Guidance note

Distribution ring-fencing class waiver for DNSP-led projects funded under the Australian Government's Community Batteries for Household Solar Program

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AUSTRALIAN ENERGY REGULATOR

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Shortened forms

Shortened Form	Extended Form
AER	Australian Energy Regulator
current guideline	Ring-fencing guideline – Electricity distribution (version 3), November 2021
DNSP	Distribution Network Service Provider
RAB	Regulatory Asset Base

Contents

1 Introduction

1.1 Purpose of this guidance note

The Australian Government has announced the Community Batteries for Household Solar Program (the Program), which will allow eligible project proponents, including electricity distribution network service providers (**DNSPs**), to apply for funding to cover capital costs of 400 new community batteries on low voltage networks across Australia.

Under clause 3.1 of the **Ring-fencing Guideline – Electricity Distribution** (the **Guideline**)[1], **DNSPs** are prevented from leasing excess capacity of any new energy storage devices to third parties to deploy in competitive markets. Further, clauses 4.2.1 and 4.2.2, respectively, of the **Guideline** require **DNSPs**, in providing direct control services, to use offices and staff that are separate from any offices or staff that are used by a related electricity service provider in the provision of contestable electricity services.

This guidance note provides information to assist **DNSPs** in complying with the conditions of the class waiver, including calculating the proportion of a battery asset that may be allocated to a **DNSP's RAB** for **DNSP**-led projects funded under the Program. This guidance note should be read in conjunction with the **Guideline**, its accompanying explanatory statement[2], and the final decision of our class waiver for **DNSP-**led batteries funded under the Program.

The approach outlined in this document is consistent with the approach to cost allocation outlined in the **AER**'s explanatory statement for the Ring-fencing Guideline (electricity distribution) Version 3, 2021. However, it has been refined to reflect learnings to date in relation to batteries. In particular, the cost allocation outlined below contains a requirement to apportion benefits on a forecast basis, and then apply this to costs borne by consumers to ensure this benefit is delivered to network customers up-front. The transparency provided via annual reporting on actual leasing revenue will also allow us to clearly assess the effectiveness of this approach to inform future treatment of similar assets.

This guidance note does not impose additional requirements on **DNSP**s. The requirements of the class waiver and **Guideline** are binding under clause 6.17.1 of the **National Electricity Rules**.

This guidance note is consistent with the **AER**'s *Strategic Plan 2020-2025.*[3]

1.2 The Ring-fencing Guideline

The **Ring-fencing Guideline – Electricity Distribution** was made under clause 6.17.2 of the **National Electricity Rules**. It was first published in November 2016 and amended in October 2017 and November 2021.

The objective of the **Guideline** under clause 1.1.1 is to:

- promote the **National Electricity Objective** by providing for the accounting and functional separation of the provision of **direct control services** by **DNSPs** from the provision of other services by them, or by their **affiliated entities**; and

1 AER, *Ring-fencing Guideline – Electricity Distribution – Version 3*, November 2021.

2 AER, *Ring-fencing Guideline – Electricity Distribution – Version 3 – Explanatory Statement*, November 2021.

3 AER, *Strategic Plan 2020-2025*, December 2020

- promote competition in the provision of electricity services.

The **Guideline** seeks to accomplish this objective by imposing obligations on **DNSP**s, targeted at, among other things:

- cross-subsidisation, with provisions that aim to prevent a **DNSP** from providing **other services** that could be cross-subsidised by its **distribution services**; and

- discrimination, with provisions that aim to:

    - prevent a **DNSP** conferring a competitive advantage on its **related electricity service providers** that provide **contestable electricity services**; and

    - ensure a **DNSP** handles ring-fenced information appropriately.

1.3 Terminology

For the purposes of this guidance note, all bold terms have the meaning defined in clause 1.4 of the **Guideline** or the **National Electricity Rules**.

1.4 Ring-fencing class waiver

The class waiver applies to: **DNSP**-led projects where the battery asset is funded under the Australian Government's Community Batteries for Household Solar Program (delivered either through the Business Grants Hub (administered by the Department of Industry, Science and Resources) or ARENA, where:

a) The asset is wholly excluded from the Regulatory Asset Base (**RAB**) **(class (a));** or

b) what is allocated to the **DNSP's RAB** is only the part of the total cost of the asset that reflects the proportionate share (that relates to *direct control services*) of the total quantified benefit that is forecast at the time the investment decision is made (**class (b)**), where:

    i. prior to the **RAB** allocation at the **DNSP's** next regulatory proposal, the **DNSP** includes in its regulatory proposal evidence, and a report from an independent auditor, that confirms compliance with this provision b);

    ii. the **DNSP** may use the Government contribution to offset costs (regulated or unregulated) either partially or fully but may not exceed the total cost allocation to a particular stack (regulated or unregulated);[4]

    iii. the total cost of the battery allocated to the **RAB** must be an amount equal to or less than the forecast network benefit; and

    iv. definitions:

        1) the **total quantified benefit** is the sum of both the forecast network benefit (quantified benefit derived from the deployment of the asset for *direct control services*) and the forecast non-network benefit (quantified benefit derived from the deployment of the asset for *other distribution service* and *other services*) over its economic life.

