

# Evoenergy Ring-fencing cost pass through application

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## 1. Introduction

Evoenergy submits this application to the Australian Energy Regulator (AER) for approval to pass through costs resulting from the publication of the Electricity Distribution Ring-Fencing Guideline (Guideline) by the AER.

The making of the Guideline became a requirement following a rule change in 2015 by the Australian Energy Market Commission (AEMC) as part of its Power of Choice (PoC) review (AEMC Rule Change).<sup>1</sup> The amendments to the National Electricity Rules (Rules) stipulated that the AER must develop and publish a Guideline by 1 December 2016.<sup>2</sup> The AER published the Guideline on 30 November 2016.<sup>3</sup>

The Guideline replaces the ring-fencing obligations set out in the Ring-Fencing Guidelines for Electricity and Gas Network Service Operators in the ACT (ACT Guideline)<sup>4</sup>, which was published by the Independent Competition and Regulatory Commission (ICRC) in 2002. Evoenergy considers that the publication of the Guideline by the AER changes its regulatory obligations and requirements in respect of ring-fencing and constitutes a pass through event (a positive change event specifically), a service standard event or, in the alternative, a regulatory change event.<sup>5</sup>

The pass through provisions in the Rules provide that material and efficiently incurred incremental costs resulting from new regulatory obligations or requirements that come into effect within the regulatory control period may be approved by the AER and passed through to distribution network users.

Evoenergy incurred material costs in order to comply with the new regulatory obligations imposed by the Guideline. These unplanned and unforeseeable costs were not included in the AER's determination of Evoenergy's revenue allowance for the 2014-19 regulatory period.

In this pass through application, Evoenergy sets out the details of the costs it incurred to comply with the changes to its regulatory obligations effected by the Guideline. Evoenergy is seeking approval for a positive pass through amount of \$2.05 million (2018/19 dollars, including the time value of money). This application includes information required for the AER to assess the proposed positive pass through amount and follows the AER's approval

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<sup>1</sup> *National Electricity Amendment (Expanding Competition in metering and related services) Rule 2015 No. 12.*

<sup>2</sup> Rules, clauses 6.17.2 and 11.86.8.

<sup>3</sup> Amended Guidelines for electricity distribution network businesses were published on 17 October 2017.

<sup>4</sup> <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/jurisdictional-ring-fencing-guidelines>

<sup>5</sup> Rules, clause 6.6.1(a1)(1) and (2).

of Evoenergy's request for an extension of the fixed time limit to submit a pass through application.<sup>6</sup>

### 1.1. Scope

- Section 2 describes the pass through mechanism in the Rules.
- Section 3 provides details of the positive change event and discusses its impact on the provision of direct control services.
- Section 4 provides details of the eligible and proposed positive pass through amounts, and demonstrates satisfaction of the AER's assessment criteria.

## 2. Regulatory framework

The pass through mechanism in the Rules provides for the Distribution Network Service Provider (DNSP) to pass through material costs for providing direct control services to customers, which were not part of the distribution determination. A pass through event occurs if the requirements of one of the four pass through events defined in the Rules, or a nominated pass through event approved in a distribution determination, are satisfied.<sup>7</sup> In the AER's view:<sup>8</sup>

*The pass through mechanism recognises that an efficient revenue allowance cannot be established with complete certainty and that it may not be efficient to require DNSPs to manage all situations or circumstances through their revenue allowance.*

The costs that a distributor has incurred must be material in order for the AER to consider an application.

*A pass through is a mechanism which allows the approved revenue of a DNSP to be adjusted during a regulatory control period. The event can be either positive or negative for a DNSP's costs but needs to be of such significance that the approved revenue allowance is no longer appropriate.<sup>9</sup>*

A pass through application is required within 90 business days of the pass through event but the AER may extend this time limit (if satisfied that the difficulty of assessing or quantifying the effect of the relevant pass through event justifies the extension)<sup>10</sup>.

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<sup>6</sup> On 10 April 2018, in response to Evoenergy's request, the AER extended the fixed time limit for an application for a pass through in respect of publication of the Guidelines to 90 business days after publication of the AER's remade final decision on Evoenergy's distribution determination for the 2014-19 regulatory control period.

<sup>7</sup> Rules, clause 6.6.1(a1)(1)-(5).

<sup>8</sup> AER 2010, *South Australia distribution determination 2010-11 to 2014-15*, May 2010, p. 223.

<sup>9</sup> AER, Final Decision: *Queensland distribution determination 2010-11 to 2014-15*, May 2010, p. 295.

<sup>10</sup> The AER, in response to Evoenergy's request, extended the fixed time limit to submit a pass through application in respect of the publication of the Guidelines to 90 business days after publication of the AER's remade final decision on Evoenergy's distribution determination for the 2015-19 regulatory control period.

The pass through clauses in the Rules set out the contents required for an application from a DNSP and the approach that the AER must take in assessing an application.

