



**Mulpha Australia Limited**

**Submission to the AER**

**Re**

**Ergon Regulatory Proposal 2015-20**

**and impact on**

**Hayman Island Undersea Cable**

**February 2015**

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# Mulpha Submission to the AER for the Hayman Island Undersea Cable

## Executive Summary

Ergon submitted a regulatory proposal to the AER on 31 October 2014. Amongst other things, that proposal and the supplementary documents to it deal with an undersea cable between Hayman Island and the mainland.

The undersea cable was put in place approximately 15 years ago pursuant to a continuing legally binding contract between Ergon and the owner of Hayman Island that commenced in November 1999. During the ensuing 15 year period, the undersea cable has always been treated by the contracting parties and the regulator as unregulated. Ergon now proposes that the undersea cable should be:

- regulated; and
- considered to be a standard control service,

despite its current and historical status of being:

- unregulated; and
- considered to be a non-distribution service.

The undersea cable contract specifies an unregulated charge to be paid by Mulpha in relation to the initial term of 15 years (expiring in December 2014). This unregulated charge comprised both capital payments (so that Mulpha was paying for the capital cost of the undersea cable) as well as interest payments (as a return on asset component) on that capital cost.

The contract also contemplates that Mulpha has an option for a further term of 15 years following the expiry of the initial term. Because Mulpha has paid for the entire capital cost of the undersea cable during the initial 15 year term, the contract provides that Mulpha does not have to pay capital and interest payments during the further term.

Put simply, Mulpha's payments during the 15 year initial term would be much higher than for the 15 year further term, because for the initial term Mulpha would be paying an unregulated charge to pay for the capital cost of the undersea cable together with interest on it. However, Mulpha's payments for the 15 year further term would then (under its contract with Ergon) be greatly reduced.

Consistent with the contract, Ergon's previous regulatory proposal to the AER for the 2010-2015 regulatory period clearly set out that the undersea cable was a non-distribution service and therefore was unregulated. By proposing that the undersea cable was a non-distribution service and therefore unregulated, Ergon ensured that there was no doubt that it could continue to receive the unregulated charges payable by Mulpha under the contract until Mulpha had paid for the entire cost of the cable (which was to occur on expiry of the initial term in December 2014). By taking this approach, Ergon also ensured that it continued to receive from Mulpha substantial interest payments (as a return on asset component) until December 2014.

During the 15 year initial term of the contract over \$18,000,000 was paid to Ergon by way of unregulated charges in relation to the undersea cable. These unregulated charges amount to the payment of the entire capital cost of the undersea cable (\$7,638,277 as stipulated in the contract) as well as over \$10,000,000 in interest payments (as a return on asset component) on that capital cost. Ergon's rate of return was therefore over 13% pa, greatly in excess of the return it would have received if the undersea cable had been regulated and therefore part of Ergon's RAB.

Having now received over \$18,000,000 in unregulated charges relating to the undersea cable and with the contract between Mulpha and Ergon providing that those unregulated payments cease (or substantially cease) in December 2014, Ergon now wishes to conveniently (though as we strongly maintain, erroneously) characterise to its substantial financial benefit the undersea cable as being regulated. This is the complete opposite of the position adopted by Ergon in its submission for the 2010-2015 regulatory period. It is also completely at odds with the characterisation of the undersea cable as being unregulated that applied for the 10 years prior to Ergon's 2010-2015 submission.

To further highlight Ergon's desire to achieve its financial goals at any cost to the customer, Ergon has offered to sell the undersea cable to Mulpha for \$8,000,000. This is despite the fact that:

- the total cost of the undersea cable was \$7,638,277;
- Ergon has already been repaid in full for the capital value of the undersea cable; together with

- Ergon receiving over \$10,000,000 in interest payments (as a return on asset component) in relation to the cable.

It is clear to Mulpha that Ergon is attempting to change the classification of the undersea cable at this time because:

- it has now received full advantage of all of the capital and interest payments payable by Mulpha under the contract;
- there is therefore no longer any benefit to Ergon in the undersea cable remaining unregulated (as under the contract, Mulpha is not required to pay capital and interest payments in the 15 year further term given that Mulpha has paid the entire capital cost of the undersea cable during the initial term); and
- if Ergon is successful, then based on Ergon's proposed charges the amount payable by Mulpha under the contract during the 15 year further term could be more than \$21,000,000 in excess of the amount which would be payable if the undersea cable remained unregulated.

Unfortunately, over the last 13 months Ergon has:

- not consulted with Mulpha about Ergon's proposed change to the characterisation of the undersea cable (but instead has just stated and restated its position without any real discussion with Mulpha);
- failed to put forward any legally valid reason why the undersea cable should be now be regulated after being unregulated for 15 years;
- unapologetically misrepresented the true legal position in relation to the undersea cable and its contract with Mulpha by characterising its position as being a requirement of the AER and NEL when it was not;
- unapologetically misrepresented the AER's position in relation to the undersea cable;
- failed to comply with the strong recommendation of the AER to consult with Mulpha in developing the proposed approach for the 2010-2015 regulatory period;
- ignored the clear intention of the contract;
- decided to conveniently seek to change the characterisation of the undersea cable at a time and in a way calculated to ensure that it can retain over \$18,000,000 in unregulated charges whilst denying to Mulpha the benefit of the cable remaining unregulated for the further 15 year term; and
- in doing so avoided any engagement with Mulpha, as it would be duty bound, on the charges applicable for the further term of the contract.

If Ergon is permitted to re-characterise the unregulated undersea cable as being regulated then this will result in:

- a windfall gain for Ergon given that it has enjoyed the benefit of the substantial unregulated charges payable by Mulpha during the initial term;
- Mulpha paying charges during the further term which completely ignore the over \$18,000,000 worth of capital and interest payments made during the initial term;
- the complete thwarting of clear existing contractual rights given the benefits to Mulpha contemplated under the contract for the further term by way of reduced charges;
- Mulpha not receiving any benefit for the unregulated charges that it has paid in relation to the undersea cable;
- Ergon being permitted to 'game the system' whereby having received substantial unregulated charges for the initial term on the basis of the undersea cable being unregulated, that as soon as there is no longer benefit to Ergon in the undersea cable being unregulated, changing the characterisation of the undersea cable (and greatly increasing the charges payable by Mulpha as a result) in direct conflict with the intention of the parties in the contract as well as the consistent treatment of the undersea cable as unregulated over 15 years;
- Ergon being rewarded for not consulting Mulpha; ignoring the AER's strong recommendation to Ergon to consult with Mulpha; and acting contrary to undertakings Ergon gave to the AER in how it deals with its customers;
- an additional cost to Mulpha which could be more than \$21,000,000 in excess of the cost that Mulpha would incur if the undersea cable retained the same characterisation during the further 15 year term as it had during the initial 15 year term (ie unregulated); and

- encouraging Ergon and other monopoly distribution network service providers to use the National Electricity regime to game play regulatory outcomes.

Due to Ergon's actions, Mulpha has been left no choice but to now make a submission to the AER to defend itself against what can only be characterised as a brazen attempt on the part of Ergon to elicit a windfall gain through subverting our pre-existing contractual entitlements via a crudely concocted regulatory ruse.

For the reasons put forward in this Submission, the undersea cable:

- cannot, as Ergon contend, be regarded as a standard control service;
- should remain, as it has always been mutually agreed by Ergon and the various energy Regulators, as being unregulated;
- requires no other service classification within the meaning of Chapter 5A of the National Electricity Rules given the clear contractual rights and obligations of the parties pursuant to contract between them; and
- any other regulatory classification would therefore be inconsistent with the objectives of the regulatory regime.

For these reasons, the Regulatory Proposal submitted by Ergon on 31 October 2014 should not be accepted by the AER to the extent that it is proposed otherwise.

Given the considerable commercial impacts to our Hayman Island business through the improper denial of a material reduction in charges (in excess of \$100,000 per month), Mulpha requests expedition by the AER in confirming the proper classification of the undersea cable now and for the future, thereby clearing the way for us to immediately proceed to prosecute a sensible outcome with Ergon, consistent with our clear rights under the existing undersea cable contract.

As a regulated monopoly and a state owned business enterprise, one would have expected a much higher standard of corporate practice from Ergon in dealing with its customers. Ergon's interaction with Mulpha has been unsatisfactory and disappointing.

Finally, because some of the documents included with this Submission are subject to confidentiality requirements, this Submission should remain confidential until Mulpha notifies the AER that the Submission may be made public.

## 1. **BACKGROUND**

### (a) **Background Undersea Cable**

The Trust Company (PTAL) Limited as trustee of the Mulpha Hotel Trust (a wholly owned entity of Mulpha Australia Limited) is the owner of the Hayman Island Resort (**Hayman Island**) located in the Whitsunday Islands in north Queensland. Hayman Island is connected to the regulated mainland electricity network by an undersea cable (**Undersea Cable**) which links Hayman Island to the Shutehaven Substation on the Queensland mainland via a connection point at Stony Beach (near Shute Harbour).

The Undersea Cable is the subject of a customer connection agreement (**Customer Connection Agreement**) between The Trust Company (PTAL) Limited (as trustee of the Mulpha Hotel Trust) (**PTAL**) and Ergon (each party through predecessor entities). The Customer Connection Agreement is explained in more detail below.

