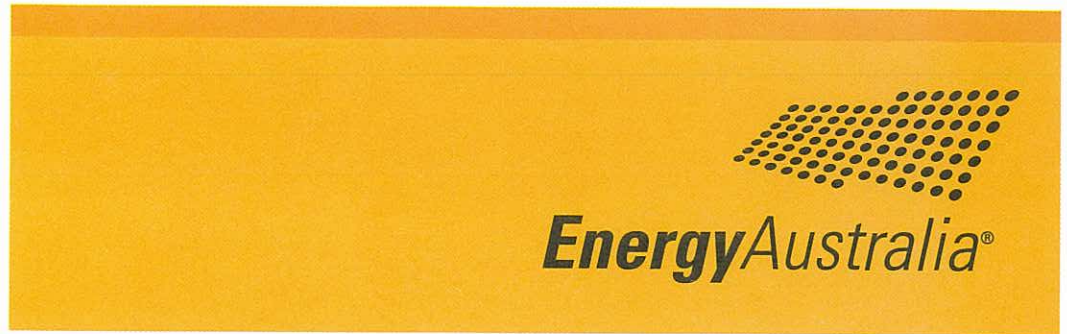


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23 July 2010

Mr John Pierce
Chairman
Australian Energy Market Commission
Level 5, 201 Elizabeth Street
SYDNEY NSW 2000

Dear Mr Pierce

Cost Recovery for Mandated Smart Metering Infrastructure: EnergyAustralia's submission to the AEMC's draft report

EnergyAustralia appreciates the opportunity to respond to the Australia Energy Market Commission's draft report on Cost Recovery for Mandated Smart Metering Infrastructure.

I understand from the Commission's draft report that it is seeking feedback on whether the proposed amendments outlined in the report are the most appropriate solution to the issues identified and, if so how they should be applied. The Commission has also indicated that it would appreciate stakeholder views on the appropriate scope of proposed amendments that may be beneficial if applied to all network expenditure.¹

EnergyAustralia acknowledges and supports the Commission's overall assessment that existing processes for cost recovery are reasonably adequate and therefore no fundamental changes are required to support mandated smart meter roll-outs. However, we find it difficult to reconcile this assessment and the subsequent comment on recommending only incremental changes to the existing framework², against the findings and far reaching recommendations contained within a 163 page report (supplemented by a consultant's report and legal advice).

Our view is that, rather than being incremental, some of these draft findings and recommendations depart considerably from the basic tenets of the incentive regulation framework under Chapter 6 of the National Electricity Rules. We consider that many of the AEMC's proposed amendments go beyond what is needed to ensure that the economic framework can adequately cater for a mandated smart meter infrastructure roll-out. These recommendations go much further than incremental changes to the existing framework.

The recommendations also go beyond the scope of changes required for mandated SMI investment and in some instances offer a complete change of course to the existing incentive regulation

¹ AEMC draft report page vi

² AEMC draft report pages i and iii.

framework. For example, the suggestion to provide the AER with the discretion to roll forward the regulatory asset base on the basis of forecast depreciation for all assets with a standard life below a specified level (suggested as 15 years), rather than only SMI assets³ appears to be beyond the scope of the terms of reference for this review. In our view, this review should focus on the demonstrable need for a different regulatory approach to mandated SMI investment. Recommendations that have application beyond mandated SMI investment should be subject to a wider review.

We are concerned that many of the recommendations are based on assertions that are not evidence based and, to some extent, fail to recognise the practical realities of operating within the regulatory determination framework under Chapter 6 of the Rules.

In our response to the AEMC's scoping paper we submitted that the focus of any review should be on the unique characteristics of an imposed mandate to accelerate smart meter investment and the extent to which these unique characteristics require amendments to the rules.

We agree with the AEMC's statement that, under a Ministerial smart meter roll-out or pilot determination, there is a shift in the responsibility and accountability for the parameters of the investment from the DNSP to the Minister. In particular, we noted that a defining characteristic may be that governments impose a mandate on the basis of potential benefits and may seek to return those benefits to customers from DNSPs, whereas the potential benefits do not accrue to DNSPs but are rather split between parties in the value chain.

We accept that the uncertainty surrounding the costs and benefits of a mandated smart meter roll-out is a key issue that needs to be addressed in this Review. Ministerially imposed investment parameters and timing added with potentially untested and unrealistic operational benefits which are used to justify the initial investment places significant regulatory risk on the DNSP to which a mandate is imposed. Added to this is the additional uncertainty of the treatment of this investment in future periods and the treatment of legacy assets which this investment replaces now.

While acknowledging that this does not require substantive change to the regulatory framework, we would have expected more attention given to addressing the additional regulatory risk attributed to the DNSP as a result of mandated requirements to roll-out smart meter infrastructure.

It is disappointing that the AEMC's report fails to properly acknowledge the additional risk to DNSPs caused by mandated roll-outs. Instead the AEMC appears to make proposed changes based on the proposition that there are windfall gains to be made. This is demonstrated in the following comment:⁴

"In these circumstances [of high uncertainty surrounding costs and benefits of a mandated roll out], the DNSP may seek to limit its risk by building an increased allowance for contingencies into its forecasts of costs and benefits. Other things being equal, the presence of uncertainty could therefore be expected to lead to an increase in the DNSP's forecast expenditure for the mandated SMI."