In assessing Evoenergy's application, the AER must take into account the following relevant factors<sup>11</sup>:

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

If the AER determines that a positive pass through event has occurred the AER must:

- 1) Determine the approved pass through amount;<sup>12</sup> and
- 2) Determine the amount of that approved pass through amount that should be passed through to users in the regulatory year in which, and each regulatory year after, the positive change event occurred.<sup>13</sup>

### **3. Occurrence of positive change event**

Clause 6.6.1(c)(1) requires Evoenergy to specify the details of the positive change event. A positive change event is defined in the Rules as a pass through event that entails Evoenergy incurring materially higher costs in providing direct control services than it would have incurred but for that event.

The AEMC Rule Change introduced a requirement for the AER to develop and publish guidelines for the accounting and functional separation of the provision of direct control services from the provision of other services by DNSPs. The publication of the Guideline effected significant changes to Evoenergy's regulatory obligations and requirements concerning ring-fencing. The Guideline is more onerous than the ACT Guideline it replaced and has resulted in significant changes to the manner in which Evoenergy is required to

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<sup>11</sup> Rules, clause 6.1.1(j)

<sup>12</sup> Rules, clause 6.6.1(d)(1).

<sup>13</sup> Rules, clause 6.6.1(d)(2).

provide direct control services such as differentiating its branding from ActewAGL Retail and implementing changes to the organisational structure.

Evoenergy considers that the publication of the Guideline by the AER on 30 November 2016 constitutes a positive change event which is a 'service standard event' as defined in the Rules for the reasons discussed in section 3.2 below or, in the alternative, a 'regulatory change event' for the reasons discussed in section 3.3 below.<sup>14</sup> This event resulted in Evoenergy incurring materially higher costs in providing direct control services for the reasons discussed in section 3.4 below.

Clause 6.6.1(c)(2) requires Evoenergy to specify the date when the positive change event occurred. The positive change event occurred on 30 November 2016. The AER extended the time limit for submitting a pass through application in respect of this event to 90 business days after publication of the AER's remade final decision on Evoenergy's distribution determination for the 2014-19 regulatory control period.<sup>15</sup>

### 3.1. Description of the introduction and new requirements of the Guideline

The key timing points for the introduction of the Guideline from the time of the initial AEMC 2015 Rule change are set out in Table 1 below.

**Table 1** Key milestones for the introduction of the Guideline

<i>Change in Evoenergy's ring-fencing regulatory obligations</i>	
26 November 2015	AEMC rule change — National Electricity Amendment (Expanding competition in metering and related services) Rule 2015 No. 12 Amendment to the Rules: cl. 6.17.2(a), 11.86.8(a).
20 April 2016	AER released a preliminary positions paper on the Guideline
15 August 2016	AER released the draft Guideline
30 November 2016	AER released the final Guideline
17 October 2017	AER publish amended Guideline
1 January 2018	Transitional arrangements end; DNSPs must fully comply with obligations in respect of existing services from this date

The AER published the Guideline that replaced the ACT Guideline on 30 November 2016 and amended it in October 2017.

The Guideline aims to prevent the harm that would be likely to result from the following three broad types of DNSP behaviour:

- cross-subsidisation: DNSPs use of regulated revenues to subsidise activities in competitive electricity markets.

<sup>14</sup> Rules, clause 6.6.1(a1)(1) and (2).

<sup>15</sup> AER letter to Evoenergy dated 10 April 2018.

- discrimination: DNSPs favouring their related contestable businesses.
- information access and disclosure: DNSPs sharing confidential information acquired through the provision of regulated services with related electricity service providers.

The Guideline does this by:

- requiring legal separation of DNSPs, which may only provide distribution (and transmission) services, from affiliated entities that may provide other electricity services.
- supporting the legal separation obligation with additional separate accounting obligations for DNSPs to maintain separate accounts, follow defined cost allocation methods and be able to report on transactions between themselves and their affiliates.
- imposing behavioural obligations on DNSPs, including imposing restrictions on sharing and co-locating staff, and co-branding of advertising materials.
- requiring a DNSP to provide access to confidential information acquired through the provision of regulated services to other legal entities (including its related electricity service providers) on an equal basis.
- requiring DNSPs to ensure service providers for electricity services also comply with the Guideline.

By contrast, compliance with the ACT Guideline only required ActewAGL Distribution to have two separate entities (the retail business being legally separated from distribution) and a number of protocols, procedures and practices for ensuring the required degree of functional and accounting separation.

An internal review found that Evoenergy was compliant with many of the requirements of the Guideline<sup>16</sup> which were present in the ACT jurisdictional ring-fencing guideline. However the additional requirements compared to the previous ACT Guideline substantially changed Evoenergy's ring-fencing obligations. The internal review identified gaps in compliance, as previously highlighted in Evoenergy's Ring-fencing Implementation Plan submitted to the AER in October 2017.

Evoenergy's new legal obligations under the Guideline (to which it was not subject under the ACT Guideline it replaces) include that:

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<sup>16</sup> Evoenergy determined that it is compliant with the following requirements of the Guideline:

- accounting separation;
- cost allocation;
- non-discrimination;
- staff sharing remuneration;
- protection of confidential information;
- disclosure of information; and
- service providers.



