

## **Application for waiver from AER Ring-fencing Guideline – Electricity Distribution**

### ***Legal separation of ActewAGL Distribution's gas businesses***

#### **1. Introduction**

The AER released the final Ring-Fencing Guideline (**Guideline**) on 30 November 2016.

The Guideline describes the legal, accounting and functional separation obligations that Distribution Network Service Providers (**DNSPs**) must comply with to promote competition in the provision of electricity services.

For existing services, the Guideline requires DNSPs to comply with the Guidelines' obligations as soon as reasonably practicable, but by no later than 1 January 2018. The AER considered this approach recognised the range of circumstances faced by different DNSPs and reflected the need for certainty and confidence amongst participants, or potential participants, in developing markets.

The Guideline allows the AER to grant a waiver to a DNSP exempting it from having to satisfy certain obligations in the Guideline. This provides the AER with flexibility to respond to circumstances as they arise.

To assist DNSPs in achieving compliance with the Guideline by 1 January 2018, the AER has requested that each DNSP provides a compliance plan and any waiver applications by 31 July 2017.

This document is an application:

- for a waiver from the obligation for ActewAGL Distribution (**AAD**) to legally separate its electricity distribution business and gas business; and
- to allow AAD to continue to provide the gas services described in paragraph 3 below and electricity distribution services within the same legal entity.

The purpose of the legal separation obligation in the Guideline is to prevent a DNSP from providing other services (such as AAD's gas services) that could be cross-subsidised by its electricity distribution services. However, there is effectively no potential for cross-subsidy to occur between AAD's electricity distribution services and gas services.

For this reason, and a number of other reasons set out in this application, AAD requests that the AER approve this application in accordance with clause 5 of the Guideline.

#### **2. Obligation in respect of which the DNSP is applying for a waiver**

AAD is applying for a waiver of its obligation under clause 3.1(b) of the Guideline (i.e. a DNSP must not provide other services) in relation to its gas business.

#### **3. Details of the service, or services, in relation to which the DNSP is applying for the waiver**

AAD currently owns a gas business comprising:

- natural gas distribution pipelines located in the ACT and the Queanbeyan-Palerang council area east of Canberra (**ACT Gas Network**);
- natural gas distribution pipelines located in the Nowra network in the Shoalhaven local government area on the NSW south coast (**Nowra Gas Network**); and
- a compressed natural gas (**CNG**) refuelling facility in the Canberra suburb of Fyshwick (**CNG refuelling facility**).

(in this application called the '**gas business**').

Operation and maintenance of the ACT Gas Network and Nowra Gas Network are wholly outsourced to Jemena Asset Management Pty Ltd (**JAM**). JAM subcontracts some of the required field services to its contracting arm, ZNX. Maintenance services of the CNG Refuelling facility is provided by Bauer Kompressoren Australia (**Bauer**). AAD employs a single individual to manage those contracts but does not otherwise play an active role in operating the gas business assets or providing services using those assets.

The gas business provides the following gas distribution services:

- one reference service (which is a pipeline service that is likely to be sought by a significant part of the market) – haulage reference service; and
- two non-reference services (which are pipeline services that are not likely to be sought by a significant part of the market) – interconnection of embedded network service and negotiated service.
- other gas services include connections services under part 12A of the National Gas Rules.

The haulage reference service includes:

- receiving gas injected into the pipeline from a different gas pipeline or other gas facility (the point of injection is referred to as the receipt point);
- transportation of gas on the pipeline from a receipt point to a delivery point;
- allowing the withdrawal of gas from the pipeline at a delivery point;
- meter reading and associated data services, and the provision and maintenance of a standard metering installation; and
- other specific network user requested activities (ancillary reference services) which include special meter reads, disconnections, reconnections, decommissioning and meter removals, and requests for service.

The Fyshwick CNG refuelling facility commenced operation in 2009. The facility compresses natural gas from the ACT Gas Network and stores it in tanks. It is then sold as CNG to customers by a gas retailer.

