Guideline. However, AES considers a waiver to allow it to continue to provide these services until the existing contract expires on 15 May 2020 is the appropriate course of action. As such a waiver beyond the end of the current regulatory period is not necessary.

The Guideline sets out the process and requirements when seeking a Waiver under the Guideline. In deciding whether to approve this waiver application the AER must have regard to:

i. the National Electricity Objective;

ii. the potential for cross-subsidisation and discrimination if the waiver is granted or refused;

iii. whether the benefit, or likely benefit, to electricity consumers of the Distribution Network Service Provider (**DNSP**) complying with the obligation (including any benefit, or likely benefit, from increased competition) would be outweighed by the cost to the DNSP of complying with that obligation; and

may:

i. have regard to any other matter it considers relevant;

ii. request from the DNSP any further information the AER considers appropriate;

iii. invite public submissions on the application; and

iv. otherwise conduct such consultation as it considers appropriate with any person.

This waiver application sets out the information required by the AER and demonstrates that granting a waiver until the end of the current regulatory control period is the appropriate course of action in the circumstances.

1 Details of the service in relation to which the DNSP is applying for the waiver

The ARC and AES have an executed Power Reticulation Agreement dated 20 October 1997 for AES to build, own, operate and supply LPG and electrical energy at Mt Baw Baw in Eastern Victoria. AES also provides the retailer function at Mt Baw Baw. The services delivered at Mt Baw Baw are not classified as distribution services as they are delivered via a stand-alone network that is not part of the National Electricity Market. As such, clause 3.1(b) of the Guideline prevents AES from delivering these services to the ARC, unless AES is granted a waiver to continue doing so.

The services are set out in the executed contract, which we have provided with this waiver application. As part of providing these services AES owns and operates:

- 2x 165kVA LPG fuelled CAT Generators (Primary Use);
- 1 x 160kVA LPG fuelled Perkins generator (Backup use);
- 1 x 300kVA diesel fuelled (hire generator for use at peak season at Mt Baw Baw);
- A reticulated underground cabling network that is used to supply electricity to the Mt Baw Baw Village;
- An LPG Storage facility (23 tonnes LPG tank capacity, with a supply of 245 tonnes of LPG per annum); and

- A reticulated gas network.

AES also uses a combination of internal and external resources to provide these services, including:

- A Liquefied Petroleum Gas supply contract with [C-I-C];
- An Equipment Hire Agreement with [C-I-C];
- AES field maintenance resources located at the AusNet Rowville office; and
- Subcontracted service providers as required.

The contractual arrangements with the ARC were implemented in accordance with government policies at that time and are supported by state-based statutory approvals and regulatory exemptions. The executed contract states that obtaining these approvals was a condition precedent of the operation of this agreement. We note that the regulatory environment has changed considerably since this contract was entered into, however, we consider that the delivery of this service is still underpinned by relevant approvals and exemptions. Particularly:

1. The ARC holds an exemption under the Electricity Industry Act 2000 for the generation, transmission, distribution and supply or sale of electricity at Mt Baw Baw. It is as the contracted service provider (under this exemption) that we are providing these services.
2. The network was built to the Victorian Electricity Supply Industry (VESI) standard.
3. The installation at Mt Baw Baw is covered in AES's Electricity Safety Management Scheme.

This waiver application relates to the continued delivery of the above services in accordance with the contractual arrangements entered into in 1997. The alternative, requiring transfer to a third party, before the end of the term, would be a complicated and costly process requiring the identification of a suitable third party, negotiation of commercial arrangements, and then the novation or exit of several contracts.

2 The obligations in respect of which the DNSP is applying for a waiver

There are two clauses in the ring fencing guideline in respect of which we are applying for a waiver. The primary clause requiring a waiver is Clause 3.1(b) of the guideline, which sets out that:

> (b) a DNSP may provide distribution services and transmission services, but must not provide other services.

A waiver is being sought in respect of services that are not distribution or transmission services and so a waiver to Clause 3.1(b) would allow AES to continue provision of these services and comply with our contractual obligations for the remainder of the contract period.