- it must use independent and separate branding for network services from contestable services and must not engage in cross-promotional activities.<sup>17</sup>
- it may provide distribution services and transmission services, but must not provide other services.<sup>18</sup>
- it must ensure staff involved in the provision or marketing of direct control services are not also involved in the provision or marketing of contestable electricity services by a related electricity service provider and are not located in any offices from which a related electricity service provider provides contestable electricity services.<sup>19</sup>

As a consequence, the Guideline has the effect of necessitating a change to how Evoenergy structures and manages its business operations to provide direct control services. Specifically, Evoenergy implemented a suite of actions in response to the changed requirements for operating the regulated electricity distribution network business in the ACT.

In particular, ActewAGL Distribution Joint Venture Partnerships became compliant with the requirement for independent and separate branding by implementing a new brand, Evoenergy, for the provision of regulated energy services.

### 3.2. Service standard event

A service standard event is defined as:<sup>20</sup>

*A legislative or administrative act or decision that:*

- (a) *has the effect of:*
- (i) *substantially varying, during the course of a regulatory control period, the manner in which ... a Distribution Network Service Provider is required to provide a direct control service; or*
  - (ii) *imposing, removing or varying, during the course of a regulatory control period, minimum service standards applicable to ... direct control services; or*
  - (iii) *altering, during the course of a regulatory control period, the nature or scope of the ... direct control services, provided by the service provider; and*
- (b) *materially increases or materially decreases the costs to the service provider of providing ... direct control services.*

Evoenergy considers the publication of the Guideline satisfies each of the requirements of the service standard event definition for the reasons set out below.

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<sup>17</sup> Clause 4.2.3 of the new Guidelines stipulates that DNSPs must use independent and separate branding for electricity distribution network services, must not advertise direct control services and contestable electricity services together and must not advertise or promote contestable electricity services provided by related electricity service providers; clause 7.1(a) requires that compliance with this obligation is achieved by 1 January 2018: AER 2017 Ring-fencing Guideline, October 2017.

<sup>18</sup> AER 2017 Ring-fencing Guideline, October 2017, clause 3.1(b).

<sup>19</sup> AER 2017 Ring-fencing Guideline, October 2017, clauses 4.2.1 and 4.2.2.

<sup>20</sup> Rules, Chapter 10.

### 3.2.1. Legislative or administrative act or decision

The AER is a body corporate established under the *Competition and Consumer Act 2010* (Cth). The AER's functions include any function or power performed or exercised by the AER under the Law or the Rules that relates to the economic regulation of services provided by a DNSP by means of, or in connection with, a distribution system (Law, section 15(1)(f) and definition of 'AER economic regulatory function or power'). The publication of distribution ring-fencing guidelines under clause 6.17.2 of the Rules is such a function or power.

The AER is thus an administrative body authorised by statute to publish the Guideline, and the publication of the Guideline is, therefore, an administrative act or decision for the purposes of the service standard event definition.

### 3.2.2. Effect of the act or decision

It is sufficient for the relevant act or decision to have any one of the effects set out in paragraph (a). For the reasons discussed below, Evoenergy considers the publication of the Guideline satisfies paragraph (a) because it has the effect enumerated in subparagraph (i). Evoenergy does not discuss subparagraphs (ii) or (iii) as it does not consider the publication of the Guideline has the effect of imposing, removing or varying a 'minimum service standard', or altering the nature or scope of the direct control services it provides.

Paragraph (a)(i) of the service standard event definition requires a substantial variation to the way in which, or method by which, Evoenergy is required to provide direct control services. It does not necessitate that Evoenergy's changed activities are new or dissimilar in nature to its existing activities.<sup>21</sup> As the AER has recognised in prior decisions:

*The term 'manner' is not defined in the NER and therefore should be construed with reference to its ordinary meaning, being 'way of doing, being done, or happening; mode of action, occurrence, etc.'<sup>22</sup> In its decision on the AusGrid SBS pass through application, the AER considered that, in the context of a service standard event, "an outcome that turns solely on changes to regulatory obligations seems incongruous". Rather, the AER considered the term 'required' to have a practical focus. Therefore, a substantial variation to the manner in which the DNSP is practically (rather than legally) required to provide a direct control service must be present to satisfy the service standard event definition in paragraph (a)(i).*

The term 'substantial', like the term 'manner', is undefined and thus takes its ordinary and natural meaning, being 'essential, material or important' or 'of ample or considerable amount, quantity, size etc'.<sup>22</sup>

Evoenergy considers that the publication of the Guideline results in a substantial variation to the manner in which direct control services are provided.

To achieve compliance with the new functional separation obligations of the Guideline, ActewAGL Distribution was required to implement the new brand, Evoenergy, for the provision of regulated electricity distribution network services; avoid cross-promotional

<sup>21</sup> AER 2012, *Final Decision Powercor cost pass through application of 13 December 2011 for Costs arising from the Victorian Bushfire Royal Commission*, March 2012, p. 20.

