Final Decision
SA Power Networks
Ring-fencing Waiver

Construction and Maintainence Contracts

September 2018

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Amendment Record

Version	Date	Pages

Contents

Shortened forms

Shortened Form	Extended Form
AER	Australian Energy Regulator
ATO	Australian Taxation Office
CAM	Cost Allocation Methodology
DNSP	distribution network service provider
NEO	National Electricity Objective
NER	National Electricity Rules

1 Introduction

The AER has decided to grant a ring-fencing waiver, effective on 1 October 2018, to allow SA Power Networks to continue to perform contestable construction and maintenance services under 21 existing contracts as in force on 28 September 2018. The waiver is subject to a condition that SA Power Networks must give the AER 30 days' written notice before entering into an extension of any of those contracts.

On 3 September 2018, SA Power Networks applied for a waiver from its obligations under clause 3.1 (legal separation) of the Electricity Distribution Ring-fencing Guideline to continue delivering contestable construction and maintenance services under 21 contracts.[1] SA Power Networks applied to extend a waiver we granted in December 2017 beyond its expiry date of 30 September 2018, in addition to four additional contracts that were not subject to the original waiver.[2]

The original waiver was granted pending a Private Binding Ruling from the Australian Taxation Office (ATO) on tax liabilities that might accrue to SA Power Networks from novating the infrastructure construction and maintenance contracts to its affiliated entity, Enerven. In its waiver extension application of September 2018, SA Power Networks informed us that it has now received a ruling from the ATO. SA Power Networks states that a tax liability of approximately $10 million would arise from novating the contracts to its affiliate Enerven.

We consider there is little or no harm to customers or contestable markets from SA Power Networks continuing to provide services under the contracts. As the contracts were awarded to SA Power Networks prior to the 1 January 2018 ring-fencing compliance deadline, there is no competition for provision of the contracted services. Competition can only occur once the contract ends, and if the contract counterparty re-tenders for the contracted services. SA Power Networks advises that once concluded, it will no longer offer to provide this kind of service. It is seeking the waiver only to fulfil its obligations under existing contracts signed prior to the 1 January 2018 ring-fencing compliance deadline.

Not extending the waiver could increase costs to customers if SA Power Networks successfully applied to pass through costs associated with the estimated $10 million in tax liabilities through to distribution customers. The tax liabilities exceed SA Power Networks' cost pass-through threshold.

The original waiver had an expiry date of 30 September 2018. This waiver extension covers contracts which will conclude outside the current waiver period, as well as four additional non-compliant contracts.

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1 SA Power Networks, Application for extension to waiver from AER Ring-fencing Guideline - legal separation: Other services maintenance and construction contracts, 3 September 2018.

2 Refer to the AER website for our Ring-fencing waiver applications final decision and waiver notice of December 2017 and SA Power Networks' original waiver application of 30 October 2017: https://www.aer.gov.au/networks-pipelines/ring-fencing/ring-fencing-waivers/sa-power-networks-ring-fencing-waiver-august-2017.

2 About ring-fencing

Ring-fencing separates the regulated and contestable parts of a DNSP's network business via legal separation and functional separation obligations. Ring-fencing facilitates competition in contestable markets and makes regulation more effective in markets that are not contestable. It aims to provide a level playing field for third party providers in new and existing markets for contestable services.[3] Without ring-fencing, there is a risk that a DNSP might cross-subsidise unregulated electricity services with revenue earned from provision of distribution (and transmission) services. There is also a risk that a DNSP might discriminate in favour of an affiliate that provides unregulated electricity services, potentially harming competition in contestable markets. Such outcomes could lead to less efficient prices for operation and use of both regulated and contestable electricity services and restrict the development of competition in contestable markets.

In this way, ring-fencing aims to drive effective competition where it is feasible, open up new markets to competition and provide effective regulation where competition is not feasible. Compliance with the Guideline will help to ensure that consumers are empowered to choose the products, services and suppliers they want, with bills that are no higher than they need to be.