### (b) **Background Customer Connection Agreement**

The Customer Connection Agreement is dated 5 November 1998 and a copy can be found in Schedule 1. Under the Customer Connection Agreement, Ergon was to provide the customer (Hayman Island) certain connection services following Ergon's completion and commissioning of works necessary to enable those services to be provided.

These works included the laying of the 30km long Undersea Cable which allowed Hayman Island to be connected to mainland electricity in November 1999. According to Ergon, the project cost was approximately \$8,000,000 (see page 13

of the Ergon Energy Annual Review 1999 which can be found in Schedule 2) and the Customer Connection Agreement specifies a capital cost for the Undersea Cable of \$7,638,277.

Under the Customer Connection Agreement, an initial term of 15 years (**Initial Term**) applied with an option exercisable by the customer for a further term of 15 years (**Further Term**). Whilst the terms of the Customer Connection Agreement also apply in general to the further term of 15 years, the Customer Connection Agreement provides that the charges during the Further Term would be significantly less than those payable during the Initial Term. Specifically, the Customer Connection Agreement provides at Clause 1.3(b)(ii) that for the Further Term:

*“Charges payable will be based on the then current connection charges (with no regard to the capital and interest repayment of the connection asset with the intention that the Charges will enable the Distributor to recover depreciation (based on straight line depreciation over 35 years), operating and maintenance costs only)”*

This is because during the Initial Term, with respect to the Undersea Cable, the customer was to pay an amount calculated with reference to the capital cost of the Undersea Cable as well as interest (as a return on asset component) on that capital cost. The customer also had to provide a bank guarantee relating to the capital cost of the Undersea Cable.

The initial amount of the bank guarantee was \$7,638,277 (reflecting the cost of the Undersea Cable) but this reduced each year as the customer made the relevant capital payments. Over the Initial Term, the capital payments by the customer were applied against the \$7,638,277 capital cost of the Undersea Cable so that the Undersea Cable was fully paid for by the customer during the Initial Term. For this reason, the amount secured by the bank guarantee reduced to zero at the end of the Initial Term (reflecting the fact that the Undersea Cable had been fully paid for by the customer) and therefore no bank guarantee is required for the Further Term.

Because Mulpha has recently completed (December 2014) all of its payments of capital and interest for the Undersea Cable, the bank guarantee has now reduced to zero.

Initially, the unregulated charges payable by the customer had two components being:

- a component for the shared use of Ergon’s mainland assets including parts of the Shutehaven Substation and the short length of bundled cable from the Shutehaven Substation to Stony Beach (shared with Hamilton Island); and
- a dedicated component for the sole use of the Undersea Cable by Mulpha from the connection point at Stony Beach to Hayman Island.

An amendment to the Customer Connection Agreement was later entered into between Mulpha and Ergon (**Amendment Agreement**). The Amendment Agreement has an effective date of 1 July 2007 and related to further works proposed by Ergon to be carried out to the Shutehaven Substation in June 2007. A copy of the Amendment Agreement can be found in Schedule 3.

The Amendment Agreement was requested by Ergon (rather than Mulpha) as it was necessitated by upgrade works which Ergon wished to carry out to Shutehaven Substation to increase authorised demand to Hamilton Island.

Ergon wrote to Mulpha on 16 December 2005 (**16/12/2005 Ergon Letter**) in relation to the proposed upgrade works. A copy of the 16/12/2005 Ergon Letter can be found in Schedule 4. Ergon states in the 16/12/2005 Ergon Letter that:

- its corporate direction for unregulated assets is that mainland assets should be regulated where possible with unregulated assets to be either offshore or on customer property; [emphasis added]

- due to the upgrade, it was an appropriate time for there to be an amendment to the Customer Connection Agreement to satisfy Ergon’s corporate direction for unregulated assets;
- on completion of the upgrade works, Ergon would transfer the relevant mainland assets from Ergon’s unregulated asset base to its regulated asset base;
- the regulated network connection point would be on Stony Beach (ie on the mainland where the Undersea Cable terminates) rather than at the Shutehaven Substation as was previously the case;
- the component of the unregulated charge for the shared use of Ergon’s mainland assets being \$75,242 pa would cease on completion of the upgrade works;
- Hayman Island would pay out the remaining ROA component of the mainland asset part of the Customer Connection Agreement, paid monthly over the remaining term of the Customer Connection Agreement (approximately \$12,800 pa);
- there would be no changes to regulated charges other than as a result of normal franchise tariff impact; and
- the existing unregulated charge of \$1,166,924 pa for the Undersea Cable would continue.

Based on the above, the Amendment Agreement was entered into. A conformed copy of the Customer Connection Agreement as amended by the Amendment Agreement (**Amended Customer Connection Agreement**) can be found in Schedule 5.

The Amended Customer Connection Agreement relevantly provides that:

- the Customer must pay regulated charges associated with the regulated network connection up to but not including the Undersea Cable at Stony Beach as approved by the relevant regulator (currently the AER) together with such charges levied on Ergon by Powerlink that Ergon is permitted at law to pass on and are not included in that regulated charge;
- the Customer must pay an unregulated charge for the Undersea Cable being \$1,168,332pa (of which \$1,020,876 is fixed and the balance is subject to quarterly CPI increases);
- the Customer must pay a fixed charge representing the unrecovered network charge component of the assets which at that time had been transferred to Ergon’s regulated network (ie those assets that were formerly the subject of \$75,242 pa unregulated charge that related to the shared use of Ergon’s mainland assets);
- the fixed charge for the unrecovered network charge component of assets transferred would be \$16,416 pa;
- the Customer would pay certain regulated charges (but not in relation to the Undersea Cable as this was unregulated); and
- the connection point which was previously at the Shutehaven Substation would now be at Stony Beach.

### (c) **Regulatory Background**

For the regulatory period 2010-2015, the relevant regulator was the Australian Energy Regulator (**AER**) instead of the Queensland Competition Authority as had previously been the case. Ergon provided to the AER a regulatory proposal dated 1 July 2009 (**1/7/2009 Ergon RP**). Amongst other things, the 1/7/2009 Ergon RP expressly referred to the Undersea Cable.

Transitional Rule 11.16.3 (discussed below in Section 10), does not require Ergon (or any Distribution Network Service Provider “**DNSP**”) to adopt the same

regulatory approach for the 2010-2015 regulatory period that was applied for the 2005-2010 regulatory period. However, Ergon chose to adopt that same regulatory approach for the Undersea Cable.

Specifically, the 1/7/2009 Ergon RP states that the Undersea Cable is a “non-distribution service” and is therefore not “regulated by the AER or covered by this Regulatory Proposal”. A copy of p112 of the 1/7/2009 Ergon RP (which contains this statement) can be found in Schedule 6.

The AER accepted this aspect of the 1/7/2009 Ergon RP, although it did not accept other aspects of the 1/7/2009 Ergon RP which lead to a subsequent amended regulatory proposal by Ergon. That subsequent amended regulatory proposal dealt with matters not relevant here and so the position stated in the 1/7/2009 Ergon RP in relation to the Undersea Cable ultimately reflects the position proposed by Ergon and accepted by the AER in relation to the Undersea Cable.

In summary, this position is that the Undersea Cable:

- is a non-distribution service (and therefore is not capable of regulation); and
- is therefore not regulated.

For the regulatory period 2015-2020, Ergon provided to the AER a regulatory proposal dated 31 October 2014 (**31/10/2014 Ergon RP**). In contrast to the 1/7/2009 Ergon RP, the 31/10/2014 Ergon RP does not expressly mention the Undersea Cable, although supporting documentation (**Supporting Documentation**) available on Ergon’s website (rather than the AER website) does mention the Undersea Cable.

On page 13 of Section 03.01.01 of the Supporting Documentation, Ergon states that the Undersea Cable was not included in Ergon’s regulatory asset base (**RAB**) at the start of the 2010-2015 regulatory period but would be transferred by Ergon to its RAB for standard control services at the commencement of the 2015-2020 regulatory period.

On page 14 of Section 03.01.01, Ergon states that:

- S6.2.1(e)(8) of the National Electricity Rules (**NER**) applies to the Undersea Cable as well as to a number of other assets ;
- despite the above, Ergon does not propose to include any of those assets in its RAB except for the Undersea Cable; and
- it has confirmed with the AER that the Undersea Cable will be included in Ergon’s RAB for the regulatory period 2015-2020.

A copy of pages 13 and 14 of Section 03.01.01 of the Supporting Documentation can be found in Schedule 7.

As discussed later in this submission, Mulpha:

- does not agree that S6.2.1(e)(8) applies to the Undersea Cable;
- does not agree that the Undersea Cable can lawfully be included in the Ergon RAB;
- is of the view that even if the Undersea Cable could lawfully be included in the Ergon RAB, it should not be included (given that it should remain unregulated and that Mulpha has paid for it); and
- is disappointed that Ergon misrepresented the AER’s position as being that the Undersea Cable had to be regulated for the 2015-2020 regulatory period (see below).

## 2. INTERACTION WITH ERGON

### (a) Initial Claim by Ergon

Ergon wrote to Mulpha on 26 November 2013 (**26/11/2013 Ergon Letter**). A copy of the 26/11/2013 Ergon Letter can be found in Schedule 8.



In that letter, Ergon stated that:

- it had undertaken a legal and regulatory review of the Customer Connection Agreement;
- the review resulted in a finding that Ergon was in breach of its obligations under the National Electricity Law (NEL);
- Ergon had to take urgent action to comply with that law;
- this action involved an immediate reclassification of the Undersea Cable from being unregulated to being regulated and with the relevant regulated services being standard control services; and
- it wanted to enter into a new customer connection agreement that was “compliant” (again, based on the unproven assertion that the existing Amended Customer Connection Agreement had suddenly ceased to be “compliant”).