<sup>22</sup> See Macquarie Dictionary Online definition of 'substantial'.

advertising and marketing activities; separately locate affected staff from the delivery of contestable (unregulated) electricity services; and restructure the regulated and contestable businesses to ensure no sharing of staff by the regulated and unregulated businesses.

Rebranding of the regulated electricity network business was the most resource-intensive activity required to comply with Evoenergy's functional separation obligations.

It was not possible for ActewAGL Distribution, the owner of Evoenergy, to retain the ActewAGL brand for its direct control services and rebrand the contestable electricity services operating under the brand 'ActewAGL' at the time of publication of the Guideline. This is because the 'ActewAGL' trademark is not owned by ActewAGL Distribution but, rather, by ActewAGL Retail which intended to continue and has continued its use of that mark. The change in its ring-fencing obligations provided no practicable option for ActewAGL Distribution to retain the brand. Unwinding the long-standing shared brand as it applies to one of the largest operational divisions within the ActewAGL Group required substantial effort and change management.

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

In addition to rebranding, ActewAGL Distribution has also implemented significant organisational changes to comply with the functional separation obligations. ActewAGL Distribution has functionally separated the regulated electricity distribution network services from contestable business activities in order to comply with the requirements of the Guideline.

Evoenergy has also undertaken a series of measures to comply with the restrictions in the Guideline on sharing and co-locating staff, which has required the development of physical infrastructure, ICT system changes and information sharing protocols as well as changes in how consumer engagement activities are conducted.

Evoenergy has developed an information sharing protocol to enable equal access to information by contestable businesses, including preparing application forms and updating the website for the ongoing management of requests for confidential information. In addition, the Guideline required changes to the tendering and procurement processes with all contracts rebranded, and a clause added to all contracts about confidential information provided to contractors.

Evoenergy also anticipates that it will incur significant costs on an ongoing basis for annual compliance auditing, reporting and administration.

As is evident from the compliance activities described above, the new obligations necessitated far-reaching and fundamental practical changes to the way the business structures and organises its activities involved in the provision and marketing of direct control services, and how its staff conduct themselves on a day to day basis. For this reason, Evoenergy considers it incontrovertible that the publication of the Guideline effects (in the words of the AER) 'a substantial variation to the manner in which [Evoenergy] is practically (rather than legally) required to provide a direct control service'.

### **3.2.3. Materially increases costs of providing direct control services**

The requirement of paragraph (b) of the service standard event definition, namely that the event materially increases Evoenergy's costs of providing direct control services, is satisfied for the reasons discussed in section 3.4 below.

### **3.3. Regulatory change event**

If the AER does not agree that publication of the Guideline constitutes a service standard event, Evoenergy considers it would then constitute a regulatory change event.

The definition in the Rules for a regulatory change event provides for a change in regulatory obligations or requirements that substantially affects the manner in which direct control services are provided, and occurs during the course of the regulatory control period. A regulatory change event is defined as:<sup>23</sup>

*A change in a regulatory obligation or requirement that:*

- (a) falls within no other category of pass through event; and*
- (b) occurs during the course of a regulatory control period; and*
- (c) substantially affects the manner in which the DNSP provides direct control services; and*
- (d) materially increases or materially decreases the costs of providing those services.*

Evoenergy considers that, in the event that the publication of the Guideline does not constitute a service standard event, the publication of the Guideline satisfies each of the limbs of the regulatory change event definition for the reasons set out below.

#### **3.3.1. Change in regulatory obligation or requirement**

The term 'regulatory obligation or requirement' is relevantly defined in section 2D of the Law to include an obligation or requirement under the Law or Rules.

Clause 6.17.1 of the Rules requires DNSPs to comply with the distribution ring-fencing guidelines prepared in accordance with clause 6.17.2 of the Rules. Prior to the publication of the Guideline, the ACT Guideline was in force and taken to be made by the AER under clause 6.17.2 of the Rules<sup>24</sup>. As a result, clause 6.17.1 of the Rules operated to require Evoenergy to comply with the ACT Guideline.

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<sup>23</sup> Rules, Chapter 10.

<sup>24</sup> Rules, clause 11.14.5(b)(3) and (c).

The publication of the Guideline by the AER replaced the ACT Guideline<sup>25</sup>. As the Guideline is not substantively identical to the ACT Guideline, the obligations and requirements applicable to Evoenergy under clause 6.17.1 of the Rules changed on publication of the Guideline.

This suffices to establish that the publication of the Guideline constituted a change to a 'regulatory obligation or requirement' within the meaning of the Law and Rules.

### **3.3.2. Falls within no other category of pass through event**

For the 'regulatory change event' category, the AER needs to be satisfied that no other category of pass through event is applicable.

The publication of the Guideline does not meet the definition set out in the Rules of a tax change event or a retailer insolvency event.

Similarly, the publication of the Guideline does not meet the definition of any other pass through event specified in Evoenergy's distribution determination for the 2014-19 regulatory control period.

