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Dear Sirs,

ISSUES CONCERNING EMBEDDED NETWORKS IN STRATA SCHEMES

We are writing to you to identify significant issues which strata owners corporations are experiencing with such networks and to suggest possible legislative solutions.

The issues

Embedded networks are becoming more and more common in strata developments and more and more new lot owners are becoming aware too late what an expensive trap these can be. Recent reforms have not adequately dealt with the issue and further reforms are required.

Embedded networks involve installation within a building, during the construction phase, of infrastructure required for delivery of various utilities and services. Using electricity as an example, there would typically be a "parent" or "gate" meter between the infrastructure forming the national electricity grid and the meters of individual occupants. This creates a private network, known as an "embedded network", through which an "embedded network service provider", acquires energy supplied by an authorised retailer and on supplies electricity to "embedded network customers". However, these arrangements can involve a wide range of services beyond grid electricity, e.g. solar electricity or heating, gas, heating, air conditioning, potable water, hot water, chilled water for cooling, telephone, internet access, storm water and waste removal systems.

These arrangements can be legitimate, involving facilitation of efficient delivery and competitive pricing of services, which have been disclosed in "off the plan" sale contracts. However, they appear more commonly to be a means of passing on development costs and squeezing substantial additional amounts out of owners corporations and occupiers. Australian Energy Market Operator research and our own experience suggests that, in relation to electricity supply, although these arrangements are generally "sold" on the basis of bulk buying leading to more competitive pricing, the reality is that embedded network customer prices are at the high end of the spectrum.

The problem scenario typically involves:

- A third party operator installing infrastructure, which the developer would otherwise have supplied, which is owned by the operator and not the owners corporation.
- The operator using the infrastructure to provide some service to the owners corporation and occupants or allowing the owners corporation to use the infrastructure to supply the service to itself and occupants. In the latter case, the operator will typically set itself up as manager for the owners corporation and charge a management fee. In both cases, there will usually be a hefty purchase price for the equipment at the end of the term (which is typically long) and exorbitant service charges and network use charges in the meantime.

- All of this being regulated by a contract negotiated by the developer and ratified by the owners corporation at the first AGM, at a point where other lot owners are disadvantaged by complex arrangements which they don't understand, lack of adequate disclosure, the strata manager likely having been appointed by the developer and being unable to provide proper advice and a perception that there is no practical alternative, the infrastructure already being in place and services being required urgently.

Legislative Response

The legislative response, though well intentioned, has done little to effectively address this issue. In particular:

- The NSW Government has passed the Fair Trading Legislation Amendment (Reform) Act 2018, the so called "better business reforms". It received assent on 31 October 2018 and commences 1 July 2020 or an earlier date appointed by proclamation, possibly 1 July 2019. It makes the following changes to the Strata Schemes Management Act 2015 ("SSMA"):
    - It inserts a new Division 7 in Part 6 of the SSMA, involving a new Section 132A, which provides that an agreement for the supply of electricity, gas or any other utility with an owners corporation:
        - Has a maximum 10 year term if in place before the amendment commences.
        - Expires at the conclusion of the first AGM if executed before that meeting.
        - Has a maximum 3 year term if executed at or after the first AGM.
    - It inserts a new paragraph (e) in Clause 6 of Schedule 1 of the SSMA, introducing as a new mandatory AGM agenda item, consideration of "any agreements for the supply of electricity, gas or any other utility relevant to the scheme".

    However, these measures fail to provide meaningful assistance with embedded network issues. In particular:

    - Supply of electricity to occupants through an embedded network is expressly excluded.
    - The section is limited in scope to supply of utilities and fails to address the real problems for owners corporation and occupants, including:
        - Third party ownership of vital building infrastructure, especially where the owners corporation is required or needs practically to purchase the infrastructure to free itself of the operator.
        - Management agreements with third party operators, especially where these involve uncommercial fees and charges.
        - Network usage agreements with third parties, especially where these involve a network use fee, as distinct from a utility supply fee.
        - The ability of developers to introduce such arrangements without transparency.

- The National Electricity Law and the National Electricity Rules provide a regulatory framework for embedded electricity networks and additional customer protections have been introduced over the last few years. In particular, they impose registration requirements, including that the operator of an embedded network:

    - be registered or have a network exemption in relation to operation of the network.
    - have a retail authorisation or a retail exemption in relation to sale of electricity through the network.
    - comply with various conditions attached to these authorisations/exemptions, failing which the operator could be operating the network illegally and be exposed to substantial penalties. These confer various customer rights, including in relation to permitted charges, billing & payment arrangements, dispute resolution, customer choice of an alternate retailer and requirement of an embedded network manager "to address technical issues presenting barriers to retail competition".