Ergon also referred to clause 6.1(a)(i) of the Amended Customer Connection Agreement which relevantly provides that Ergon must comply with the law and the requirements of the AER even if such compliance was inconsistent with the Amended Customer Connection Agreement.

If Mulpha had accepted the position put by Ergon then the outcome would have been as follows:

### **Balance of Initial Term**

DUOS Charges	\$ 1,911,255	(estimated)
TUOS Charges	\$ 366,778	(estimated)
Unregulated Charges	<u>Zero</u>	
<b>Total Charges</b>	<b>\$2,278,033 pa</b>	

### **Option Term (position at commencement)**

DUOS Charges	\$ 1,911,255	(or thereabouts depending on usage)
TUOS Charges	\$ 366,778	(or thereabouts depending on usage)
Unregulated Charges	<u>Zero</u>	(due to Ergon’s unilateral action in reclassifying the Undersea Cable without consultation with Mulpha)
<b>Total Charges</b>	<b>\$2,278,033 pa</b>	

However, Mulpha did not accept the position put by Ergon (despite the considerable pressure placed on Mulpha by Ergon) but instead decided to ask a few preliminary questions of Ergon. Because Mulpha did not automatically accept the position put to it by Ergon, the position under the Amended Customer Connection Agreement remained unchanged. This position is as follows:

### **Balance of Initial Term**

DUOS Charges	\$ 478,111	(estimated)
TUOS Charges	\$ 366,778	(estimated)

Unregulated Charges	<u>\$1,196,352</u>	
Total Charges	<b>\$2,041,241 pa</b>	

### **Option Term (position at commencement)**

DUOS Charges	\$ 478,111	(or thereabouts depending on usage)
TUOS Charges	\$ 366,778	(or thereabouts depending on usage)
Unregulated Charges	<u>Zero</u>	(as the Undersea Cable has effectively been paid for by Mulpha during the Initial Term)
Total Charges	<b>\$844,889 pa</b>	

As you can see, the Ergon position (which Ergon stated was required by law) would have resulted in:

- an immediate increase of \$236,792 pa in the charges payable by Mulpha under the Amended Customer Connection Agreement during the Initial Term (without there being any increase in usage by Mulpha or additional services provided by Ergon) – being the difference between the \$2,278,033 pa which Ergon claimed was payable due to the forced recharacterisation of the Undersea Cable as regulated and the \$2,041,241 pa which applied if the Undersea Cable remained unregulated; and
- an increase of \$1,433,144 pa in the charges payable by Mulpha under the Amended Customer Connection Agreement during the Option Term (again, without there being any increase in usage by Mulpha or services provided to it) – being the difference between the \$2,278,033 pa which Ergon claimed was payable due to the forced recharacterisation of the Undersea Cable as regulated and the \$844,889 pa which would have been payable if the Undersea Cable remained unregulated.

Fortunately for Mulpha, it did not immediately accept the position stated by Ergon as representing the true legal position (although at the time, Mulpha was not aware of the full financial implications of accepting or questioning that position). Instead, Mulpha sought further clarification from Ergon on certain matters.

Mulpha wrote to Ergon on 23 December 2013 (**23/12/2013 Mulpha Letter**). A copy of the 23/12/2013 Mulpha Letter can be found in Schedule 9.

In that letter Mulpha:

- stated that it did not necessarily agree with the contents of the 26/11/2013 Ergon Letter or its conclusions;
- asked Ergon to let Mulpha know which obligations of the NEL Ergon was breaching by complying with the Amended Customer Connection Agreement; and
- asked Ergon to let Mulpha know when those breaches first commenced.

Ergon wrote to Mulpha on 8 January 2014 (**8/1/2014 Ergon Letter**). A copy of the 8/1/2014 Ergon Letter can be found in Schedule 10. That letter did not:

- specify which obligations of the NEL Ergon was breaching by complying with the Amended Customer Connection Agreement (as had been claimed by Ergon); or
- specify when those breaches first commenced,

despite Mulpha's express questions in this regard.

As at the date of this submission, Ergon still has not answered these questions.

Mulpha wrote to the AER on 19 February 2014 (**19/2/2014 Mulpha Letter**). A copy of the 19/2/2014 Mulpha Letter can be found in Schedule 11.

In that letter, Mulpha:

- noted that there was a dispute in relation to the Amended Customer Connection Agreement;
- informed the AER that Mulpha was to have a teleconference with Ergon the following week and hopefully resolve the matter; and
- noted that if resolution did not occur at the teleconference, then Mulpha would like to provide a formal submission to the AER.

On 19 February 2014, Mulpha sent to Ergon a copy of the 19/2/2014 Mulpha Letter.

On 24 February 2014, a teleconference was held between representatives of Mulpha and Ergon. The teleconference did not resolve the dispute. In addition, the teleconference did not answer Mulpha's questions about various matters. In particular, Mulpha still was not given an answer to its questions in the 23/12/2013 Mulpha Letter about which obligations of the NEL Ergon was breaching and when those breaches first occurred.

During that teleconference, Ergon undertook to refer the matter to the AER and advise Mulpha of the outcome. Ergon wrote to Mulpha on 25 February 2014 (**25/2/2014 Ergon Letter**) and confirmed that it would refer the matter to the AER and advise Mulpha of the outcome. A copy of the 25/2/2014 Ergon letter can be found at Schedule 12.

Mulpha wrote to Ergon on 27 February 2014 (**27/2/2014 Mulpha Letter**) asking Ergon to confirm the date on which the bank guarantee previously provided by Mulpha to secure the capital payments by it in relation to the Undersea Cable, would be returned. A copy of the 27/2/2014 Mulpha Letter can be found in Schedule 13.

Ergon wrote to Mulpha on 28 February 2014 (**28/2/2014 Ergon Letter**) confirming that the bank guarantee would probably end on 30 May 2014 (subject to confirmation from the relevant bank being the ANZ). A copy of the 28/2/2014 Ergon Letter can be found at Schedule 14.

Although Ergon had undertaken to refer to the matter to the AER and advise Mulpha of the outcome, Ergon did not in fact contact Mulpha in this regard until late May 2014 (see (b) below dealing with Ergon's second claim).

In summary, the Ergon initial claim which was repeated in various forms commencing in November 2013, was that:

- Ergon was currently in breach of the NEL;
- Ergon had to immediately cease to apply the charges as specified in the Amended Customer Connection Agreement;
- Ergon also had to immediately commence to charge on a basis which would mean an increase in the charges payable by Mulpha of \$236,792 pa for the balance of the Initial Term and \$1,433,144 pa at the start of the Option Term; and
- these significantly increased new charges would apply even though there was no increased usage by Mulpha or additional or improved services provided to Mulpha.

## **(b) Second Claim by Ergon**

Ergon wrote to Mulpha on 26 May 2014 (**26/5/2014 Ergon Letter**). A copy of the 26/5/2014 Ergon Letter can be found in Schedule 15. In that letter, Ergon stated that:

- it had raised with the AER the question as to whether Ergon was in breach of the NEL by complying with the Amended Customer Connection Agreement;
- it had received correspondence from the AER that made it clear that at least for the 2015-2020 regulatory period, Ergon would have no choice but to apply regulated standard control services to the Undersea Cable; and
- the separate unregulated charge could continue until the commencement of the 2015-2020 regulatory period (despite Ergon's strong and repeated position over the previous 7 months that it was currently in breach of the NEL and had to immediately cease to comply with the Amended Customer Connection Agreement and instead apply charges on a regulated standard control service basis which was far more favourable to Ergon).

Ergon wrote to Mulpha on 3 June 2014 (**3/6/2014 Ergon Letter**). A copy of the 3/6/2014 Ergon Letter can be found in Schedule 16. In that letter, Ergon:

- stated that the AER had confirmed that the Undersea Cable was currently unregulated (despite Ergon's initial claim to the contrary);
- stated that the AER had confirmed that the unregulated status of the Undersea Cable would apply at least for the 2010-2015 period;
- stated that the transitional arrangements that applied to the 2010-2015 period would not apply to the 2015-2020 period;
- was therefore claiming that the Undersea Cable was unregulated for the 2010-2015 period due only to those transitional arrangements; and
- attached a copy of a letter to Ergon from the AER dated 27 May 2014 (**27/5/2014 AER Letter**).

A copy of the 27/5/2014 AER Letter can be found in Schedule 17. This letter provided that:

- the Undersea Cable was currently unregulated;
- the Undersea Cable would remain unregulated for the 2010-2015 period (in contrast to the initial Ergon claim which was the exact opposite of this);
- Ergon should set out its reasons as to the future regulatory treatment of the Undersea Cable given the historical approach that has been used to date (ie given that the Undersea Cable had been unregulated for the entire period since it was commissioned in late 1999); and
- the AER "strongly" recommends that Ergon consult with Mulpha in developing the proposed approach for the 2015-2020 period.

Because the 27/5/2014 AER Letter was so clear on the above points, it was impossible to avoid the conclusion that Ergon had:

- misrepresented to Mulpha the effect of the relevant law in relation to the characterisation of the Undersea Cable; and
- misrepresented to Mulpha the AER's position in relation to the Undersea Cable.