It follows, therefore, that if the AER does not agree that publication of the Guideline is a service standard event, it falls within no other category of pass through event.

### **3.3.3. Occurred during the course of the 2014-19 regulatory control period**

The AER published the Guideline on 30 November 2016. It follows that the change in regulatory obligation or requirement described in section 3.2.3 above occurred during the course of the 2014-19 regulatory control period.

### **3.3.4. Substantially affects the manner in which Evoenergy provides direct control services**

The effect element required for a regulatory change event is that the relevant event 'substantially affects the manner in which the [DNSP] provides direct control services'. There are differences between the articulation of this effect element and that in subparagraph (a)(i) of the service standard event definition (discussed in section 3.2.2 above), which requires that the relevant event has the effect of 'substantially varying ... the manner in which ... a [DNSP] is required to provide a direct control service'. However, the differences are largely differences of form, rather than substance, and are not of any significance in the present circumstances.

For the reasons outlined in section 3.2.2 above in relation to subparagraph (a)(i) of the service standard event definition, Evoenergy considers the manner in which it provides direct control services has been substantially affected by the publication of the Guideline.

### **3.3.5. Materially increases costs of providing direct control services**

The requirement of paragraph (d) of the regulatory change event definition, namely that the event materially increases Evoenergy's costs of providing direct control services, is satisfied for the reasons discussed in section 3.4 below.

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<sup>25</sup> Rules, clause 11.14.5(b)(3).

### 3.4. Materiality requirement

The pass through provisions in the NER are triggered by events which have a 'material' impact on costs for providing direct control services.<sup>26</sup>

*A pass through is a mechanism which allows the approved revenue of a DNSP to be adjusted during a regulatory control period. The event can be either positive or negative for a DNSP's costs but needs to be of such significance that the approved revenue allowance is no longer appropriate.<sup>27</sup>*

Chapter 10 of the NER defines 'materially' such that an event results in materially higher costs if a change in costs (as opposed to the revenue impact) that a DNSP has incurred, and is likely to incur, in any year of a regulatory control period, as a result of the event, exceeds 1 per cent of the annual revenue requirement for the DNSP for that regulatory year.<sup>28</sup>

Evoenergy has incurred materially higher costs in complying with its new ring-fencing obligations under the Guideline.

#### 3.4.1. Details of the costs incurred in complying with the Guideline

The Guideline replaces the ACT Guideline, which was largely confined to requiring separation of the provision of monopoly regulated services and competitive retail services. Evoenergy undertook the ring-fencing compliance project to address the additional ring-fencing requirements outlined in the Guideline compared to the ACT Guideline.

Shortly after the 2016 Guideline was published, Evoenergy established an internal ring-fencing Steering Committee to develop a governance approach to become compliant with the new regulations. The Steering Committee established a Working Group to develop and manage a compliance programme of work to put in place the necessary changes.

More than 370 hours of senior staff time was used to participate in Steering Committee and Working Group meetings. This does not include the work that staff members and their teams undertook to progress the approximately 130 action items arising from Working Group meetings. Costs for this time are not included in this ring-fencing pass through application.

The costs included in this application relate to material costs incurred by ActewAGL Distribution to comply with its new ring-fencing obligations, including the following incremental expenditure activities:

- re-branding and communications;
- website design;
- project management; and

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<sup>26</sup> NER, clause 6.6.1(j)(2).

<sup>27</sup> AER, Final Decision: *Queensland distribution determination 2010–11 to 2014–15*, May 2010, p. 295.

<sup>28</sup> Chapter 10 of the NER defines 'materiality' as the change in costs (as opposed to the revenue impact) that a distributor has incurred, and is likely to incur, in any year of a regulatory control period. The change in costs must exceed 1 per cent of the annual revenue requirement for the distributor for that regulatory year.

- forecast compliance auditing and reporting.

The costs included in this pass through application (with the exception of forecast compliance costs) are all invoiced costs incurred in engaging additional services outside Evoenergy between the period February 2017 and February 2018.

### 3.4.2. Materially higher costs

Compliance with the ring-fencing obligations in the Guideline has resulted in material increases in Evoenergy's costs. Evoenergy has assessed that the compliance costs associated with the new obligations in the Guideline are material in 2017/18 of the 2014-19 regulatory control period.

The Rules require a comparison of the change in the costs a DNSP has incurred, and is likely to incur, in a regulatory year as a result of the event with its annual revenue requirement for that year. If the change in costs is 1 per cent or more of the annual revenue requirement for any regulatory year then the costs are considered material.

The AER has, in previous decisions, maintained that the term 'costs' in this context refers to the sum of opex, return on capital, return of capital and tax (and other adjustments), consistent with the building blocks described in clause 6.4.3 of the Rules.<sup>29</sup> The AER's building block methodology for calculating these costs is captured in the Post Tax Revenue Model (PTRM).

Evoenergy has used the PTRM to compare the annual revenue requirement with and without the pass through costs to assess materiality. Table 2 shows the additional opex costs incurred by Evoenergy in complying with the new ring-fencing obligations.