The main CNG Refuelling facility's customers are courier companies, local businesses such as concrete vendors which operate delivery trucks, other businesses that run fleets of light to medium gas-fuelled trucks and several private domestic users, including ActewAGL's gas-fuelled fleet. Many vehicles that use the CNG refuelling facility are not dual fuel (i.e., there is no alternative fuel option) and therefore are totally reliant on AAD's CNG refuelling facility. The CNG refuelling facility is the only facility in the Canberra region open to the public, with the nearest similar facility several hours' drive away outside Sydney.

#### **4. Reasons why the DNSP is applying for the waiver**

To comply with clause 3.1(b) of the Guideline in relation to its gas business, AAD would need to either:

- establish a new legal entity and transfer the gas business to that entity; or
- obtain a waiver for that obligation in accordance with the Guideline.

AAD wishes to apply for the grant of a waiver from compliance with clause 3.1(b) in relation to the gas business to enable the gas business to remain owned by AAD.

#### **5. Reasons why the waiver should be granted**

AAD considers that the waiver should be granted for a number of reasons, including:

- the 'harm' which the obligation is designed to prevent does not arise in this case because
  - the gas distribution services are already subject to economic regulation by the AER; and
  - the actual provision of the gas distribution services has been wholly outsourced by AAD to third parties (JAM and Bauer), providing effective contractual and financial separation from AAD; and
- AAD's Cost Allocation Methodology (CAM) already deals with, and will continue to deal with, the allocation of costs to its regulated services (including its gas business).

Each of these reasons is discussed in further detail below.

##### **(a) Harm to be addressed by the obligation**

The 'harm' that legal separation is intended to prevent is cross subsidisation (i.e. preventing a DNSP from providing other services (in this case, the gas services) that could be subsidised by its electricity distribution services.<sup>1</sup>

However, there is no risk of AAD using its electricity distribution services to subsidise its gas business services for several reasons:

- AAD's gas network business is a monopoly business whose gas distribution services are already subject to economic regulation by the AER;
- The actual provision of the gas services has been wholly outsourced by AAD to third party (JAM and Bauer) under the terms of an arm's-length contract and therefore the provision of the gas services is contractually and financially separated from AAD;
- AAD's electricity distribution services customers do not subsidise the CNG refuelling facility. It is wholly separate from AAD's electricity distribution assets and the income, expenditure, assets and liabilities relating to the CNG refuelling facility are accounted for separately from the income, expenditure, assets and liabilities relating to the electricity distribution business because it is located (from a financial perspective) within the gas business portfolio.

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<sup>1</sup> AER, *Ring-Fencing Guideline: Electricity Distribution*, November 2016, cl 1.1.1.

## ***Economic regulation by the AER***

The gas business is subject to two different economic regulatory arrangements:

- Part 9 of the National Gas Rules applies to covered pipelines such as AAD's pipelines in the ACT and Queanbeyan-Palerang region.
- The regulatory arrangements contained in the *National Gas (South Australia) (Pipelines Access-Arbitration) Amendment Act 2017* (SA) will apply to uncovered pipelines such as AAD's pipeline in the Shoalhaven region.

### *Regulation of pipelines in the ACT and Queanbeyan-Palerang region*

Part 9 of the National Gas Rules requires AAD to periodically submit an access arrangement and supporting information to the AER for its pipelines in the ACT and Queanbeyan-Palerang. The AER reviews that information to determine a forecast revenue requirement for that part of AAD's gas business.

The gas information that AAD provides to the AER includes extensive accounting data in the form of Regulatory Information Notices (RIN), along with other information formally requested from time to time by the AER. This promotes transparency and accountability, and provides the AER with the ability to identify and address any potential concerns the AER may have in relation to the electricity distribution business subsidising the gas business (noting that, in any case, there is effectively no practical risk of subsidisation due to the outsourcing arrangements described below).

This information, along with the AER's revenue determinations for gas, is largely available to the public on the AER's website.<sup>2</sup>

Further, the tariff charges applied by AAD for gas distribution services in the ACT region are approved by the AER on an annual basis. AAD offers the same published tariff charges to all retailers operating in the ACT and Queanbeyan-Palerang.