Mulpha wrote to Ergon on 1 September 2014 (**1/9/2014 Mulpha Letter**). A copy of the 1/9/2014 Mulpha Letter can be found in Schedule 18. Amongst other things, this letter:

- noted that Mulpha had been asking for almost 3 years for Ergon to provide to it information supporting the calculation of the charges specified in the Amended Customer Connection Agreement;
- summarised the correspondence to date and noted that Ergon had been completely incorrect in its analysis and conclusions with respect to the 2010-2015 period;
- noted that from the 27/5/2014 AER Letter, the AER had no objection to Ergon and Mulpha jointly developing a submission that the Undersea Cable remain unregulated;
- noted Ergon's comment in the 27/5/2014 Ergon Letter that "the AER has already made a decision on the classification of our services through its Framework and Approval process" as being completely inconsistent with the true position of the AER as shown in the 27/5/2014 AER Letter where the AER stated that the "service classification status, regulated or unregulated, of the undersea cable was not explicitly dealt with under the [AER F&A] for the next regulatory period";
- stated that Ergon had not only misrepresented the legal position in relation to the Undersea Cable, but misrepresented the AER's position in that regard;
- quoted from Ergon's 2014-2015 Pricing Proposal and showed how Ergon in its dealings with Mulpha had not complied with a number of matters in relation to the assignment of customers to Ergon's standard control service tariff classes, which included:
  - not advising Mulpha that it could object to the reclassification,;
  - not advising that Mulpha could seek resolution under Part 10 of the NEL; or
  - including a link to Ergon's website where a copy of the internal procedures for reviewing objections should be located; and
- expressed disappointment as to the treatment received from Ergon.

**(c) Current Ergon Letter**

Ergon wrote to Mulpha on 5 November 2014 (**5/11/2014 Ergon Letter**). A copy of the 5/11/2014 Ergon Letter can be found in Schedule 19.

Again, rather than addressing Mulpha's many unanswered questions, Ergon simply restated its position. In particular, Ergon:

- did not provide any of the information previously requested by Mulpha relating to the calculation of the initial charges under the Customer Connection Agreement;
- did not provide any of the information previously requested by Mulpha relating to the calculation of the charges under the Amended Customer Connection Agreement;
- did not provide any of the information previously requested by Mulpha relating to various charges that Ergon had proposed to apply over the previous 12 months;
- did not explain which provisions of the law Ergon was in breach of (a claim first made in the 26/11/2013 Ergon Letter with the explanation requested by Mulpha in the 23/12/2013 Mulpha Letter);

- did not explain the date on which those breaches commenced (as requested by Mulpha in the 23/11/2013 Mulpha Letter);
- did not apologise for Ergon’s misrepresentation of the legal position in relation to the Undersea Cable (which if Mulpha had accepted would have cost Mulpha millions of dollars);
- did not apologise for misrepresenting the AER’s position; and
- did not apologise or explain why in the 12 month period between the 26/11/2013 Ergon Letter and the 5/11/2014 Ergon Letter, Mulpha’s questions had not been answered or requested information provided.

**(d) General Interaction with Ergon**

It is fair to say that the general interaction with Ergon has been deeply disappointing. Our treatment by Ergon has led us to the conclusion that Ergon:

- has misrepresented the law;
- has misrepresented the position of the AER;
- has failed to provide requested information (or even to explain why it is refusing to provide such information);
- has not complied with its representations to the AER as to how it deals with customers;
- has not followed the strong recommendation from the AER (in writing) to develop an approach with Mulpha re the Undersea Cable for the 2015-2020 regulatory period;
- has not been transparent; and
- has taken advantage of its monopoly position.

The undeniable fact is that if Ergon’s position is accepted then:

- the charges that Mulpha agreed to pay under the Amended Customer Connection Agreement will not apply and a price increase of well over 100% will apply instead;
- Ergon will have had a substantial “windfall gain” in that Mulpha would have effectively paid off the Undersea Cable through its payments of capital and interest during the Initial Term, only for Mulpha to be denied the benefits of such capital payments that are supposed to apply under the Amended Customer Connection Agreement during the Further Term;
- Ergon will include in its RAB something that has been paid for by Mulpha;
- the intent of the Customer Connection Agreement will have been thwarted; and
- the objective of the National Electricity Rules (which refers to the long term interests of consumers) will have been subverted as explained in Section 8.

**(e) Ergon Customer Policy**

Ergon provided to the AER a 2014-2015 Pricing Proposal dated 13 June 2014 (**13/6/2014 Ergon PP**). A copy of various pages of the 13/6/2014 Ergon PP can be found at Schedule 20.

This document deals with several matters including in relation to the assignment of customers to Ergon’s standard control service tariff classes. In particular, Section 6.2.1 of the 13/6/2014 Ergon PP states as follows:

*“It is important to note that Ergon Energy does not reassign customers without careful review and adequate justification. Reassignment would only occur in a situation where a customer alters the underlying characteristics of their connection, in terms of size or nature of usage...”*

Whilst the 26/11/2013 Ergon Letter states that Ergon had carried out a legal and regulatory review of the Amended Customer Connection Agreement, it is clear that:

- significant doubts must exist as to how “careful” that review was given the fact that the position adopted by Ergon arising out of that review was wrong as a matter of law;
- there has been no justification put forward by Ergon for any reassignment of the Undersea Cable to standard control services other than the position (incorrectly) adopted by Ergon that it was unlawful for it to apply charges in accordance with the Amended Customer Connection Agreement; and
- in any event, Hayman Island as the customer has not altered the underlying characteristics of its connection in terms of size or nature of usage (which are stated by Ergon as being the “only” circumstances in which reassignment would occur – see above).

Section 6.2.3 of the 13/6/2014 Ergon PP also relevantly provides that Ergon will provide written notification to the customer (prior to any assignment or reassignment occurring) and that such written notice must include:

- advice that the customer may request further information from Ergon and that they may object to the proposed assignment or reassignment;
- a link to Ergon’s website where a copy of the internal procedures for reviewing objections is located; and
- advice that the customer is entitled to seek resolution via the dispute resolution process under Part 10 of the National Electricity Law if the objection is not resolved by Ergon to the satisfaction of the customer.

Neither the 26/11/2013 Ergon Letter, 8/1/2014 Ergon Letter, 28/2/2014 Ergon Letter, 26/5/2014 Ergon Letter, 3/6/2014 Ergon Letter nor the 5/11/2014 Ergon Letter include any of the matters referred to above. In other words, Ergon’s attempt to treat the Undersea Cable as regulated is not only unlawful but is also in breach of the undertakings given by Ergon in the 13/6/2014 Ergon PP.

### **3. ERGON REGULATORY PROPOSAL**

#### **(a) Basis of Proposal**

Although the AER’s Framework and Approach Paper for the 2015-2020 regulatory period (**AER F&A**) does not expressly mention the Undersea Cable, it does deal generally in Appendix B with a number of regulated and unregulated services. On page 14 of the 31/10/2014 Ergon RP, Ergon states that:

- it adopts the AER’s classification of services set out in Appendix B of the AER F&A; and
- Ergon provides a range of services that do not fall within the definition of a distribution service (Appendix B of the AER F&A sets out various services which are unregulated).

One of the categories specified in Appendix B of the AER F&A is “Operate and Maintain large customer connections” which is specified as being a non-distribution service which is unregulated both for the 2010-2015 and the 2015-2020 regulatory periods. The further description in Appendix B for this category specifies “Contract to provide, operate and maintain services for connection assets owned by customer”.

As mentioned above, Mulpha has made substantial capital and interest payments in relation to the Undersea Cable. These payments exceed \$18,000,000 (and include not only payment of the entire \$7,638,277 in capital cost, but also over \$10,000,000 in interest). Clearly, Mulpha has now fully paid for the Undersea Cable and in equity, the Undersea Cable must therefore be owned by Mulpha.

Therefore, even Ergon's claim that it has adopted the AER's classification of services set out in Appendix B of the AER F&A is incorrect. If Ergon had adopted the AER's classification as it claims to have done, then the Undersea Cable would be a non-distribution service and therefore unregulated (ie no change from the current position).

## **(b) No Reason for Change Provided**

The 31/10/2014 Ergon RP provides no logical reason whatsoever as to why Ergon:

- proposes that the Undersea Cable ceases to be considered a non-distribution service (in contrast to the position that has existed since 1999 and was specifically reflected in the 1/7/2009 Ergon RP which was accepted in this regard by the AER);
- proposes that the Undersea Cable be classified as a standard control service (given that it fails to meet the relevant test as explained in Section 7(c)); and
- completely ignored the strong recommendation from the AER to Ergon that Ergon consult with Mulpha in developing the proposed approach for the 2015-2020 period (see the 27/5/2014 AER Letter in Schedule 17).

In various correspondence with Mulpha, Ergon has quoted definitions of "distribution network" and "distribution system" apparently due to Ergon's belief that these definitions support a change in the characterisation of the Undersea Cable. However, none of these definitions have changed from those that applied previously.

In addition, on page 14 of the 31/10/2014 Ergon RP, Ergon states that the Undersea Cable meets the requirements of S6.2.1(e)(8) of the NER apparently in an effort to justify Ergon's proposed inclusion of the Undersea Cable in its RAB. For the sake of completeness we note that Ergon is incorrect in this regard and the Undersea Cable clearly does not meet the requirements of S6.2.1(e)(8).

Amongst other things, clause S6.2.1(e)(8) does not apply unless:

- the AER considers the asset to be reasonably necessary to achieve one or more of the capital expenditure objectives; and
- the value of the asset has not been otherwise recovered.