**Table 2** Categories of costs for compliance with the Guideline

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

Notes: Excludes overhead costs

Evoenergy's ring-fencing compliance costs are material when compared to the AER's remade annual revenue requirement for the 2014-19 regulatory control period as set out in Table 3, together with the change in Evoenergy's required revenues in each of the relevant years are detailed in Table 3. The change in Evoenergy's required revenues represents 1.01 per cent of Evoenergy's annual revenue requirement in 2017/18, which exceeds the materiality threshold of 1 per cent.

<sup>29</sup> In determining whether Ausgrid's costs relating to the NSW solar bonus scheme are material, the AER considered the meaning of the terms 'costs' and 'materiality'. AER 2011 Ausgrid cost pass through application in relation to the NSW solar bonus scheme, March 2011, p.2.

**Table 3** Materiality of cost of compliance with the new ring-fencing obligations

\$million, nominal	2014-15	2015-16	2016-17	2017-18	2018-19
Annual Revenue Requirement (ARR) (unsmoothed)	155.75	148.68	153.84	160.37	164.38
Positive pass through amount + ARR (unsmoothed)	155.75	148.68	154.00	161.99	164.53
Pass through amount	0.00	0.00	0.17	1.62	0.15
Materiality of pass through event against ARR (per cent)	0.00	0.00	0.11	1.01	0.09

## 4. Eligible and proposed positive pass through amounts

### 4.1. Eligible pass through amount

Clause 6.6.1(c)(3) of the Rules requires Evoenergy to specify the eligible pass through amount.

The 'eligible pass through amount' is relevantly defined in Chapter 10 of the Rules to mean 'the increase in costs in the provision of *direct control services* that, as a result of that *positive change event*, the [DNSP] has incurred and is likely to incur (as opposed to the revenue impact of that event)' until the end of the regulatory control period in which the positive change event occurred.

The eligible pass through amount refers to the increase in costs in the provision of direct control services as a result of the pass through event. It covers all expenditure including the capex and incurred.

In determining the eligible pass through amount, Evoenergy incorporates only incremental costs consistent with the Rules to capture the total cost of compliance. Internal resources that were not fully allocated to implementing compliance activities, such as part time work on the project and allocated overheads, are not included in the eligible pass through amount.

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

**Table 4** Project costs for compliance with the new ring-fencing obligations<sup>1</sup>

\$, nominal	2014-15	2015-16	2016-17	2017-18	2018-19	Total
Opex	0	0	161,255	1,551,724	139,800	1,852,779

Notes: <sup>1</sup> Excludes overhead costs

### 4.2. Evidence of the costs included in the eligible pass through amount

Clause 6.6.1(c)(6)(i) of the Rules requires Evoenergy to provide evidence of the actual and likely increase in costs included in the eligible pass through amount.

Table 5 provides a breakdown of the costs included in the eligible pass through amount. The costs are actual costs for compliance with requirements of the Guideline, including



the transitional arrangements. As discussed in section 3, the majority of the costs incurred in complying with the ring-fencing obligations were associated with rebranding.

**Table 5** Key project costs for compliance with the new ring-fencing obligations<sup>1</sup>

\$, nominal	2016-17	2017-18	2018-19
<b>Rebranding</b>			
Website		\$334,657	
Communications <sup>2</sup>		\$327,476	
Personal protective equipment and uniforms		\$266,913	
Additional resources		\$219,291	
Signage and collateral rebranding <sup>3</sup>		\$169,517	
Stationery and promotional items <sup>3</sup>		\$48,883	
Creative design		\$28,860	
Industry memberships		\$7,068	
<b>Project management &amp; legal</b>	\$161,255	\$149,058	\$139,800
<b>Total</b>	<b>\$161,255</b>	<b>\$1,551,724</b>	<b>\$139,800</b>

Notes:

<sup>1</sup> Not including overhead costs

<sup>2</sup> Media and communications expenditure includes costs for advertising, website development, marketing and promotions

<sup>3</sup> Signage and stationary expenditure includes costs for vehicle logos, printing and photocopying, marketing and promotions, stationery, and office supplies.

With the exception of forecast expenditure for 2018/19, the costs in Table 5 were captured and extracted from Evoenergy's corporate accounting system, Oracle. Section 4.3 below explains why the AER can have confidence that the costs in its Oracle accounting system occur solely as a consequence of the positive change event (an extract from Oracle is provided on a confidential basis as Attachment 1).

#### **4.3. Costs included in eligible pass through amount are solely as a consequence of the positive change event**

Clause 6.6.1(c)(6)(ii) of the Rules requires Evoenergy to provide evidence that the actual and likely increase in costs included in the eligible pass through amount occurred solely as a consequence of the positive change event. Similarly, clause 6.6.1(j)(5) of the Rules requires the AER, in determining the approved pass through amount and the amount to be passed through to users in each regulatory year, to take into account the need to ensure the DNSP only recovers any actual or likely increment in costs that is solely as a consequence of the positive change event.