AAD's gas business is also subject to ring fencing requirements under the *National Gas (South Australia) Act 2008* (SA) that are similar to the ring fencing requirements under the Guideline. By way of example, Division 2 of that Act prohibits the carrying on of a gas related business, prohibits marketing staff from taking part in gas related businesses, and requires accounts to be prepared, maintained and kept separate. The AER's role in determining the ring fencing obligations applicable to AAD's gas business is also reflected in Part 6 of the National Gas Rules.

AAD submits to the AER annual compliance reports regarding duties of pipeline service providers, structural and operational separation requirements, access arrangements and determinations.<sup>3</sup> These reports are in response to AER's annual regulatory information order under section 48 of the National Gas Law. The AER review the reports and publish their findings annually.

### *Regulation of pipelines in the Shoalhaven region*

A new regulatory framework applicable to uncovered gas pipelines, such as the Nowra pipeline in the Shoalhaven region, is contained in the *National Gas (South Australia) (Pipelines Access-Arbitration) Amendment Act 2017* (SA) (**Amending Act**).

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<sup>2</sup> See, e.g., [www.aer.gov.au/networks-pipelines/determinations-access-arrangements/actewagl-act-queanbeyan-and-palerang-access-arrangement-2016-21](http://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/actewagl-act-queanbeyan-and-palerang-access-arrangement-2016-21).

<sup>3</sup> <https://www.aer.gov.au/networks-pipelines/compliance-reporting/annual-gas-compliance-reports-2015%E2%80%9316>

The Amending Act was assented to on 27 June 2017 and will come into force on a date to be fixed by proclamation.

The Amending Act will amend the *National Gas (South Australia) Act 2008* (SA) to address concerns in relation to:

- information asymmetry as between parties negotiating access to uncovered pipelines; and
- the superior negotiating position of the pipeline operator.

In particular, the Amending Act:

- establishes a framework for enhanced disclosure and transparency of uncovered pipeline information, including pricing and contract terms and conditions;
- establishes a framework for commercial arbitration that can be commenced by a party serving a notice on the AER (who will be the scheme arbitrator) where the parties are unable to agree the terms of access; and
- reinforces the position that a party seeking access to a pipeline service on an uncovered pipeline must negotiate commercially before resorting to commercial arbitration (i.e. both the pipeline operator and the access seeker have a duty to negotiate in good faith).

In addition, the Gas Market Reform Group has released draft changes to the National Gas Rules that support the Amending Act. The drafting of Part 23 of the National Gas Rules contains relatively detailed financial reporting for uncovered pipelines including cost allocation requirements and an audit. These requirements will commence in 2018, although the initial rules are intended to come into effect in September 2017. The draft Rules also make provision for the development and issue of a binding guideline for the preparation of financial reports and non-binding guides in relation to the arbitration process. The AER will be involved in the development of the financial reporting guidelines. Weighted average prices will be required to be published on websites by February 2018. Uncovered pipeline operators will be required to publish their financial reports.<sup>4</sup>

The AER already has visibility of the expenditure of AAD's electricity network business through the CAM (see further below) and the very detailed information that either is required to be produced or the AER can request, under the National Electricity Rules. This in itself should provide a significant degree of confidence that there is no cross subsidisation taking place. Now, with the extensive nature of the Amending Act and the draft changes to the NGR, there are additional means of verifying this, an increased level of regulatory oversight, and greater transparency of pricing, for uncovered gas pipelines. As a result, the AER will have all of the information it needs to identify and address any potential concerns in relation to cross subsidisation of this part of AAD's gas business (noting once again that, there is effectively no practical risk of cross-subsidisation due to the outsourcing arrangements described below).<sup>5</sup>

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<sup>4</sup> Gas Market Reform Group, *Gas Pipeline Information Disclosure and Arbitration Framework*, June 2016, p 16.

<sup>5</sup> Whilst distribution firms may apply for an exemption on the basis of low volume, the AER approves or rejects exemptions. The AER will also have the opportunity to review material financial statements through this process.