[4] This differs from our approach stated in the initiation notice. It is a decision for the Government whether Program funding will be used to offset the regulated or unregulated costs associated with the batteries. Clarification of this change is in section 3.4 ('Treatment of Government Funding') of our Decision document

For projects that fall into **class (a)** above, section 2 of this Guidance Note does not apply. For projects that fall into **class (b)** above, all sections of this Guidance Note apply.

1.5 Class waiver criteria

The following criteria apply to projects that fall within class (b):

1. A **DNSP** must comply with the Cost Allocation Principles that require a **DNSP** to appropriately allocate and attribute costs for use of the asset between *direct control services*, and *other distribution services* and *other services*.
2. A **DNSP** must provide, as part of that **DNSP's** independently audited annual ring-fencing compliance report under clause 6.2 of the Guideline, an independent audit report that covers:
    a. the total quantified benefit derived from the deployment of the asset for all services over the most recent financial year,
    b. the total quantified benefit derived from the deployment of the asset from *direct control services* over the most recent financial year, and
    c. the total quantified benefit derived from the deployment of the asset from *other distribution services* and *other services* over the most recent financial year.

        (Note: the benefit in 2.a. should be the sum of the value in 2.b. and the value in 2.c.)
    d. a comparison of the uses (volume and frequency) of the battery that confirms the usage by the **DNSP** and usage by its retail partner (or other third party), including the initial proposed allocation as a baseline against which actual usage of the assets can be compared.

The following criteria apply to projects which fall within class (a) or (b):

3. A **DNSP** must provide the AER with information as to the terms and conditions of the contracts entered into with third parties for the leasing of battery capacity. This information should include:
    a. The name of the contracting party or parties;
    b. The volume of capacity (in kW and kWh) leased to that party or parties;
    c. The price the capacity is leased for; and
    d. Which party controls the operation of the battery and on what terms.

2 Calculating allocation to the Regulatory Asset Base

2.1 Introduction

The cost allocation detailed in our decision document is based on apportionment (or distribution) of project benefits. In this section we detail different examples of how the method works, how controls are applied, and examples of information we expect to see supporting a DNSP's calculations of costs and benefits.

2.2 Applications

In this section we provide some steps on how cost allocation applies in principle and a worked example to provide clarity to the **DNSP** when determining how to appropriately allocate costs. We note that this is not a fulsome example and may not apply to all scenarios. **DNSPs** are encouraged to contact the AER if they have specific questions.

Step 1 – Derive percentage of costs that can be allocated to the Regulatory Asset Base (based on percentage of total benefits):

The **DNSP** should forecast the total benefits of the battery, being the sum of the network benefits (including innovation benefits where these have been accepted by the AER through the Demand management innovation allowance (DMIA) funding process) and non-network benefits (quantifiable benefits which accrue to the **DNSP** such as leasing revenue). This should then be expressed as percentage split of benefits between network benefits and unregulated (non-network) benefits. The percentage allocation derived from this approach should then be applied to the total costs of the battery under Step 2 to obtain the battery cost which can be allocated to the **RAB** to be funded by network customers.

Scenario 1 – a simple scenario:

- The **DNSP** determines that the total network benefit is $600,000 and the total non-network benefit is $600,000.[5]
- As a result, the total benefit is $1.2m, therefore the network benefit is 50% of total benefit.
- As a result, the **DNSP** can allocate 50% of the total cost of the battery to the **RAB**. i.e. if the total cost of the battery is $1m, $500,000 can be allocated to the **RAB** subject to step 2 and the controls below.

Scenario 2 – an expanded scenario with innovation funding:

- The benefits of this scenario remain as in the scenario above. However, the **DNSP's** proposed battery costs of $1m are funded partially with $500,000 of innovation funding (DMIA).
- As with the previous scenario **DNSP** will roll 50% of asset into the **RAB**. However, they will reflect the innovation funding as a capital contribution towards this amount (so regulated customers' cost is 0, but 50% of the asset notionally sits in the **RAB**). This means that future replacement capex, for example, would be funded 50% out of the regulated revenue.