The Ring-fencing Guideline recognises that strict adherence to the ring-fencing obligations, might in some circumstances result in outcomes that are not in the interests of consumers. This is why the Guideline makes provision for ring-fencing waivers. Waivers provide the ring-fencing framework with flexibility by allowing DNSPs exemptions, subject to AER approval. We consider that waivers are not to form part of a business as usual approach but may be considered where alternatives are inappropriate. DNSPs will normally be expected to achieve compliance with the Guideline's obligations.[4]

Clause 5.3.2 of the Guideline states that, in assessing a waiver application and deciding whether to grant a waiver (subject to any conditions) or refuse to grant a waiver, we must have regard to:

i. the National Electricity Objective (NEO)

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

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

Clause 5.3.2 of the Guideline also states that we may have regard to any other matter we consider relevant. Some of the factors we have considered in granting past waivers are detailed in our Explanatory Statement to the Guideline, and our Decision on DNSP Applications for Waivers from the Electricity Distribution Ring-fencing Guideline.[5]

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3 AER, Electricity Distribution Ring-fencing Guideline Explanatory Statement, November 2016, p. 1.

4 AER, Electricity Distribution Ring-fencing Guideline Explanatory Statement, November 2016, p. 6.

5 AER, Decision: DNSP Applications for Waivers from the Electricity Distribution Ring-fencing Guideline, December 2017, p.

3 SA Power Networks' waiver application

3.1 SA Power Networks' original waiver

In December 2017 we granted a ring-fencing waiver to SA Power Networks in relation to 20 construction and maintenance contracts. The waiver allowed SA Power Networks to continue performing the 'other services' required by the contracts. The contracts mostly concern the construction of transmission and telecommunications infrastructure, such as pylons or towers. The last contract will expire on 30 June 2021. The contracts are all between SA Power Networks and other large organisations.

This waiver was provided until such time as the contracts either expired or SA Power Networks received a Private Binding Ruling from the ATO indicating that transferring the contracts would not trigger a capital gains tax event. SA Power Networks now advise that it has not received a favourable ruling from the ATO. As a result, SA Power Networks consider that transferring the contracts to an affiliate entity would result in a significant capital gains tax event, estimated to be approximately $10 million.

3.2 SA Power Networks' new waiver application

SA Power Networks submitted an application to the AER to extend the existing waiver on 3 September 2018. SA Power Networks' new waiver application is substantially the same as the previous waiver application that we granted in December 2017. It covers 21 construction and maintenance contracts that will extend beyond 30 September 2018. The final contract concludes on 30 June 2021. Three contracts that were addressed by the previous waiver have concluded. However, the new waiver application includes four contracts that were not included in the previous waiver. SA Power Networks identified these contracts in August 2018 granted and have reported them as breaches of the guideline.

SA Power Networks have also executed variations to some contracts during the waiver period. SA Power Networks have informed us that this is primarily due to the expansion of required works or delays associated with large projects. SA Power Networks advises that these variations were subject to the terms of the original contracts and were requested by the counter-party and not SA Power Networks. The terms of the original waiver did not preclude SA Power Networks from extending its contracts without consultation with the AER. None of the extensions increase the total time for which the waiver will be required.

15; AER, Electricity Distribution Ring-fencing Guideline Explanatory Statement, November 2016, pp. 55, 58.

4 Assessment

In assessing SA Power Networks' original waiver application and its request to extend the waiver expiry deadline and expand the waiver scope to encompass four additional contracts, we have considered factors outlined in Clause 5.3.2 of the Ring-fencing Guideline. In addition to this, we have also considered:

- the likely cost of compliance to SA Power Networks customers and/or the business
- potential harms to contestable markets from allowing SA Power Networks to continue to act as the legal counterparty to these contracts.

4.1 Benefits to customers from SA Power Networks complying with the obligation

We consider that there are unlikely to be appreciable benefits to customers from refusing to grant the waiver and requiring SA Power Networks to comply with its legal separation obligations in relation to the services provided under these contracts. SA Power Networks no longer signs new agreements or market its ability to perform these services. The costs and revenue from these projects will be allocated according to SA Power Networks' Cost Allocation Methodology (CAM) and regulated revenue to will not subsidise these activities. Additionally, the functional separation obligations of the Guideline will still apply in respect of these contracts. SA Power Networks' affiliate entity, Enerven, will effectively provide the services as a functionally separate entity using Enerven branding and Enerven staff. We consider that the combination of functional separation and proper cost allocation is likely to mitigate any harm to the competitiveness of contestable markets.

There is no potential harm to the counterparties who receive these services from granting this waiver. The contract counterparties concerned, signed the relevant contracts prior to the introduction of the new Ring-fencing Guideline. By contrast, if we were to refuse the waiver application and SA Power Networks were forced to novate the contracts, it is possible that there would be disruption in the performance of some elements of the contracts.