### ***Outsourcing of services to JAM and Bauer***

As mentioned above, the provision of gas distribution services using AAD's pipelines has been wholly outsourced since AAD was established in 2000, and there are no plans to change this arrangement. This arrangement is formalised in an arm's length contract between AAD and JAM AAD (known as the Distribution Asset Management Services (DAMS) Agreement)<sup>6</sup> and is fundamental to the operation of the partnership. As noted above, JAM in turn engages ZNX, Jemena's separated legal entity that meets Jemena's ring fencing obligations, to perform some field-related services on behalf of AAD. Whilst this, and the contract between AAD and Bauer to manage the CNG facility, do not legally separate ownership of the businesses, they do contractually, financially and practically separate the provision of gas services from the provision of electricity distribution services. As such, it adds an extra control over the risk of cross subsidy. We note that the legal separation provisions of section 3 of the Guideline are not concerned with separation of ownership (sometimes referred to as structural separation) but rather separation of services.

The conclusion from the above is that there is no identifiable harm to be avoided by requiring AAD's gas business to be legally separated from its electricity distribution business. Such a requirement would not advance the policy objectives underlying clause 3.1(b) of the Guideline.

Requiring the legal separation of the AAD gas business from the electricity distribution business will cause each business to incur additional costs (i.e. costs it would not need to incur but for the obligation to legally separate) and reduce the efficiency of both businesses without delivering any increase in benefits to electricity consumers or gas consumers. This is clearly not an efficient and prudent outcome.

#### **(b) Cost Allocation Methodology (CAM)**

The AER, in the Explanatory Statement to the Guideline, stated that it will only grant a waiver in respect of a DNSP providing other services, which are also regulated services, subject to the DNSP agreeing to establish a CAM that deals with all of its regulated services.<sup>7</sup>

AAD's CAM allocates corporate services between all of its business activities that receive corporate services, including separate allocations for its electricity distribution business and gas business. The CAM covers the allocation and attribution of all shared costs related to AAD's gas business regardless of the location of the relevant pipeline or assets.

The CAM also explains drivers of cost allocations. This is not strictly required under the regulatory arrangements. However, AAD has implemented these additional requirements for the following internal reasons:

- The outsourcing of the operation of the gas business under the Distribution Asset Management Services (DAMS) Agreement with Jemena requires clear and transparent cost allocations.

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<sup>6</sup> Under the DAMS Agreement, Jemena has agreed to provide project management services to ActewAGL for capital works associated with the expansion and renewal of AAD's gas distribution network. See information published on AER website: [https://www.aer.gov.au/system/files/ActewAGL%20Distribution%20AAI\\_Attachment%204%20Efficient%20delivery%20of%20services\\_Public%20%28redacted%29%20-%20July%202015.pdf](https://www.aer.gov.au/system/files/ActewAGL%20Distribution%20AAI_Attachment%204%20Efficient%20delivery%20of%20services_Public%20%28redacted%29%20-%20July%202015.pdf)

<sup>7</sup> AER, *Electricity distribution Ring Fencing Guideline: Explanatory Statement*, November 2016, p 58.

- Due to the different ownership of businesses to which AAD provides corporate services, the allocation of corporate services costs across different businesses needs to be clear and transparent.
- These multiparty arrangements require a high level of visibility and due diligence in implementation to ensure there are no cross subsidies that could impact different owners inappropriately.

As required by clause 6.15 of the NER and the AER's cost allocation guidelines, AAD's CAM has been approved by the AER. The AER can be assured that AAD is applying the approved CAM and cost allocation principles correctly through the audit and verification requirement set out in clause 3.2(a)(7) of the AER's cost allocation guidelines.

Accordingly, AAD's CAM already provides the AER with transparency concerning the shared corporate cost allocations between its electricity distribution business and gas business.

**6. Proposed commencement date and expiry date (if any) of the waiver and the reasons for those dates**

AAD proposes that the waiver commences as soon as practicable, but no later than 1 January 2018.

The waiver is intended to be ongoing in nature but AAD recognises that over time, as circumstances change and the market develops, the basis upon which this waiver is granted may no longer be valid.

In order to take a practical and balanced approach, AAD therefore proposes that the waiver apply for at least the current and the next regulatory control period (i.e. the 2014-2019 and the 2019-2024 regulatory control periods) at which point the AER can reassess the appropriateness of the waiver. This is consistent with the approach set out in the Explanatory Statement to the Guideline.<sup>8</sup>

**7. Details of the costs associated with the DNSP complying with the obligation if the waiver of the obligation were refused**

If this application was refused, AAD will incur a number of one-off transaction costs, higher ongoing operating costs and loss of operational efficiencies as a result of separating the gas business from the electricity distribution business.