Step 2: Determine total costs that can be allocated to the Regulatory Asset Base

After step 1 is complete the **DNSP** must account for the Government's contribution.

As outlined in our initiation notice and final decision, the treatment of the Government contribution under the Program is a policy question for the Government. If the Government's policy intent is to deliver benefits to all regulated electricity customers, they may wish to direct the grant funding to offsetting regulated network costs. If, on the other hand, they wish to incentivise the development

[5] Benefits quantified in accordance with the AER's DER integration expenditure guidance note.

of innovative retail products allowing for direct participation by customers in local batteries, they may wish their funding to be directed to the non-network costs.

The Government contribution could be used to reduce the cost from either the regulated or unregulated share of costs or could be divided between both cost stacks (to any percentage split).

The approach taken by this step is not prescribed by the ring-fencing guideline or class waiver.

It is important to note that this step has certain controls:

1. The Government contribution may be used to offset costs (regulated or unregulated) either partially or fully but may not exceed the total cost allocation to a particular stack (regulated or unregulated). For example, assume that 80% of the battery's total cost of $1m is attributed as a network cost allocation (i.e $0.8m). Then the unregulated network costs to the business is $0.2m. If the Government's funding (in this example $0.5m) is used to offset unregulated costs, they can only do this up to the amount of those costs (i.e $0.2m). Any remaining Government funding above this amount must be applied to the other cost stack. This means that unregulated costs are reduced from $0.2m to 0, and regulated costs are reduced from $0.8m to $0.5m.
2. Notwithstanding the apportionment percentage derived under Step 1, the cost of the battery allocated to the **RAB** cannot exceed the forecast network benefit (e.g. if the total network benefits were $0.25m, and the total unregulated benefits were $0.25m, resulting in a benefit allocation of 50%, this would not allow 50% of the cost of a $1m battery ($0.5m) to be allocated to the **RAB**. In this case, the control would cap the total **RAB** allocation at $0.25m).

Worked example: Cost allocation approach

A summary of the steps above as a worked example are below. *Please note the numbers used in this calculation differ from the dollar examples above.*

Project:

Total project cost: $1.2m

Grant funding: $0.4m

DNSP forecasts total benefits and determines the percentage of network benefit and non-network benefit.

***Total network benefit is found to be $1.5m and the benefit is 80% network and 20% non-network*.**

Benefits:

- Network benefits: $1.2m (0.8x $1.5m)
- Non-network benefits: $0.3m (0.2x $1.5m)

DNSP accounts for Government funding grant and costs using 80/20 ratio.

Cost allocation:

- Regulated (network) services (**RAB**): $0.96m (80% x $1.2m)
- Non-regulated (non-network) services: $0.24m (20% x $1.2m)

The grant funding of $0.4m is then deducted from either cost stack.

Cost allocation if 100% of grant funding is applied to regulated cost stack:

- Regulated services (**RAB):** $0.56m ($0.96m-0.4m)
- Non-regulated services: $0.24m (remains the same)

Cost allocation if 100% of grant funding is applied to non-regulated cost stack:

- Non-regulated services: $0 ($0.24m – $0.24m). i.e. max deduction that can be taken out of non-regulated cost stack.
- Regulated services (**RAB):** $0.8m (0.96m - $0.16m) i.e. remaining grant funding of $0.16m must be applied to the regulated cost stack.

2.3 Expectations of evidence to be provided

We expect a **DNSP** to provide rigorous evidence to support the allocation of costs to the **RAB** as noted in our Final Decision, at the time of **RAB** allocation and annual compliance reporting. This would include an estimation of benefits from both regulated and unregulated streams, a summary of method used to calculate the value of those streams, (including the assumptions used) the expected asset costs, and an assessment against other options for investment in that location.

For costs:

- The **DNSP** must calculate the present value of forecast expenditure for the project (an input to the cost-benefit analysis that informed the investment case).

For non-network benefits:

- The **DNSP** must deduce the benefits of the battery. We note at the time of this waiver decision, the AER considers that non-network benefits would include leasing revenue, or capital contributions from a retail partner. These are quantifiable benefits that accrue to a **DNSP**'s shareholders. However, there may be other benefits that we are not yet aware of that will also fall into this category.
- Within 20 business days of execution, the **DNSP** must provide, the relevant details of the contract that a **DNSP** holds with their leasing partner.
    - We expect to see that this contract, including the leasing rates, has been market tested.
- The **DNSP** must calculate the present value of quantified benefits, which may include wholesale market, network sector and environmental benefits.