In determining the eligible pass through amount, Evoenergy included only the incremental costs incurred solely as a consequence of the positive change event.

Evoenergy employed the existing accounting system to clearly record and track the costs incurred as a consequence of the positive change event by creation of a separate project code in Oracle.

The costs recorded for the ring-fencing compliance project differentiated between the expenditure incurred for activity types and business as usual (BAU) expenditure. The nature of the costs incurred included:

- direct costs, such as the costs of materials and contract services; and
- indirect costs (overheads) allocated through the use of a labour rate.

The accounting structure allowed separation of costs into pass through and non-pass through costs, and into capital and operating expenditure categories. Individual expenditure tasks for the ring-fencing compliance project were tracked using Evoenergy's corporate accounting system, Oracle to enable cost capturing at a detailed level throughout the life of the project.

The remainder of the costs recorded for the ring-fencing compliance project were incurred for BAU resources that were engaged to provide input to the project. These BAU costs are funded by means of the expenditure allowance for the 2014-19 regulatory control period. Evoenergy does not include BAU costs in the eligible pass through amount due to the shared nature and the difficulty of tracking these costs.

#### **4.4. Efficiency of eligible pass through amount**

Clause 6.6.1(j)(3) of the Rules requires the AER, in determining the approved pass through amount and the amount to be passed through to users in each regulatory year, to take into account the efficiency of Evoenergy's decisions and actions in relation to the risk of the positive change event. This includes whether Evoenergy's actions have minimised the magnitude of the eligible pass through amount.

This section provides justification for the efficiency of Evoenergy's decisions and actions in relation to the risk of the positive change event.

Evoenergy considers that its actions were efficient as:

- the event was uncontrollable and unexpected: no action or decision by Evoenergy could have reduced the risk of occurrence of the positive change event;
- it undertook change management processes within a dedicated ring-fencing compliance project and categorised all costs in determining the eligible pass through amount to ensure only incremental costs were included;
- Evoenergy undertook steps that have reduced the magnitude of the costs, including seeking a waiver for the gas business to avoid significant costs to consumers that would not have delivered a commensurate benefit;
- Evoenergy undertook an initial detailed assessment of the change in requirements for ring-fencing resulting from the introduction of the Guideline to identify areas of compliance and avoid any duplication or unnecessary expenditure;

- Evoenergy implemented required activities by engaging external service providers using cost-effective competitive tendering and procurement processes.

Evoenergy maintains that there were no other decisions or actions it could have taken to reduce the magnitude of the eligible pass through amount.

Evoenergy had no ability to prevent or avoid the positive change event. The publication of the Guideline was the unavoidable consequence of the AEMC Rule Change.

Similarly, there was no option to not comply with the change in Evoenergy's ring-fencing obligations as a consequence of the publication of the Guideline. Once the Guidelines were published, Evoenergy had a legal obligation under clause 6.17.1 of the Rules to comply with them.

Further, the eligible pass through amount represents the minimum increase in costs in the 2014-19 regulatory control period as a consequence of the positive change event.

Evoenergy implemented the ring-fencing compliance project to achieve and maintain compliance at minimum cost. The business strategy to comply with the change in Evoenergy's ring-fencing obligations involved a robust assessment of the likely compliance costs. Evoenergy explored strategic options for compliance by undertaking a thorough internal business assessment to manage the impacts on the business and to remain compliant with the regulatory framework.

A key element of the compliance strategy involved seeking waivers in respect of the legal separation of ActewAGL Distribution's gas business. The obligation in the Guideline for legal separation requires that a DNSP may provide distribution and transmission services but not other services. In the absence of a waiver, this obligation would mean that a DNSP delivering gas services would not comply.

In selecting the least cost alternative, ActewAGL Distribution made the decision to include the gas business under the Evoenergy brand and, accordingly, sought a waiver from the AER in respect of the legal separation obligation to permit this. The AER granted Evoenergy a waiver from the requirement to separate out the provision of the gas business from its regulated electricity network business.<sup>30</sup> A copy of Evoenergy's waiver application is provided as Attachment 2.

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<sup>30</sup> The AER granted a waiver from ActewAGL Distribution's obligation to comply with clause 3.1(b) of the Guidelines for legal separation from 18 December 2017 until 30 June 2024 to allow ActewAGL Distribution to continue to own and operate its:

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

The AER also granted a waiver from ActewAGL Distribution's obligation to comply with clause 3.1(b) of the Guidelines from 18 December 2017 until 31 December 2019 to allow ActewAGL Distribution to continue to own and operate its compressed natural gas refuelling facility in the Canberra suburb of Fyshwick (CNG Refuelling Facility).