Whilst we do not agree that the Undersea Cable is necessary for Ergon to meet the capital expenditure objectives as defined in Rule 6A.6.7 of the NER, it is clearly not the case that the value of the asset has not been otherwise recovered.

As explained above, the Amended Customer Connection Agreement provides for Mulpha as the customer to pay during the Initial Term an unregulated charge by way of capital repayment of the Undersea Cable (as well as provide a bank guarantee in favour of Ergon as security for those capital repayments). Those repayments ceased on expiry of the Initial Term (which has now occurred) and therefore will not apply to the 2015-2020 regulatory period.

In other words, it is completely incorrect for Ergon to claim (as it does on page 14 of the 31/10/2014 Ergon RP) that the value of the asset has not otherwise been recovered. Clearly, the value of the asset has been fully recovered from Mulpha under the Amended Customer Connection Agreement.

## **(c) Misrepresentations by Ergon – Legal Position**

As stated above, Ergon has misrepresented various matters a number of times in its dealings with Mulpha. These misrepresentations include:

- misrepresenting to Mulpha that Ergon was required to increase the charges payable by Mulpha during the 2010-2015 regulatory period due to some legal requirement on Ergon to do so;
- misrepresenting to Mulpha that Ergon had received correspondence from the AER that made it clear that at least for the 2015-2020 regulatory period,



Ergon would have no choice but to apply regulated standard control services to the Undersea Cable (the truth was that the AER had not indicated this at all and instead had strongly recommended that Ergon consult with Mulpha in developing the proposed approach for the 2015-2020 regulatory period – a recommendation that Ergon completely ignored). Further, it should be noted that this misrepresentation is then repeated in the 31/10/2014 Ergon RP.

Mulpha has yet to receive an apology from Ergon in relation to these misrepresentations. Mulpha is currently obtaining legal advice in relation to the legal ramifications of the various misrepresentations by Ergon and the conduct of Ergon generally in this matter.

#### **4. COMMERCIAL CONSEQUENCES IF ERGON REGULATORY PROPOSAL ACCEPTED**

##### **(a) Intention of Customer Connection Agreement Thwarted**

If the 31/10/2014 Ergon RP is accepted by the AER then the clear intention of the Amended Customer Connection Agreement will be completely thwarted.

As noted above, the intention of the Amended Customer Connection Agreement (and the Customer Connection Agreement itself before being amended by the Amendment Agreement) was in relation to the Undersea Cable for:

- Mulpha as the customer to make capital repayments (as well as interest on those payments) by way of an agreed unregulated charge payable during the Initial Term;
- Mulpha as customer to provide Ergon a bank guarantee for the entire amount of those capital repayments as security;
- the capital repayments and the bank guarantee be for the entire cost of the Undersea Cable so that Ergon would be repaid the costs incurred in providing same;
- when Mulpha had made all of the capital repayments (and interest on those payments) the bank guarantee would be returned and the charges payable by Mulpha under the Amended Customer Connection Agreement would drop significantly for the Further Term (which has recently commenced); and
- the amount paid under the Amended Customer Connection Agreement in relation to the capital repayments and the interest on them is over \$18,000,000 (this is in the context of an initial capital cost of the Undersea Cable of \$7,638,277).

As you can see from the above, if the 31/10/2014 Ergon RP is accepted by the AER then the intent of the Amended Customer Connection Agreement will be completely thwarted. In addition, Ergon will get a windfall gain from receiving unregulated payments of over \$18,000,000 in relation to an initial cost of the Undersea Cable of \$7,638,277 without needing to honour the price reduction that the parties agreed would occur for the Further Term.

##### **(b) Higher Costs for Mulpha**

As you can see from the above, another commercial consequence if the 31/10/2014 Ergon RP is accepted by the AER is that Mulpha's costs will increase markedly from those costs that Mulpha had agreed to pay (given all the capital and interest payments in relation to the Undersea Cable having been made).

The difference in costs payable by Mulpha over the Further Term of 15 years depending on whether the 31/10/2014 Ergon RP is accepted or not is substantial. Although that difference cannot be calculated precisely at this stage, an approximate estimation can be made based on the difference between Mulpha's

calculation of initial charges payable during the Further Term (\$844,889) and the figures provided by Ergon (\$2,278,033) – see Section 2(a) above.

Over a Further Term of 15 years this difference amounts to \$21,497,160. Once actual figures are known the difference might be more than this.

**(c) Mulpha’s Payment for the Cable Ignored**

If the 31/10/2014 Ergon RP is accepted, then Mulpha’s payment for the Undersea Cable will be completely ignored. Ergon will have been able to manipulate the system so that:

- during the Initial Term, Ergon would receive a substantial unregulated charge amounting to in excess of \$18,000,000 (but promising in the Amended Customer Connection Agreement that the charges payable by Mulpha would then substantially decrease during the Further Term as no further capital and interest payments would be required); and
- during the Further Term claim that the Undersea Cable should be regulated and regarded as providing standard control services (in other words, there will be no benefit to Mulpha in having made the capital and interest payments for the Undersea Cable during the Initial Term).

**5. SUMMARY OF ARGUMENTS RE ERGON REGULATORY PROPOSAL**

**(a) Non-Distribution Service**

The Undersea Cable has always been regarded as a non-distribution service. In the 1/7/2009 Ergon RP, Ergon proposed that the Undersea Cable be a non-distribution service. This was accepted by the AER.

Despite no material change in the use of the Undersea Cable and no change whatsoever in the relevant definitions of “distribution network” and distribution service” etc, Ergon has proposed in the 31/10/2014 Ergon RP that the Undersea Cable be a distribution service.

For a number of reasons as explained in Section 6, the Undersea Cable should remain characterised as a non-distribution service.

**(b) If Distribution Service, AER should not regulate**

Even if the Undersea Cable had historically been characterised as a distribution service but not regulated by the AER, the AER should nevertheless decide to continue not to regulate the Undersea Cable as explained in Section 7 below.

**(c) National Electricity Objective**

If the Undersea Cable becomes subject to regulation, then the National Electricity Objective will not be achieved as explained in Section 8 below.

**(d) Monopoly Position of Ergon**

Ergon is in a monopoly position in relation to enabling electricity to be provided to Mulpha. Normally, regulation would be seen as providing some protection to the customer against an abuse by Ergon of that monopoly position. However, for the reasons discussed in Section 9 below, in this case regulation will actually provide for a substantially worse result for the customer and (perhaps ironically) will facilitate the very abuse of monopoly position that regulation normally seeks to prevent.

**(e) Transitional Provisions**

At times it has appeared that Ergon wished to put forward certain transitional provisions as legally preventing Ergon from previously proposing to the AER that

the Undersea Cable be regulated. In particular, Rule 11.16.1 has been put forward as a reason why Ergon could not previously propose that the characterisation of the Undersea Cable change from unregulated to regulated. However, as explained in Section 10 below:

- Rule 11.16.1 does not prevent the recharacterisation of the Undersea Cable to become unregulated (but merely provides that the AER had to accept a proposal which did not change the characterisation from the 2005 Determination – ie. it was free to Ergon to propose another classification if it thought this was appropriate); and
- Therefore presumably the real reason why Ergon did not previously propose a recharacterisation of the Undersea Cable so that it would become regulated is that it was not in Ergon’s interests at that time for this change to occur (and would not become in Ergon’s interests for that change to occur until December 2014 when the initial term providing a full return of capital on the cable and comparatively generous return on capital was extinguished).

#### **(f) Connection Agreements Not to Change due to Rules**

Chapter 5 of the NER provides for various obligations on Registered Participants (which includes Ergon). However, the clear intent of the NER is that such obligations are not intended to alter the terms of connection agreements (such as the Amended Customer Connection Agreement) as explained in Section 11 below.

For the sake of completeness, we note that the Amended Customer Connection Agreement (and various information in connection with it) is subject to a confidentiality obligation under that agreement although we understand that Ergon has already provided a copy of the agreement and various correspondence and information to the AER and we have no objection to this.

### **6. ALWAYS BEEN A NON-DISTRIBUTION SERVICE**

#### **(a) Non-Distribution**

Ergon previously submitted to the AER that the Undersea Cable was a non-distribution service. Specifically, the 1/7/2009 Ergon RP states that the Undersea Cable is a “non-distribution service” and is therefore not “regulated by the AER or covered by the Regulatory Proposal” (see p112 of the 1/7/99 Ergon RP (which contains this statement) can be found in Schedule 7).

In fact, the Undersea Cable has always been a non-distribution service and has been treated by mutual agreement as such by both Ergon and Mulpha. The fact that it was a non-distribution service necessarily meant the following:

- because a distribution service is a service provided “by means of or in connection with a distribution system”, the Undersea Cable by not being a distribution service is not part of a distribution system (Chapter 10 of NER, p1115);
- because a distribution system is “a distribution network, together with the connection assets associated with the distribution network, which is connected to another transmission or distribution system”, the Undersea Cable by not being part of a distribution system is not part of a distribution network (Chapter 10 of NER, p1115);
- because the distribution network connection point is a connection point on a distribution network (Chapter 10 of NER, p1114), the relevant distribution network point is where the Undersea Cable joins the Ergon Distribution Network; and
- as a practical matter, the point where the Undersea Cable joins the Ergon Distribution Network is at Stony Beach.