3 AER expectations for engagement of third parties

2.3.1 Engaging related entities

More dynamic and robust markets, as well as opportunities for innovation, rely on opportunities for participation by a range of entities. In the case of community batteries, while we acknowledge the key role of **DNSPs**, the full breadth of opportunities and benefits may only be realised through wider participation. The class waiver is not intended to close-off these opportunities.

For both class (a) and class (b) projects, we expect that **DNSPs** will make reasonable efforts to ensure such wider participation. At a minimum, we will look for a **DNSP** to demonstrate that for each project under the Program it has 'tested the market' through a range of efforts. This may include:

- Expression of interest, competitive tender process and/or request for proposals, published publicly and advertised or communicated to all groups equally, that are open for a reasonable period.

- Engagement and partnership models with entities including community-based and consumer groups, local councils, energy services providers and retailers.

The situation of each project will be unique, and the AER expects different approaches may be needed, however, we expected **DNSPs** to be able to demonstrate and justify why they have taken specific approaches.

DNSPs must provide evidence of their undertaking these actions, and the results, on a confidential basis.

When providing this information, the **DNSP** should outline why the specific process was undertaken, and if applicable, why a competitive tender process was not run.

2.3.2 Information about contracts with related entities

The class waiver applies only to specific sections of the Guideline. All other obligations of the Guideline will continue to apply. We will require **DNSPs** to provide on a commercial in confidence basis, within 20 business days of the contract being executed:

- The names and contract details for all parties to the contract

- Information on the volume of capacity in kW or kWh that is leased to that party or parties

- The price the capacity is leased for

- Which party controls the operation of the battery and on what terms

- Information on how the contract satisfactorily addresses the other requirements of the Guideline for the **DNSP**, such as preventing information obtained through the battery project being shared or used for any other purpose.

This information should be provided using the template in Appendix A. We may also require a **DNSP** to provide, on a confidential basis, a copy of the contract.

4 Information on compliance

The class waiver has been granted under clause 5.3A.1 of the Guideline. This provides that the AER may, in its absolute discretion, at any time, grant, vary or revoke a class waiver. In this case, the class of **DNSPs** are those who have installed and are operating a battery funded through the Program.

It is important to note that clause 6.17.2 requires all **DNSPs** to comply with the Guideline. Each **DNSP** covered by the class waiver is responsible for its compliance with the conditions of the waiver. In effect, a **DNSP** who fails to comply with those conditions would no longer be a member of the class to whom the waiver applies.

We have powers to investigate breaches or possible breaches of the Guideline (including the class waiver). We would do this relying on the requirements of procedural fairness, including giving notice to the **DNSP** that a breach of possible breach has come to our attention.

Following such an investigation, we may determine that a **DNSP** no longer satisfies a substantive condition of the class waiver. In that instance, the **DNSP** would no longer be a part of the 'class' to which the waiver applies. This means that the waiver would cease to apply to the **DNSP** and any battery installed under the Program.

The effect of this would be that the **DNSP** would be in breach of the Guideline if it continued to operate that battery. It should be noted that we have powers to institute and conduct proceedings against a **DNSP** involved in such a breach under section 15 of the National Electricity Law. A **DNSP** who continued to operate a battery in these circumstances, whether under either class (a) or class (b) of the waiver, could be open to civil penalty provisions.

4.1.1 Appendix A

4.1.2 DNSP Battery Lease Agreement

The below table is a non-exhaustive form which must be completed by DNSPs subject to the AER's Ring-fencing Class Waiver, entering into lease agreements for community batteries funded by the Commonwealth Government's Community Batteries for Household Solar Program.

When completing this form, DNSPs must not only respond to the prompts, but provide any further terms or conditions which the DNSP reasonably considers may be material to the AER.

Please note that the AER may at any point require a DNSP to provide a copy of the contract in full.

The AER acknowledges the commercially sensitive nature of this information and will treat it accordingly, noting our policies regarding information privacy and disclosure of information.

DNSPs are required to return this form within 20 days of the contract being executed. Where there are any changes to the contractual arrangement, the AER should be notified within 20 business days.

Contract supplied by: [business] [contact person] on [date]

Contractual Information	Contract clause no.(s)	Excerpt/Commentary
Parties and contact details for each party		
Term		
Volume and capacity		
The price		
Payments and/or method of calculating payments and (if applicable) market rate benchmarking		
Terms about who controls the battery		
Codification of ring-fencing		
How the contract addresses the other requirements of the Guideline including but not limited to information sharing		
Include any relevant terms and conditions which the DNSP considers may be material, including but not limited to: any favourable/unfavourable terms for one party; or anything otherwise demonstrating the agreement is/is not an arms' length commercial transaction between unrelated parties		