To continue to provide these services we then also request a waiver under Clause 4.2.3(i) of the guideline, which requires that a DNSP:

> i. must use branding for its direct control services that is independent and separate from the branding used by a related electricity service provider, such that a reasonable person would not infer from the respective branding that the DNSP and the related electricity service provider are related.

A waiver under this clause would allow AES to avoid the cost of rebranding the assets used to provide this service. Further, as the contractual arrangements will continue to sit with AES, it is hard to see how the brand can be practically separated from service delivery.

Importantly, we are not requesting a waiver under clauses 4.2.3(ii) and 4.2.3(iii), which state a DNSP:

ii. must not advertise or promote its direct control services and its contestable electricity services that are not direct control services together (including by way of cross-advertisement or cross-promotion).

iii. must not advertise or promote services provided by a related electricity service provider.

We acknowledge that it would be inappropriate for us to use our existing market position to promote the services of a related electricity service provider that could bid for this work once the contract expires. As such, we are not requesting a waiver from these clauses, these provisions would remain in force and we are prevented from engaging in this conduct.

3 The reasons why the DNSP is applying for the waiver

We are applying for a waiver for these services because we consider it is the prudent and efficient approach to dealing with a service that AES is contractually obligated to deliver but does not fit properly within the changed regulatory environment. Providing a waiver is appropriate in this case because:

1. It minimises the cost to the ARC and AES – Changing the existing arrangements will incur cost and there is no guarantee the necessary contractual changes will be mutually agreeable to both parties. We note that the ring-fencing guideline is an obligation placed on AES and that without the waiver additional costs would be incurred by a third party (the ARC) in order for us to achieve compliance with the ring-fencing guideline.
2. There is no identified detriment from continuing to provide the services under the existing delivery model until the expiration of the contract in 2020.
3. There is a clearly identified end date for a waiver to apply to (the end of the current regulatory period) and so the waiver is a temporary measure rather than a long term arrangement.
4. We do not consider that a process to finalise alternative arrangements could be completed by 31 December 2017. There are a number of commercial and legal arrangements that would need to be renegotiated and operationalised by that date.
5. It is uncertain that we could find a third party provider to take on this commercial obligation, and on reasonable terms, for the short remaining contract period and so it may not be feasible to achieve compliance with the existing contract without the waiver.

For these reasons we consider that the waiver is the best course of action in respect to the services we provide at Mt Baw Baw.

4 The proposed commencement date and expiry date (if any) of the waiver and the reasons for those dates

We note that the Guideline commenced on 1 December 2016, but the Guideline allows that despite this commencement date:

a DNSP must fully comply each of the obligations in clauses 3 and 4 of this Guideline in respect of its existing services as soon as reasonably practicable, having regard to the likely costs of having to fully comply with those obligations any sooner, but in any event must fully comply with those obligations by no later than 1 January 2018.

Accordingly, we propose that the waiver commencement date is the date that the AER approves this waiver or no later than 1 January 2018. Further, we propose the expiry date of the 31 December 2020. In proposing this date for expiry of the waiver we considered:

- 31 December 2020 is the last day of the current regulatory period. Clause 5.3.4 (B) of the ring-fencing guideline requires the term of the waiver to coincide (or apply) for whole regulatory control periods.

- The existing contractual arrangements expire on 15 May 2020, which falls toward the end of the current regulatory period. As such a waiver beyond the end of the current regulatory period is not necessary.[1]

5 Details of the costs associated with the DNSP complying with the obligation if the waiver of the obligation were refused

If a waiver is not provided, then AES will need to novate its contract to a third party to achieve compliance with the Guideline. We have considered below the costs of achieving compliance separately for each of the stakeholders.

5.1 Alpine Resorts Commission and its customers

If the waiver is not granted, then the ARC will need to be involved in the negotiation to novate the contract to an affiliated entity. This will involve legal resources and administration cost on behalf of the ARC. We note that novating to third party may be difficult for the following reasons:

1. The network was built to Victorian Electricity Supply Industry (VESI) standard and so the entity the contract is novated to must be licenced to operate the network at this standard.
2. The current installation is covered by AES's ESMS. We consider it likely the ESV would require the new party to put an ESMS in place.