**(a) Transaction costs**

One off transaction costs that will be incurred by AAD include:

- Stamp duty, taxation and capital gains tax for transfer of assets related to the Shoalhaven pipeline which is in NSW. There is an exemption from taxes for transfer of assets or liabilities for ring fencing in the ACT.<sup>9</sup>
- The ACT/Queanbeyan/Palerang gas pipelines are key assets of AAD which were vested in AAD by a ministerial declaration under section 11 of the *ActewAGL/AGL Partnership Facilitation Act 2000* (ACT). Their continued ownership by AAD is a principle embedded in the suite of agreements by which

<sup>8</sup> See AER, *Electricity distribution Ring Fencing Guideline: Explanatory Statement*, November 2016, p 61.

<sup>9</sup> *National Gas (ACT) Act 2008* (ACT), Pt 4.

AAD was established in 2000. If these assets were to be excised from the AAD partnership, it would require a fundamental re-structure of this suite of agreements and probably actions to reverse the ministerial vesting under the *ActewAGL/AGL Partnership Facilitation Act 2000* (ACT). These would be complicated processes which would incur significant legal and other costs.

- Application fees and legal work related to making an application to the Foreign Investment Review Board for establishment of a separate foreign controlled legal entity for the separated business.
- Establishment of financial arrangements for the new legal entity to purchase the gas business assets from AAD, offset by the sale receipts from the gas business.
- AAD's Nowra gas business is based on a small localised regional gas network serving a very small residential customer base with low levels of gas consumption (apart from the one large industrial customer mentioned above) and low revenues which, as mentioned above, are very small compared to electricity distribution services revenues. Natural gas distribution services are directly substitutable by electricity distribution services supplied by other distribution firms and bottled gas. Gas distribution is not an essential service.
- AAD's CNG refuelling facility is a very small business, generating revenue which (as detailed above) is immaterial as compared to the revenue from the provision of electricity distribution services. It is currently marginally unprofitable. The CNG refuelling facility is part of the arm's length gas business so there is no cross subsidy from electricity customers. Although the loss of scale economies from a legal separation would not be substantial for the electricity business, the resulting cost increase at the margin for the CNG facility would render it financially unviable if operated through a separate legal entity. Without the waiver, AAD would probably need to close the CNG refuelling Facility to the detriment of gas powered vehicle users in Canberra. This would be a retrograde step in our view, noting that cars fuelled by gas emit lower levels of carbon dioxide than petrol and diesel and therefore offer a 'greener choice' for consumers.

**(b) Ongoing Operating costs**

As mentioned in point 5(c) above, there will also be ongoing costs associated with legal separation of AAD's gas business. These include the duplication of corporate overhead costs across AAD and the separate legal entity, such as costs for audit and accounting, reporting, taxation and company secretarial services.

The costs for these services are estimated to be approximately additional \$50,000 per annum for the gas business.

As has been explained above, the small scale of AAD (and consequently its electricity distribution business and gas business) increases the importance of retaining these operational efficiencies. Separating the gas business into a separate legal entity would disadvantage both businesses when procuring operational services from potential service providers in the ACT.

Given the considerable reduction in purchasing power, the legally separated entity in particular would be less able to procure the required quality of service that the gas business needs without facing higher rates.



This would ultimately be to the detriment not just of gas consumers in the ACT, but also electricity consumers since nearly all gas consumers in the ACT are also electricity consumers.

**(c) Loss of Operational Efficiencies**

Although existing arrangements for outsourcing AAD's gas services would not change if there were legal separation, at the margin there are some corporate operational expenditure efficiencies from retaining AAD's gas services and electricity distribution services within the same legal entity. By way of example, a requirement of a legal entity is to have its accounts independently audited. The costs of both the electricity distribution business and the gas business would be higher because of the loss of economies of scale that would result from the removal of the common/shared service approach. This would affect the gas business proportionally much more because of its significantly smaller size compared to electricity. The entire gas business revenues are around 22% of revenues of the electricity network services, with the Nowra network being only 1.2% and the CNG facility a mere 0.03%. It might be observed at this point that these numbers alone indicate that the risk of cross subsidy of the Nowra network or the CNG facility is immaterial, even ignoring the substantive reasons described in this application and the other effective and significant controls that are in place.