As explained in ActewAGL Distribution's waiver application, the main purpose of the waiver was to minimise the costs of complying with the new ring-fencing requirements, which is consistent with efficient decision making.<sup>31</sup> The application details the one-off transaction costs, higher ongoing operating costs and loss of operational efficiencies that would have resulted from the separation of the gas business from the regulated electricity distribution business.<sup>32</sup>

The actions and decisions taken by Evoenergy in response to the AEMC Rule Change are consistent with internal governance processes. Evoenergy managed change within the business by implementing a new organisational structure and brand. Achieving compliance with the obligations of the Guideline provides assurance of Evoenergy's effective, measurable and responsive legal compliance framework and risk management. The ring-fencing compliance project was delivered within the budget allocation communicated to the AER in ActewAGL Distribution's Ring-fencing Draft Implementation Plan dated 27 April 2017. A copy of the Implementation Plan is provided in Attachment 3.

The Evoenergy rebranding project commenced on 31 August 2017 following ActewAGL Joint Venture Board approval of the name and was completed in 80 business days. Evoenergy managed resources efficiently in the short timeframe available for completing the rebranding project, containing costs to below the budget provision detailed in the Draft Implementation Plan.

Prudent decisions were made in response to the new ring-fencing requirements and within the available time constraints, including delivering the new website on 22 December 2017 for a go-live on 18 January 2018. For example, Evoenergy prioritised installing new signage on network equipment and vehicles to provide assurance to customers and enable public awareness of the new brand. Staff uniforms were replaced to avoid customer confusion arising from the introduction of the new brand. Replacement of uniforms rather than re-badging logos proved to be a lower cost option. Evoenergy has contained other costs for the rebranding project, such as undertaking a gradual and ongoing rollout of replacement markers on a large number of mini-pillars in the ACT network.

BAU costs were absorbed by the business as part of the 2014-19 expenditure allowance, including staff members of the project board, internal legal and IT services, and administrative support services.

Rebranding costs for the gas business were not included in the calculation of costs for rebranding to Evoenergy. The costs incurred by the gas business include expenditure for:

- stationery;
- asset signage in the ACT and Nowra;
- ID cards for Zinfra staff and contractors; and

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<sup>31</sup> ActewAGL Distribution, *Application for waiver from AER ring-fencing Guideline - Electricity Distribution, Legal separation of ActewAGL Distribution's gas businesses*, 31 July 2017.

<sup>32</sup> *Ibid* pp. 7-9.

- vehicle signage for contractors to reference Evoenergy in place of ActewAGL Distribution.

Evoenergy undertook steps to reduce the magnitude of the costs for the ring-fencing project, including continually reviewing the budget provision by scheduling tasks and coordinating activities to reduce expenditure.

#### 4.5. Positive pass through amount

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

Evoenergy has calculated the proposed positive pass amount as the change in its required revenues for the 2014-19 regulatory control period as a result of the positive change event. Specifically, Evoenergy has:

1. Taken the sum of the unsmoothed revenues for distribution and dual function assets from the AER's 2014-19 final remade decision for each regulatory year.
2. It has then recalculated the unsmoothed revenues for distribution by including the opex associated with ring-fencing in the AER's PTRM for the remade decision. These revenues are added to the unsmoothed revenues for dual function assets from the AER's 2014-19 remade decision. This gives the unsmoothed revenues associated with the remade decision plus the ring-fencing cost pass-through for each regulatory year;
3. The pass-through amount is then calculated as the difference between the values in step 2 and step 1 above for each regulatory year. The nominal values of the pass-through amounts for each regulatory year are summed to give the total pass through amount for the 2014-19 regulatory control period of \$2.05 million (2018/19 dollars, including the time value of money).

Each of these steps is shown in Table 6 below. Evoenergy's calculations are provided in the PTRM at Attachment 4.

**Table 6** Calculation of positive pass-through amount

\$million, nominal	2014-15	2015-16	2016-17	2017-18	2018-19
1. AER 2014-19 remade decision unsmoothed revenue (distribution plus dual function assets)	155.75	148.68	153.84	160.37	164.38
2. AER 2014-19 remade decision plus ring-fencing costs unsmoothed revenue	155.75	148.68	154.00	161.99	164.53
3. Positive pass-through amount (2 minus 1)	0.00	0.00	0.17	1.62	0.15

Source: Evoenergy Attachment 4 – RF Final Decision PTRM.

#### **4.6. Annual pass through amount**

Clause 6.6.1(c)(5) of the Rules requires Evoenergy to specify the annual amount that it proposes to pass through to customers in the year and each regulatory year after that in which the positive change event occurred.

Evoenergy proposes to recover the entirety of the proposed positive pass through amount of \$2.05 million (2018/19 dollars, including the time value of money) in the 2019-24 regulatory control period. Evoenergy proposes that, as the positive pass through amount reflects costs incurred in the 2014-19 regulatory period, the annual amount passed through to customers in each regulatory year of the 2019-24 period should be determined so as to provide for Evoenergy to recover the positive pass through amount as early in that period as practicable having regard to the impact of the annual pass through amount on network charges in the relevant regulatory year. Evoenergy does not propose specific dollar amounts for each regulatory year of the period in this application, as it expects better information to support an assessment of the impact of the annual pass through amount on network charges in the relevant regulatory year of the 2019-24 period will become available as the decision-making process on this application progresses.