This is consistent with the position agreed to by Mulpha and Ergon under the Amended Customer Connection Agreement. Schedule 2 of the Amended Customer Connection Agreement refers to the “Distribution Network Connection Point” as being at Stony Beach (originally it was at the Shutehaven Substation but was moved to Stony Beach as a result of the Ergon upgrade works carried out for Hamilton Island in 2007).

The Amended Customer Connection Agreement also provides that Ergon is to provide Customer Connection Services to Mulpha using Ergon’s distribution network at the “Connection Point” as defined in that Agreement (clause 2.1). The definition of “Connection Point” is then defined as meaning the connection point with Ergon’s distribution network as described in Schedule 2. This provides that the Distribution Network Connection Point is at Stony Beach as explained above.

Because the Undersea Cable was providing non-distribution services, Ergon had the benefit of receiving over \$18,000,000 in unregulated charges for the Initial Term of 15 years. However, those unregulated charges would then cease when Mulpha had paid off all of the capital repayments (and associated interest) and would therefore not apply during the Further Term.

In summary:

- the Undersea Cable has always been regarded as providing non-distribution services;
- Ergon has benefited greatly from this arrangement by receiving over \$18,000,000 in unregulated charges on the basis that the Undersea Cable was providing non-distribution services; and
- because Ergon has received the benefit referred to above and there is no longer any benefit to it in regarding the Undersea Cable as providing non-distribution services, Ergon is now suggesting that the Undersea Cable should not be regarded as providing non-distribution services.

It is difficult not to regard Ergon’s change of view in relation to the Undersea Cable as providing non-distribution services, as being motivated purely by a desire on the part of Ergon to:

- enjoy a characterisation of the Undersea Cable which would provide substantial financial benefits to it which it would not otherwise receive during the Further Term of the Amended Customer Connection Agreement; and
- use the regulatory system to unilaterally change the current characterisation of the Undersea Cable without consultation with Mulpha, otherwise outside of its contractual rights and without any change by Mulpha in the usage of the Undersea Cable, if Ergon regards such a change as being in its financial interest.

## **(b) No Reason to Change**

Ergon has given no reason for its proposed change to the characterisation of the Undersea Cable. It has repeatedly quoted various definitions of the NER, in particular claiming that the Undersea Cable should be characterised as part of the Ergon distribution network as it is part of a distribution system.

However, none of the definitions quoted by Ergon have changed since the 1/7/2009 Ergon RP in which Ergon stated the Undersea Cable provided non-distribution services.

It appears that it was in Ergon’s commercial interest at that time to continue to receive a substantial unregulated charge for the Undersea Cable (in addition to regulated charges) by way of repayment of capital and interest by Mulpha. Such an unregulated charge would not have been payable had the Undersea Cable at the time been characterised as providing standard control services as now contended for by Ergon.

Again, it is hard to escape the conclusion that:

- Ergon was readily satisfied for the Undersea Cable to be a non-distribution service and therefore unregulated for as long as it meant that it would receive the substantial unregulated charge payable by Mulpha under the Amended Customer Connection Agreement; but
- Ergon's position changed at the point where it does not now want to experience a substantial decrease in charges for the Further Term when the unregulated charge will no longer be payable (as Mulpha will have paid off the capital cost of the Undersea Cable together with the associated interest payments).

As can be seen from the analysis in Section 6(a), the Undersea Cable is not part of Ergon's distribution network and never was.

In addition, none of the relevant definitions quoted by Ergon have changed since the 1/7/2009 Ergon RP. So if Ergon:

- agreed in the Amended Customer Connection Agreement that the connection point with the Ergon Distribution Network is at Stony Beach (something proposed by Ergon rather than Mulpha);
- regarded the Undersea Cable as providing non-distribution services in 2009 (consistent with the Amended Customer Connection Agreement);
- therefore in 2009 regarded the Undersea Cable as not being part of the Ergon distribution network;
- none of the relevant definitions have changed since that time; and
- the Amended Customer Connection Agreement has not changed since that time,

it is unsustainable that Ergon can in good faith now propose that the Undersea Cable should be characterised as part of the Ergon distribution network.

Again, given the above it is difficult to see Ergon's proposal as based on anything other than a desire to enjoy a windfall gain from its receipt of the unregulated charges paid during the Initial Term whilst now attempting to change the characterisation of the Undersea Cable to maximise its returns for the Further Term.

## **7. AER SHOULD NOT REGULATE**

### **(a) Preference not to Regulate**

Even if Ergon and Mulpha had previously regarded the Undersea Cable as providing distribution services, they could still have agreed for Ergon to propose in its 1/7/2009 Ergon RP that the AER not regulate the Undersea Cable. In fact, such an approach would have been consistent with the desire of the AER not to regulate if possible.

As stated recently by the AER, "if possible, we classify services with less prescriptive forms of regulation or do not regulate at all" (see p25 of the AER F&A). Amongst other things, the AER considers the ability of a Distribution Network Service Provider to abuse its monopoly position and the existence of any factors which might provide some countervailing power.

In relation to Mulpha and Ergon, Mulpha has substantial countervailing power due to the existence of the Amended Customer Connection Agreement but only if the Undersea Cable remains unregulated. If the Undersea Cable remains unregulated then:

- Ergon's often repeated argument that it would be "unlawful" for it to comply with the terms of the Amended Customer Connection Agreement (even though it has done so for over 15 years already) would not apply; and

- Mulpha would be able to enjoy the benefits that the Amended Customer Connection Agreement provides in the Further Term now that over \$18,000,000 in capital and interest payments have been made as unregulated charges during the Initial Term.

For this reason alone, even if the Undersea Cable did provide distribution services the AER should decide against classifying the Undersea Cable so as not to otherwise impact the Amended Customer Connection Agreement entered into by Mulpha and Ergon and under which Mulpha has already made substantial payments of unregulated charges as described above on the basis that the Undersea Cable would remain unregulated for the Further Term.

In any event, we note that the AER must consider various matters set out in clause 6.2.1(c) of the NER and we discuss this below.

## **(b) AER to consider Factors**

Under Rule 6.2.1 of the NER, if the AER decides against classifying a distribution service then the service is not regulated. Whilst we submit that:

- the Undersea Cable has always provided non-distribution services;
- Ergon proposed to the AER in the 1/7/2009 Ergon RP that the Undersea Cable provided non-distribution services;
- nothing has changed since that time that necessitates a change in the characterisation of the Undersea Cable; and
- Ergon has received full and fair payments on this basis of the Undersea Cable providing non-distribution services,

and therefore even if the Undersea Cable did provide distribution services the AER should decide against classifying it.

Under Rule 6.2.1(c)(2) of the NER, the AER must have regard to whether the Undersea Cable was previously regulated. It is common ground as between Ergon and Mulpha that the Undersea Cable was not previously regulated and the AER must therefore under Rule 6.2.1(c)(2) of the NER have regard to this in deciding whether or not to classify the Undersea Cable.

Under Rule 6.2.1(c)(4) of the NER, the AER must have regard to any other relevant factor in deciding whether or not to classify the Undersea Cable. We submit that other relevant factors include:

- the fact that the parties had agreed in the Amended Customer Connection Agreement that Mulpha would pay substantial unregulated charges by way of repayment of capital and interest during the Initial Term but then enjoy greatly reduced charges during the Further Term due to not having to pay any further capital and interest charges in relation to the Undersea Cable;
- to accept the 31/10/2014 Ergon RP in relation to the Undersea Cable would mean that Ergon would be able to thwart the intention of that Agreement; and
- Ergon would receive a substantial and unfair windfall gain if it is allowed to simply change the characterisation of the Undersea Cable halfway through the 30 year total term of the Amended Customer Connection Agreement.

We also note Rule 6.2.1(d) of the NER which provides that in classifying distribution services that have previously been subject to regulation under the present or earlier legislation, the AER must act on the basis that if there has been no previous classification then the classification should be consistent with the previous applicable regulatory approach. In this case, the decision should be not to classify as the previous approach was not to classify.

Whilst we accept that strictly speaking Rule 6.2.1(d) applies to distribution services that have previously been subject to regulation, we submit that the same approach should apply to those that haven't been regulated. In other words, where

something has not been regulated then it should remain unregulated unless there is some compelling reason why it should be regulated. This is particularly the case where it is the DNSP which is arguing for regulation rather than the customer.

**(c) Fails to meet the test for a Standard Control Service**

On page 14 of the AER F&A, standard control services are described as:

*“Services that are central to electricity supply and therefore relied on by most (if not all) customers such as building and maintaining the shared distribution network.”*

The Undersea Cable:

- has been built specifically for Hayman Island;
- has been paid for by Hayman Island; and
- is used only by Hayman Island.

It is clearly not part of the “shared distribution network” as referred to in the AER’s description of “standard control service”. It is difficult to see on what possible basis Ergon could regard the Undersea Cable as being a standard control service given:

- the Undersea Cable has never been regarded as a standard control service, a position previously acceptable to Ergon whilst it was receiving unregulated charges for the Undersea Cable;
- the Undersea Cable is not part of a shared distribution network but instead has been built for and paid for by Hayman Island and is used only by Hayman Island and no other customer.

Put simply, Ergon cannot be correct in its proposal that the Undersea Cable is a standard control service.

**8. OBJECT OF NEL**

**(a) Long Term Interests of Consumers**

Rule 7 of the NEL relevantly provides that:

*“The objective of this Law 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 price, quality, safety, reliability and security of supply of electricity.” (National Electricity Objective).*

In our view, this objective of the NEL would be undermined if Ergon’s position in relation to the Undersea Cable is accepted.