    In practice, these measures provide little practical assistance to an owners corporation stuck with an uncommercial embedded network. Factors working against owners corporations here include:

    - These measures being limited to electricity and not extending to the various other kinds of embedded network.
    - These measures dealing with supply and not extending to related agreements, such as:
        - Management agreements and management fees.
        - Third party ownership of building infrastructure and imposition of network use fees and infrastructure purchase requirements.
    - So far as electricity supply is concerned, the technical difficulties, costs and retailer reluctance involved in persuading an alternate retailer to supply to customers in embedded networks. The basic problem is that, where third party electricity supply infrastructure is already in place, it is generally impractical to use that infrastructure or install additional infrastructure for the purpose of receiving supply from an alternate retailer, locking the owners corporation into the existing arrangements.
    - Developers and third party operators often frame the embedded network arrangements such that the owners corporation is the operator of the embedded network and the third party acts as a manager, in an attempt to shift obligations from the third party to the owners corporation.
- The Energy and Water Ombudsman NSW ("EWON") can receive and deal with complaints by embedded network customers. However, EWON decisions on complaints by customers of embedded networks will only be enforceable against embedded network operators who are EWON members, exempt sellers not being required to be members.

Proposed Solution

The current regulatory framework places owners corporations, strata committees and lot owners at a distinct disadvantage compared to developers and third party service providers. The limited

requirements for disclosure and transparency, the complexity of the arrangements (even if disclosed) and the limited remedies after the event enable developers to trap owners corporations into arrangements which are highly beneficial to the developer, but very much adverse to the owners corporation's interests. This unfair playing field needs to be levelled.

In our view, the following legislative measures would present a more effective solution and should be considered:

1. Conveyancing Act 1919 ("CA") & Conveyancing (Sale of Land) Regulation 2017 ("CR")

Section S52A(2)(a) of the CA provides that vendors must attach prescribed documents to the contract for sale, which include those set out in Schedule 1 of the CR.

Section S52A(2)(b) of the CA imposes prescribed implied warranties into the contract for sale, which include those set out in Part 1 of Schedule 3 of the CR.

These involve issues which are rightly considered matters which should be brought to a purchaser's attention before entry into a contract. It is entirely consistent and reasonable that matters concerning embedded network arrangements be brought to a purchaser's attention. Considerations:

- At the very least, this should be the case with "off the plan" sale contracts, where a purchaser is unable to conduct its own enquiries, by inspecting strata records. However, given the complexity of the arrangements involved, there is a strong case for extending this to all sale contracts.
- This could be effected by:
    - Adding to Schedule 1 copies of any agreements with third parties relating to:
        - the existence of an embedded network.
        - the supply of utilities and services to the common property and/or lot through an embedded network.
        - the management of the embedded network or supply through the embedded network.
    - Adding to Part 1 of Schedule 3 a warranty that, other than as may have been disclosed to the purchaser:
        - All infrastructure required for supply of services and utilities to the common property and/or lot will be owned by the owners corporation.
        - That there are not and will not on completion be any agreements in place with third parties relating to the existence of an embedded network, the supply of utilities and services to the common property and/or lot through an embedded network or the management of the embedded network or supply through the embedded network.

- This would be relatively straightforward for a vendor to address, especially in an "off the plan" sale context, where the developer is familiar with the arrangements and entering into substantially the same contract with all purchasers.

- Without this measure, it would be virtually impossible for a purchaser to properly assess what they are purchasing and what their costs will be as owner of the lot being purchased.

2. SSMA: Section 184

Section 184 provides for the issue of certificates by owners corporations, typically by their strata managing agent on their behalf, advising as to various prescribed matters concerning the scheme and lot. These have become important to strata conveyancing practice, enabling prospective purchasers to verify matters disclosed or warranted in sale contracts.

It is consistent and reasonable that the existence of embedded network arrangements and associated supply and management arrangements be disclosed in same way.

This could be effected by adding to the matters to be disclosed in a certificate under Section 184, copies of any agreements with third parties relating to:

- the existence of an embedded network.

- the supply of utilities and services to the common property and/or lot through an embedded network.