These factors present a considerable challenge for a party taking over the contract and it is not apparent that any third party would take this on (for the remainder of the contract period) on terms commercially neutral to ARC. That is the ARC may need to incur greater costs in order for them to secure provision of these services for a short period of time. Further, we note that the existing contract expires in 2020 and that at that time, the ARC would need to re-let the contract and renegotiate the contract in its entirety. The novation of the existing contract would appear to offer no benefits to this later re-letting process and is an unnecessary administrative expense for both parties.

We note the ARC is under no legal obligation to agree to a contract novation and could prevent AES from achieving compliance with the Guideline, simply by refusing to engage in this process. Imposing additional costs onto the ARC, which entered into a commercial contract in accordance with what was then the existing regulatory framework is not consistent with the principles of regulatory certainty and would not contribute to the National Electricity Objective (**NEO**). Allowing the existing contract to reach its natural conclusion ensures the original intent of the contract is achieved without additional cost.

5.2 AusNet Services

The provision of these services to Mt Baw Baw is underpinned by appropriate cost allocation approaches, which ensures that there is no cross-subsidy between these customers and the customers of the regulated network. Accordingly, any costs incurred in achieving compliance with the Guideline will be borne directly by AES and not customers of the regulated electricity network.

However we do not consider this negates the requirement to consider the cost imposed on AES when analysing whether the waiver is appropriate. We have identified the following costs that may be borne by AES:

- Legal and Administrative costs to progress the novation to a third party – Estimate $100,000 for internal legal resources over a six month period.
- Forfeit of the Bank Performance Bond of [C-I-C].

[1] If one of AusNet Services related electricity service providers tenders to provide this service, it would need to do so in a manner that complies with the ring fencing guideline.

- The possible write-down, abandonment, or sale of the existing assets at reduced value – The book value of these assets currently sits at [C-I-C].
- Cost involved in terminating contracts necessary for provision of input services (i.e. gas and equipment supply).

It is uncertain on what terms the contract would be novated and whether AES would incur any costs in handing over its obligations under the contract to a third party. Under the Guideline, AES cannot discriminate in favour of its related electricity service providers and so we cannot simply direct a related entity to take over this contractual arrangement. Further, as discussed above, the third party may need to receive relevant statutory approvals and this may make it hard to novate our contract to a third party in the timeframe available.

5.3 Customers of AusNet Services' regulated services

As noted above the provision of these services is supported by appropriate controls to ensure that the cost and revenue is separated from the direct control services provided to customers of the regulated network. Any cost borne by AES in meeting this requirement would not impact on these regulated customers.

6 Any additional measures the DNSP proposes to undertake if the waiver were granted

Our implementation approach sets out a detailed response on how we will comply with the Ring Fencing Guideline. We are implementing a range of changes to our business including:

- Updating or creating policies, procedures and a reporting and compliance framework;
- Training staff;
- Establishing a new ring-fencing policy;
- Clear communication to our employees on the operational change requirements; and
- Modify existing business arrangements for compliance.

7 The reasons why the DNSP considers the waiver should be granted with reference to the matters specified in clause 5.3.2(a), including the benefits, or likely benefits, of the grant of the waiver to electricity consumers

A waiver should be granted in this case because granting a waiver is a short term transition measure that is consistent with the objectives of the Guideline. In section 5 we outlined the costs involved if the waiver is not granted. We consider granting the waiver results in the lowest cost provision of service to these customers and has no identifiable harms to the ARC, AES or customers of its regulated network. In making its decision the AER must have regard to:

i. the NEO;
ii. the potential for cross-subsidisation and discrimination if the waiver is granted or refused;
iii. whether the benefit, or likely benefit, to electricity consumers of the DNSP complying with the obligation (including any benefit, or likely benefit, from increased competition) would be outweighed by the cost to the DNSP of complying with that obligation.