Retaining these operational efficiencies within one entity, would promote efficient investment in, and efficient operation and use of electricity services for the long term interests of consumers of electricity services, as well as efficient investment in, operation and use of gas services for the long term interests of consumers of those gas services.

AAD is the smallest network firm for both electricity and gas in the NEM.<sup>10</sup> The relatively small scale of AAD's combined operations (and its individual electricity distribution business and gas business) increases the importance of retaining the operational efficiencies associated with jointly providing gas services and electricity distribution services compared to larger distribution firms in the NEM. AAD's customers benefit from these economies of scale and efficiencies in relation to AAD's provision of energy distribution services. A legal separation waiver would enable customers to continue to benefit directly from AAD delivering both gas services and electricity distribution services at least cost.

**8. Regulatory control period(s) to which the waiver would apply**

See point 6 above.

**9. Any additional measures the DNSP proposes to undertake if the waiver were granted**

As mentioned above, there is no practical risk of AAD using its electricity distribution services to cross-subsidise its gas services and therefore there is no requirement for further action.

To address any concerns the AER may have, AAD will commit to provide further transparency and assurance to the AER that cross subsidies do not and will not occur, including:

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<sup>10</sup> AER, *State of the Market*, 2017, p 108.

- providing the AER with an example of the terms and conditions in place for shippers seeking access to AAD's pipeline in Nowra; and
- responding to information requests from the AER.

AAD will revise the existing CAM to include reference to:

- the requirements under 3.2.2 in the Ring-fencing Guideline; and
- changes to the organisational structure arising from the creation of one or more separate legal entities, should that occur.

AAD will:

- ensure that costs allocated to electricity distribution services do not include any costs that are incurred by other business divisions;
- ensure that business divisions are allocated the appropriate cost allocations according to the relevant drivers of those costs; and
- publish the revised CAM on AAD's website.

**10. 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) National Electricity Objective**

The National Electricity Objective (**NEO**) is as follows:

*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:*

- a) price, quality, safety, reliability and security of supply of electricity; and*
- b) the reliability, safety and security of the national electricity system.<sup>11</sup>*

As mentioned above, there is no detriment to electricity consumers in allowing the continued ownership of the gas business by AAD because there is effectively no risk of cross subsidy from AAD's electricity consumers to gas consumers.

Requiring legal separation where no harm exists unnecessarily increases costs and potentially the charges payable by both electricity and gas consumers in the ACT. It could also result in a reduction in the standard of service currently provided to both electricity consumers and gas consumers in the ACT.

Granting the waiver would continue to promote the efficient operation and use of AAD's electricity services for the long term interests of electricity consumers, as well as gas consumers, particularly in respect to price, quality and standard of services provided.

**(b) Potential for cross-subsidisation and discrimination if the waiver is granted or refused**

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<sup>11</sup> *National Electricity Law*, s 7 (as contained in the Schedule to the *National Electricity (South Australia) Act 1996* (SA)).

As explained above, there is no potential for cross-subsidy to occur between AAD's electricity distribution services and gas distribution services. This would continue to be the case if the legal separation waiver is granted.

**(c) 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**

As mentioned above, there is no benefit to be gained for AAD's electricity distribution customers in requiring the legal separation of AAD's gas business. Therefore, there are no benefits to outweigh the costs to AAD of complying with that obligation.

The CNG refuelling facility serves a useful community function in the ACT as a number of customers rely solely the availability of this service. It is the main supplier to courier companies, local vendors and corporate entities, which operate gas-fuelled vehicles that produce less greenhouse emissions. These customers have invested by either purchasing gas-fuelled vehicles or converting their fleet to gas power because of the establishment of the CNG refuelling facility. Consequently customers rely on the continued operation of the facility. Requiring the facility to operate as a standalone company dedicated only to the gas business will increase running costs because of the loss of scale economies which would need to be passed on. The increased cost could be significant to a relatively small pool of customers.