- the management of the embedded network or supply through the embedded network.

This would be relatively straightforward for a strata managing agent to address, with the arrangements (if any) being recorded in the scheme's records and substantially the same information being provided to all applicants.

Without this measure, purchasers would have difficulty verifying the new CA warranty proposed above.

3. Strata Schemes Development Act ("SSDA"): Section 24(2)

Section 24(2) provides in effect that, on registration of a strata plan:

- The common property vests in the owners corporation.

- The common property is freed from encumbrances and leases, except "a lease that is necessary for the purpose of providing a service to the scheme".

- This is without prejudice to the lessee's rights, other than in relation to the common property.

In our experience, this causes considerable confusion in relation to schemes with embedded networks, because the agreement between the developer and third party operator regarding installation and retention of the embedded network infrastructure is generally not framed as a lease and may or may not be <u>necessary</u> for providing a service. This leads to doubts:

- About ownership and retention rights. As a fixture, does it now form part of the common property and vest in the owners corporation? If not, does the third party still own it, but lack the right to retain it on site and need to remove it?

- About respective liabilities. Depending on the answer to the issue raised in the previous bullet point, does the third party have compensation rights and who against, i.e. the developer or the owners corporation?

- About possible actions against the developer. Case law suggests that the developer owes a fiduciary duty to the owners corporation and it follows that, if the developer receives undisclosed benefits by passing on the cost of providing infrastructure to the owners by inflated prices in long term contracts, the developer may be breaching its fiduciary duty and be liable to the owners corporation on this basis or under the law relating to secret commissions.

It would be highly desirable to remove this confusion by amending Section 24(2) to the effect that, except to the extent recorded on title by registered lease or disclosed to all purchasers in their respective contracts for sale, on registration of the strata plan:

- All infrastructure within or attached to the common property required for the provision of any service vests in the owners corporation and any third party right to it are extinguished.

- Subject to any contrary agreement between the original owner and the third party, the developer must compensate the third party for any extinguished rights and indemnify the owners corporation in relation to any claim against the owners corporation.

4. SSMA: Division 7

Section 132A, when it commences, will cap the term of certain utility supply contracts. However, this does not extend to the supply of electricity through embedded networks.

This mirrors caps on terms of other owners corporation agreements, such as strata managing agent agreements and building management agreements, where there is a legitimate concern about the ability of a developer to lock an owners corporation into uncommercial contracts with third parties. It is consistent with this approach and reasonable that other forms of management agreement be subject to the same safeguards, i.e. agreements for operation or management of embedded networks or management of supply of utilities be subject to the same caps. In fact, given the complexity of the issues involved, there is a strong case for additional safeguards for agreements executed at the first AGM, particularly, a requirement that the validity of such an agreement to be conditional on:

- A copy of the agreement being circulated prior to the meeting.

- The owners corporation receiving independent legal advice in relation to the agreement for consideration at the meeting.

- The strata managing agent, who may have been appointed by the developer and be conflicted, disclosing that and not advocating entry into the agreement without independent legal advice.

Without this measure, it would be impossible for owners corporations, at this vulnerable period, to avoid being locked into long term uncommercial arrangements by developers.

5. SSMA Section 26

Section 26 prohibits entry into specified arrangements during the initial period (the period during which owners of lots, other than the original owner, have unit entitlements less than one-third of total unit entitlements), including:

- incurring a debt for an amount that exceeds the amount then available for repayment of the debt from its administrative fund or its capital works fund.

- appointing a strata managing agent or a building manager or other person to assist it in the management or control of use of the common property, or the maintenance or repair of the common property, for a period extending beyond the holding of the first annual general meeting of the owners corporation,

In practice, it can be difficult to enforce these rights, as:

- Developers have an available defence, involving being unaware of the contravention.

- Developers can (and do) frame the embedded network arrangements to the effect that amounts which would have been payable prior to conclusion of the initial period are deferred until conclusion of the initial period and can then be recovered retrospectively, arguably circumventing Section 26.

It would be consistent and reasonable to extend these protections to embedded network arrangements, i.e. to prohibit entry into arrangements, during the initial period, relating to operation or management of embedded networks or management of supply of utilities for a term spanning beyond the first AGM.

Without this measure, it would be impossible for owners corporations, at this vulnerable period, to avoid being locked into long term uncommercial arrangements by developers.

If you have any queries please contact me.

Yours faithfully
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