We have set out our consideration against each of these criteria below.

7.1 National Electricity Objective

The NEO is to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to —

(a) price, quality, safety, reliability and security of supply of electricity; and

(b) the reliability, safety and security of the national electricity system.

We consider that receiving a waiver to continue to providing these services is in accordance with the NEO. We have an existing contractual obligation to provide a service to these customers. This is a longstanding arrangement that was entered into in 1997 and it is getting close to its expiry in May 2020. At the expiry of the contract, ownership of the assets reverts to the ARC and they will presumably undertake a procurement process to find another suitable long term supplier.[2] Maintaining the existing arrangements ensures that there is no disruption in terms of price, quality, safety, reliability and security of supply to the customers connected at Mt Baw Baw. As outlined above, novating the contract early imposes additional costs on these customers (with no offsetting benefit) and so failure to receive a waiver would be counter to the NEO.

7.2 The potential for cross-subsidisation and discrimination if the waiver is granted

The Guideline seeks to address two potential harms with two separate sets of obligations for DNSPs:

- First, the Guideline addresses the risk of a DNSP cross-subsidising other services with revenue earned from provision of distribution (and transmission) services. It does this through legal separation of the DNSP, which may only provide distribution (and transmission) services, from affiliated entities that may provide other electricity services. The legal separation obligation is supported by other obligations for the DNSP to maintain separate accounts, follow defined cost allocation methods (CAMs) and be able to report on transactions between itself and its affiliates.
- Second, the Guideline addresses the risk of a DNSP favouring its own negotiated services or other distribution services, or an affiliated entity's other electricity services, in contestable markets. The Guideline does this by imposing behavioural obligations on DNSPs, including restrictions on sharing and co-locating staff, information and on co-branding of advertising materials.

Our assessment is that the existing arrangements for Mt Baw Baw energy services do not result in the outcomes the Guideline is seeking to avoid. We have appropriate internal controls to ensure that the cost and revenue from providing the services to Mt Baw Baw are appropriately separated from the customers of the regulated network. This is supported by:

1. Mt Baw Baw revenue is separately accounted for with a specific general ledger account (it is the only revenue item that goes into this GL Account). The revenue stream is audited on an annual basis, under a separate Mt Baw Baw Revenue engagement. This is a requirement of the Mt Baw Baw contract.
2. Costs are captured on the Mt Baw Baw opex project in an Unregulated Work code in the DNSP. These costs are reported as 'Unallocated' in the annual Regulatory Submissions, which reflects the unregulated nature of the costs.
3. The assets associated with Mt Baw Baw currently reside in a separate entity.

In respect to the second outcome contemplated by the Guideline (the potential for discrimination), we note that AES is the sole supplier to the ARC across the generation, distribution and retail of electricity. Mt Baw Baw is a standalone system unconnected to the NEM and this sole supplier arrangement arises as a result of the contractual arrangements entered into with the ARC to provide this bespoke service. As we are the sole supplier this service is not provided on a contestable basis. As no component of the supply chain is a contestable service it is not possible for us favour our affiliated entities or their services above other entities.

[2] If one of AusNet Services related electricity service providers tenders to provide this service, it would need to do so in a manner that complies with the ring fencing guideline.

7.3 Cost Benefit of granting the Waiver

The existing service provision is provided pursuant to a contractual arrangement that was entered into between AES and the ARC. We did not identify any benefits to electricity consumers from novating this contract before its expiry and note that:

1. There are additional costs imposed on the ARC and AES if the waiver is not granted. These costs have been quantified in Section 5.

2. There is no detriment or additional cost to customers from maintaining the existing contractual arrangements. That is the price, quality, safety, reliability and security of supply of electricity will continue in accordance with existing contractual arrangements. Further, the contractual arrangements contain dispute resolution clauses and there is a limited contractual period remaining. The ARC has options at its disposal to deal with any detriment it incurred under the existing contractual arrangements.

The counterfactual is to allow existing contractual arrangements to expire, with no additional cost to the ARC or AES and no change in the service being provided to the ARC.