Under the Amended Customer Connection Agreement, Mulpha has secured long term provision of Undersea Cable services by agreeing to make substantial payment of capital and interest during the Initial Term so that it can enjoy much reduced prices in the Further Term (having by then paid off the Undersea Cable). Clearly, it would be in the interests of Mulpha as a consumer for the AER to make a determination which was consistent with Mulpha enjoying the benefit of the Amended Customer Connection Agreement as was intended rather than the detriment of suffering an unintended price increase of over \$21,000,000 in charges for the Further Term representing a windfall gain to the monopoly service provider.

Clearly the long term interests of Mulpha as the consumer will dramatically undermined if the AER makes a determination that the Undersea Cable is regulated.

## **(b) AER and NEL Objective**

Under Section 16(1)(a) of the NEL, the AER must perform or exercise the relevant functions or powers in a manner that will or is likely to contribute to the achievement of the National Electricity Objective. Relevantly to the 31/10/2014 Ergon RP, this means that the AER should not accept the 31/10/2014 Ergon RP (at least to the extent that it relates to the Undersea Cable) if to do so would not serve the National Electricity Objective.

Clearly, it would not serve the National Electricity Objective if:

- Ergon was allowed to unilaterally decide when the Undersea Cable is to be unregulated or regulated;
- Ergon was allowed to make that decision to avoid its obligations under the Amended Customer Connection Agreement for the Further Term after receiving over \$18,000,000 of unregulated charges in full and fair payment for those assets under that Agreement during the Initial Term;
- Ergon was allowed to make that decision in the absence of any consultation with Mulpha;
- Ergon was allowed to make that decision even though this contravenes its own policies; and
- Ergon was allowed to misrepresent both the relevant law and the position of the AER on the matter in an effort to improve its commercial position and is then rewarded with the AER accepting the 31/10/2014 Ergon RP to the extent it relates to the Undersea Cable.

## **9. MONOPOLY POSITION OF ERGON**

Ergon enjoys a monopoly position in relation to enabling electricity to be provided to Mulpha. Normally, the regulation of particular assets is motivated by a recognition that the customer requires regulatory protection from what might otherwise be an abuse of the monopoly position enjoyed by Ergon. Put simply, regulation is typically thought to benefit the customer.

In fact, where a customer does not require the protection of regulation (whether due to the presence of competition or some other reason), the AER can more easily accept that a particular asset provides:

- non-distribution services and therefore cannot be regulated; or
- should not be regulated even though it provides distribution services.

In the case of the undersea cable, regulation is currently harmful to the customer. This is because the customer already enjoys protection under the Amended Customer Connection Agreement. It is this document which provides for Mulpha to receive the benefit of paying greatly reduced charges during the Further Term because it has paid for the entire capital cost of the Undersea Cable during the Initial Term as well as over \$10,000,000 in interest payments (as a return on asset component).

However, if the AER decides that the Undersea Cable:

- doesn't provide non-distribution services (despite Ergon enjoying the substantial benefit of this characterisation of the Undersea Cable for the Initial Term); and
- should be regulated,

then we understand Ergon will attempt to apply a provision of the Amended Customer Connection Agreement which it believes has the effect that Ergon and Mulpha must comply with a decision of the AER in relation to the characterisation of the Undersea Cable even if this is inconsistent with the intention of parties pursuant to the Amended Customer Connection Agreement.



As noted by the AER in the 27/5/2014 AER Letter, the QCA advised that the original offer re the Undersea Cable:

*“was made on the basis that the assets would be excluded and not considered as part of the MEB’s revenue cap. The exclusion was subsequently accepted by the Queensland government. The undersea supply cable to Hayman Island had since been treated as [an] unregulated asset by QCA up to June 2010 when QCA’s economic regulation function ceased.”*

As noted above, Ergon made no objection to the Undersea Cable being unregulated for the 2010-2015 regulatory period. In fact, it proposed that this be the case and the AER accepted that proposal.

We believe that Ergon has decided that:

- it no longer receives any benefit from the Undersea Cable being unregulated;
- it will receive by way of unintended windfall more than \$21,000,000 in increased charges under the Amended Customer Connection Agreement if it is successful in having the Undersea Cable regulated than if the Undersea Cable remains unregulated; and
- therefore, it will do everything in its power to ensure that the Undersea Cable becomes regulated (despite Ergon having no objection whatsoever to the Undersea Cable being unregulated during the previous 15 year period when this position was to Ergon’s financial advantage).

Put simply, regulating the Undersea Cable will not help the customer in this instance. Instead, it will simply put Ergon in a position where it has effectively been allowed to choose to:

- enjoy the benefit of the Undersea Cable being unregulated during the period when this suited Ergon; and
- as soon as that benefit ceased, change the characterisation of the Undersea Cable so as to provide an advantage of over \$21,000,000 to Ergon and deny Mulpha the opportunity to enjoy reduced charges under the Amended Customer Connection Agreement for the Further Term (having paid off the entire capital cost of the Undersea Cable during the Initial Term together with over \$10,000,000 in interest).

## 10. TRANSITIONAL PROVISIONS

During some of our discussions with Ergon, it has at times seemed to us that Ergon might put forward certain transitional provisions as legally preventing Ergon from previously proposing to the AER that the Undersea Cable be regulated. However, this does not seem to be consistent with either those transitional provisions or what has actually occurred as a factual matter.

As noted above, the 1/7/2009 Ergon RP states that the Undersea Cable is a “non-distribution service” and is therefore not “regulated by the AER or covered by this Regulatory Proposal” (see p112 of the 1/7/2009 Ergon RP (which contains this statement) in Schedule 6). However, the relevant transitional provisions did not require Ergon to propose that this be the case.

We have been referred to Rule 11.16.3 in this regard. Whilst this rule makes it clear that the AER must accept the approach proposed by Ergon for the 2010-2015 regulatory period if it is consistent with the approach in the 2005 Determination, it in no way prohibits Ergon from proposing a different approach.

The real reason why Ergon didn’t propose a different approach for the 2010-2015 regulatory period was simply because:

- Mulpha still had another 5 years left under the Amended Customer Connection Agreement of paying unregulated charges;
- those charges were commercially beneficial to Ergon as they not only covered the entire capital cost of the Undersea Cable but substantial interest payments (as a return on that capital cost) as well; and

- the rate of return to Ergon on the capital cost of the Undersea Cable if it remained unregulated for the 2010-2015 regulatory period was over 13% pa which was substantially higher than what it would have received if the Undersea Cable became regulated.

In any event, we have not been referred to any transitional rule which would have prevented Ergon from proposing in the 1/7/2009 Ergon RP that the Undersea Cable be regulated. Even if such a transitional rule did exist, we maintain that this would have simply provided a convenient excuse for Ergon and that its true motivation for the approach taken is as outlined above.

## 11. CONNECTION AGREEMENTS NOT TO CHANGE

As mentioned above, the clear intent of the NER is that they are not intended to alter the terms of connection agreements.

For example, Rule 5.2.2(c) provides that nothing in Chapter 5 of the NER is intended to have, nor is it to be read or construed as having the effect of:

- altering the terms of a connection agreement;
- altering the contractual rights or obligations of any of the parties under the connection agreement as between those parties; or
- relieving the parties under any such connection agreement of their obligations under such an agreement.

The only exception to the above position is limited to situations where the application of any provisions of the connection agreement (that are inconsistent with the NER) affect the “quality or security of network service to other Network Users” which is clearly not the case here.

## 12. OTHER NON-DISTRIBUTION SERVICES

In the 1/7/2009 Ergon RP, a number of assets were specified as being non-distribution services. This included not only the Undersea Cable, but a general category being “Non-Distribution Services at Customer’s request”.

Also Ergon’s supporting documentation to the current 31/10/2014 Ergon RP (see p26 of supporting document 02.02.01) undersea cables are not a distribution service unless connected to a regulated network. Whilst this might be true of certain undersea cables in the far north of Queensland, it seems unlikely in relation to other submarine cables in the vicinity of the Undersea Cable.

For example, at the Stony Beach connection point between the Undersea Cable and Ergon’s regulated distribution network is a connection point for the undersea cable that services Long Island and Hamilton Island. However, although we understand that the undersea cable to Long Island and Hamilton Island is connected to the Ergon distribution network at the Connection Point, this does not appear to have caused the undersea cable that services Long Island and Hamilton Island to be regarded as providing standard control services.

Similarly, the undersea cable from Daydream Island to a separate connection point with the Ergon distribution network on the mainland does not appear to lead Ergon to propose that the Daydream Island cable is providing standard control services.

We understand that both Hamilton Island and Daydream Island paid the entire cost of their respective undersea cables direct to the relevant contractors. The only difference for Mulpha is that it has paid to Ergon that same cost (together with over \$10,000,000 in interest on that capital cost).

As a matter of principle, we submit that where an undersea cable (or any other piece of significant electricity infrastructure for that matter) has been paid for by a customer because it services that customer only, then it cannot be said that such a cable is a standard control service.

### 13. SUPPLEMENTARY SUBMISSION

As mentioned above, Mulpha has asked Ergon for various information in relation to the calculation of the charges under the Customer Connection Agreement and the Amended Customer Connection Agreement together with the legal and regulatory review that Ergon claims led it to the conclusion that it had no alternative but to:

- calculate charges based on a recharacterisation of the Undersea Cable as being regulated; and
- determine that the relevant type of regulation was standard control services.