Now that the ATO has not issued a favourable ruling, there is no other avenue for resolving these issues prior to the expiry of the waiver. Either SA Power Networks will be forced to withdraw from the contracts, which may result in costs and impose inconvenience on the other parties, or it will novate them and potentially incur a tax liability.

SA Power Networks' original waiver was the subject of consultation as part of our Draft Decision on Ring-fencing Waiver Applications in October 2017, and received no submissions, indicating that this issue does not significantly impact stakeholders.[6]

4.2 Cost of compliance to SA Power Networks

6 AER, Decision: DNSP Applications for Waivers from the Electricity Distribution Ring-fencing Guideline, December 2017, p. 57.

Were SA Power Networks to not seek or obtain approval for a cost pass through event, refusal to grant the waiver would impose costs on the distribution business. SA Power Networks' waiver application highlighted that this tax liability would come on top of costs that SA Power Networks has already incurred as a result of legal separation, rebranding, and setting up staff sharing arrangements for its new legal entity, Enerven.

The Ring-fencing Guideline specifies that, in assessing a waiver application, we will consider the benefits to customers of the DNSP being required to comply with the obligation, relative to the cost to the business of complying with the obligation. In this case we consider that the cost to the business of complying with the obligation are genuine and significant.

4.3 Cost to customers

SA Power Networks' waiver application submits that the estimated $10 million tax liability would meet the criteria for a cost-pass through. This would require that the expenditure meet the NER's definition of a regulatory change event and exceed the materiality threshold. The expected $10 million tax event would likely exceed the materiality threshold of 1% of SA Power Networks' annual revenue requirement.[7] The NER defines a regulatory change event as a change in a regulatory obligation or requirement that occurs during the course of a regulatory control period which substantially affects the manner in which the DNSP provides direct control services and materially increases the costs of providing those services.[8]

We have not made any decision here whether we would approve a cost pass through application for ring-fencing compliance costs if one was submitted by SA Power Networks under clause 6.6.1 of the NER. If a pass through was sought and approved, the estimated $10 million tax liability would be borne by customers instead of by SA Power Networks.

Ultimately, as this cost will be borne either by SA Power Networks (if a cost pass through is not approved) or by customers (if a cost pass through is not approved), our decision to grant the waiver for reasons outlined sections 4.1 and 4.2 is not affected by the possibility of a cost pass through application.

4.4 Future extensions or variations to the relevant contracts

SA Power Networks have informed us that it executed several variations during the current waiver period, as highlighted above. This is in keeping with the previous waiver we granted.

However, we consider that there is some risk that SA Power Networks may agree to extend the relevant contracts in the future, so that they either expire beyond 30 June 2021, or to vary the scope of the services to be provided under the contracts in ways that may alter the appropriateness of this waiver.

As a result, we have decided to grant this waiver subject to a condition requiring SA Power Networks to give us 30 days' notice if it proposes to execute an extension of any of the agreements. This condition would not apply if the extension arises from the relevant

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[7] NER Chapter 10. SA Power Networks Annual Revenue for the 2017-18 Financial Year was approximately $780 million.

[8] NER, Chapter 10.

customer exercising an option already present within the contract to extend or vary the agreement – in these circumstances, the extension would not depend on the future actions of SA Power Networks, and would be outside SA Power Networks' control.

We consider that variations not based on pre-existing contractual obligations would substantively alter the nature of a contract, meaning that it would be inappropriate to do so without a further wavier being sought and granted. This accords with the review process outlined in 5.5 of the Ring-fencing Guideline. We have therefore decided to grant the waiver for the existing contracts only - that is, the contracts as in force at 28 September 2018. For clarity, variations are the establishment of new or varied terms and conditions on which a service is provided, and changes to the range of services that may be sought under the contract.

4.5 Conclusion

On balance, we consider that the cost to SA Power Networks of complying with the obligation substantially outweighs any marginal benefits customers may receive from compliance with the Guideline. We also consider that there is low possibility for cross subsidisation and discrimination if the waiver is granted. For these reasons we consider that granting the waiver subject to an appropriate condition will promote the NEO.

5 Decision

We have decided to grant a waiver from SA Power Networks' obligation to comply with clause 3.1 of the Guideline from 1 October 2018 until 30 June 2021 to allow SAPN to continue to provide maintenance and construction services under 21 existing contracts as in force on 28 September 2018.

This waiver is granted on condition that SA Power Networks notify the AER 30 days' prior to entering into an extension of any of the relevant contracts. For clarity, this condition does not apply if the extension arises from the relevant customer exercising an option to extend or vary the agreement.