However, Ergon has not provided any of the information requested. Despite this, Mulpha is still hopeful to obtain the relevant information. When it does, Mulpha will be able to determine with more certainty various matters dealt with in this Submission and whether it is therefore necessary to make a Supplementary Submission to the AER to confirm those matters in a more exact form. We trust that the AER understands why Mulpha needs to adopt such an approach at this stage and would therefore accept such a supplementary submission when more information becomes available to Mulpha.

### 14. CONCLUSION

As you can see from the above:

- Ergon's general interaction with Mulpha has been unacceptable;
- Ergon's conduct centres on its desire to subvert pre-existing contractual rights between it and Mulpha as its customer, through claiming (incorrectly) an overriding statutory obligation in order to elicit a windfall gain;
- In doing so, Ergon has misrepresented the law in relation to the Undersea Cable and the AER's position re the Undersea Cable; and
- Ergon's misrepresentations (if accepted by Mulpha) would have resulted in Ergon receiving (at Mulpha's expense) additional charges of more than \$21,000,000 during the Further Term without any increase in the services provided to or the usage by Mulpha.

In addition, Ergon has completely failed to show why the current classification of the Undersea Cable as being "non-distribution services" should change given that:

- it has been in place for over 15 years;
- Ergon proposed that this position apply to the 2010-2015 regulatory period (a position which was accepted by the AER), when it was free to propose otherwise;
- Ergon has had the benefit of substantial unregulated payments of over \$18,000,000 during that time on the basis that the Undersea Cable was unregulated;
- this would effectively deny to Mulpha the benefit of paying reduced charges during the Further Term given that Mulpha has paid off the Undersea Cable in the Initial Term (together with over \$10,000,000 in interest);
- the definition of "distribution services" has not changed since the 1/7/2009 Ergon RP where Ergon stated that the Undersea Cable was a "non-distribution service";
- the connection point to Ergon's distribution network is described in the Amended Customer Connection Agreement as being at Stony Beach (and therefore, Ergon's distribution network ends at that Connection Point); and
- because the Undersea Cable is downstream of the Connection Point, it cannot be part of the Ergon distribution network in any event.

Ergon has also failed to show:

- how charging Mulpha more than \$21,000,000 during the Further Term by regulating the Undersea Cable (and for no increased usage or increase in services

provided) can possibly be in accordance with the National Electricity Objective; and

- that any transitional provisions applied to the Undersea Cable for the 2010-2015 regulatory period which meant that Ergon could not at that time propose that the Undersea Cable become regulated.

We therefore submit that the status of the Undersea Cable should remain unchanged as “non-distribution services” as has always been the case. It should therefore remain unregulated.

If despite:

- the long term history of the Undersea Cable as being a non-distribution service and therefore unregulated;
- the fact that this position was clearly acceptable to Ergon for the Initial Term because such a characterisation meant that Ergon would receive over \$18,000,000 in capital and interest payments during that period;
- the fact that Mulpha’s obligation to make such unregulated payments has recently ceased and therefore it is no longer in Ergon’s financial interest that the Undersea Cable remain unregulated; and
- the fact that the relevant definitions in the NER have not changed in relation to the Undersea Cable (and therefore can be no argument that some change in those definitions has motivated Ergon’s proposal to change the characterisation of the Undersea Cable),

the AER decides that the Undersea Cable is a distribution service rather than a non-distribution service, then we submit that the AER should determine that the Undersea Cable remain unregulated because:

- the National Electricity Objective is served by the Undersea Cable remaining unregulated for the Further Term;
- the National Electricity Objective would not be served by the Undersea Cable being regulated for the Further Term (in fact, the National Electricity Objective would be defeated if regulation for the Further Term was allowed);
- under Rule 6.2.1(c)(2) of the NER, the AER must have regard to whether the Undersea Cable was previously regulated (and clearly it was not previously regulated);
- under Rule 6.2.1(c)(4) of the NER, the AER must have regard to any other relevant factor in deciding whether or not to classify the Undersea Cable (and as this Submission shows, there are many relevant factors as to why the Undersea Cable should not be regulated for the Further Term);
- as a matter of principle, regulation is typically used to place customers in a better position in relation to service providers than would otherwise be the case given the disparity in bargaining power – however, in this case regulation for any part of the Further Term puts Mulpha in a materially worse position and removes the bargaining power that it would otherwise enjoy by virtue of the Amended Customer Connection Agreement.

Finally, Ergon’s characterisation of the Undersea Cable as being a standard control service simply cannot be correct. As noted in Section 7(c) above, the Undersea Cable:

- has been built specifically for Hayman Island;
- has been paid for by Hayman Island; and
- is used only by Hayman Island.

It is clearly not part of the “shared distribution network” as referred to in the AER’s description of “standard control service” in the AER F&A.

## 15. SUMMARY OF SUBMISSION

The Undersea Cable is currently a non-distribution service and is therefore unregulated. Ergon proposes to change the characterisation to standard control service even though the Undersea Cable is clearly not part of the “shared distribution network”.

Ergon’s reasons for doing this are financial in nature rather than by way of legal necessity as Ergon has claimed. It has been in Ergon’s financial interest for the Undersea Cable to be unregulated for the Initial Term so that Ergon could receive over \$18,000,000 in unregulated charges for the Undersea Cable during that period (such payments representing capital and interest payments in relation to the cost of the Undersea Cable).

Under the Amended Customer Connection Agreement, Ergon will no longer receive unregulated payments now that Mulpha has paid off the Undersea Cable and its \$7,638,277 bank guarantee for the capital cost of the Undersea Cable has been returned to Mulpha. It is now in Ergon’s financial interest to seek to game play the regulatory framework to re-characterise the Undersea Cable as being a standard control service and to ignore the historical treatment of the Undersea Cable, and subvert its contractual obligations to its customer.

For the reasons noted in this Submission, the Undersea Cable should remain unregulated. This is because it is either:

- a non-distribution service and therefore cannot be regulated; or
- a distribution service which for the Further Term should not be regulated for the reasons mentioned in this Submission.

On any analysis, Ergon’s proposal that the Undersea Cable is a standard control service should be rejected. It has been built specifically for Hayman Island, paid for by Hayman Island and is used only by Hayman Island.

## GLOSSARY

- **16/12/2005 Ergon Letter** means Ergon letter to Hayman Island dated 16 December 2005.
- **1/7/2009 Ergon RP** means a regulatory proposal dated 1 July 2009 from Ergon to the AER.
- **26/11/2013 Ergon Letter** means Ergon letter to Mulpha dated 26 November 2013.
- **23/12/2013 Mulpha Letter** means Mulpha letter to Ergon dated 23 December 2013.
- **8/1/2014 Ergon Letter** means Ergon letter to Mulpha dated 8 January 2014.
- **19/2/2014 Mulpha Letter** means Mulpha letter to the AER dated 19 February 2014.
- **27/2/2014 Mulpha Letter** means Mulpha letter to Ergon dated 27 February 2014.
- **28/2/2014 Ergon Letter** means Ergon letter to Mulpha dated 28 February 2014.
- **26/5/2014 Ergon Letter** means Ergon letter to Mulpha dated 26 May 2014.
- **27/5/2014 AER Letter** means letter to Ergon from the AER dated 27 May 2014.
- **3/6/2014 Ergon Letter** means Ergon letter to Mulpha dated 3 June 2014.
- **13/6/2014 Ergon PP** means 2014-2015 Pricing Proposal dated 13 June 2014 which Ergon provided to the AER.
- **1/9/2014 Mulpha Letter** means Mulpha letter to Ergon dated 1 September 2014.
- **31/10/2014 Ergon RP** means a regulatory proposal dated 31 October 2014 from Ergon to the AER.
- **5/11/2014 Ergon Letter** means Ergon letter to Mulpha dated 5 November 2014.
- **AER** means Australian Energy Regulator.
- **AER F&A** means the AER's Framework and Approach Paper for the 2015-2020 regulatory period.
- **Amended Customer Connection Agreement** means a conformed copy of the Customer Connection Agreement as amended by the Amended Agreement.
- **Amendment Agreement** means the amendment agreement to the Customer Connection Agreement entered into between Mulpha and Ergon effective as of 1 July 2007.
- **Customer Connection Agreement** means the customer connection agreement originally between Permanent Trustee Australia Limited (as trustee of the BT Hotel Trust) (being the previous owner of Hayman Island) and the Mackay Electricity Corporation Limited (as a predecessor to Ergon) trading as Mackay Electricity Board (a copy of which is in Schedule 2).
- **Further Term** means an option exercisable by the customer for further term of 15 years.
- **Hayman Island** means the resort known as Hayman Island and owned by Mulpha.
- **Initial Term** means an initial term of 15 years.
- **MEB** means Mackay Electricity Board.
- **Mulpha** means Mulpha Hotel Pty Ltd (ACN 070 662 627)

- **National Electricity Objective** means Rule 7 of the NEL.
- **NEL** means the National Electricity Law.
- **NER** means the National Electricity Rules.
- **PTAL** means The Trust Company (PTAL) Limited (ACN 008 412 913) .
- **RAB** means Ergon’s regulatory asset base.
- **Supporting Documentation** means documentation available from Ergon website in relation to the 31/10/2014 Ergon RP.
- **Undersea Cable** means the connection link from the electricity network between Shute Substation on the Queensland mainland to Hayman Island.