The approval of a higher level of forecast expenditure as a result of uncertainty during the distribution determination process has the potential to lead to windfall gains being made by the DNSP during the regulatory control period. If the DNSP does not require the contingencies that have been included in its forecast expenditure, actual costs will be lower than forecast costs by an increased margin. If significant uncertainty remains when the AER makes its distribution determination, then it is likely that this uncertainty could result in the AER approving a higher level of forecast expenditure."

³ AEMC draft report page 29

⁴ AEMC draft report page 20.

Again, the justification of this conclusion appears anecdotal and not necessarily based on hard evidence. This type of comment fails to appreciate the regulatory assessment process that occurs under Chapter 6 of the Rules.

We believe the conclusions reached by the AEMC incorrectly suggest that the regulatory framework is dominated by asymmetric upside benefits to the DNSPs, particularly where there is uncertainty surrounding costs and benefits. The primary solution proposed by the AEMC to address this in almost all circumstances is to grant the AER open ended discretion to determine how those incentives will operate – in some cases after the fact. This is a shift in the wrong direction. It adds an additional layer of regulatory uncertainty that is unhelpful and unnecessary for these types of investments.

Some of these changes significantly impact the basis for the economic incentive framework and the fit for purpose model which has been adopted previously by the AEMC and MCE – all for a process which the AEMC states upfront should not require fundamental change.

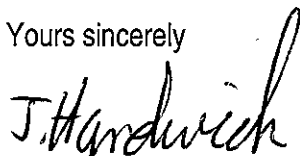
Even if the AEMC's proposals are limited only to SMI investment, because there is little separating the regulatory approach for MCE imposed smart meters and other network investment, we are concerned that the AEMC's proposals will gain legitimacy in other regulatory approaches. As a result, proposed changes intended for Ministerially imposed smart meters are applied more broadly to other network investments on the basis that there is little differentiating them.

We consider that any recommended changes, even those we support, that are not specific to the unique attributes of mandated smart meter roll-outs should be subject to wider consultation and tested against a broader range of distribution and transmission investment scenarios. It is inappropriate to make Rule changes to the regulatory framework for network investment based on a limited scope of review of mandated smart meter roll-outs.

EnergyAustralia's specific responses to the draft findings and related questions contained in the draft report are attached to this letter.

If you have any questions on the attached example, please do not hesitate to contact Ms Jane Smith on 9269 4171.

Yours sincerely



JOHN HARDWICK

Executive General Manager (acting)
System Planning and Regulation

Response to AEMC's Draft Report

Cost recovery under the distribution determination process

Draft Finding 1: DNSPs have an ability to seek recovery for mandated SMI expenditure under the current distribution determination process.

EnergyAustralia agrees with this finding. We note that the AER also currently has discretion at the time of the determination whether to roll forward the asset base using actual or forecast depreciation. This applies equally to all investments and is not dependant on the age or relative uncertainty of the investment.

Therefore, under current Rules, the AER can make decisions around the recovery of mandated SMI expenditure and, in terms of applying incentive mechanisms, can take into account the existence or likelihood of a mandated roll-out when making its decision.

Draft Finding 2: DNSPs would have an incentive to delay the roll-out of smart meters under the current distribution determination process.

We do not agree with this statement. The AEMC's discussion surrounding DNSP incentives to delay investment appears anecdotal rather than empirically based and ignores a wide range of factors that may influence timing of investment. It ignores the broader economic incentives offered in the regulatory framework and other incentives placed on the DNSP by the Minister in respect of a roll-out.

The AEMC notes that where a Ministerial determination has specified annual roll-out targets, non-compliance with the Ministerial determination would be considered a breach of the NEL, and the AER may be able to seek a court injunction to require the DNSP to comply with the Ministerial determination. This appears to be quite a strong incentive not to defer investment.

We note the AEMC's analysis regarding the proportion of capital expenditure savings retained by DNSPs over an assets life. We accept the calculations provided by the AEMC regarding the proportion of underspend retained by a DNSP based on different age profiles. However this analysis needs to be considered in context. We note in the most recent draft determination in Victoria that the AER was not convinced that the underspend of capital expenditure was related to efficiency and on this basis substituted a lower capital expenditure forecast than proposed by the DNSP in the forthcoming regulatory period.

"A major feature of an incentive based regulatory framework is that the regulated firm should achieve efficiency gains whereby actual expenditure is lower than the forecast. However, equally it is the case that the regulator must take great care to ensure that the forecasts adopted are accurate and well substantiated as the observed difference may be due to efficiency gains, forecasting errors or to some combination of the two competing explanations. This AER's trend analysis suggests that the DNSPs' capital expenditure forecasts tend to systematically over estimate capital expenditure. DNSPs appear to spend significantly less than forecast, and previously allowed, and DNSPs' actual capital expenditure tends to follow a fairly gradually increasing trend.⁵"

"The AER has compared the actual SCADA and Network Control capex incurred in the current and previous regulatory control periods with the corresponding ESCV allowances. The

⁵ AER, Draft decision for Victorian DNSPs, June 2010, p282

*observed trends in actual capex have been considered in the AER's estimate of the required capex for the forthcoming regulatory control period*⁶

Economic regulation of monopoly businesses is a repeat game. While it may be theoretically correct to say that there is a within period incentive to delay investment, – if this delay is not founded in efficiency considerations – it may result in unfavourable regulatory decisions in future periods. In the alternative, if the underspend can be demonstrated to be on the basis of efficiencies generated within the business, we would consider this to be an outcome of the incentive at work – not a “windfall” gain as the AEMC suggests.

We note, and disagree with the AEMC's proposed solution to address the perceived incentives to delay investment and outline our reasons why in response to Question 1.1.

Draft Finding 3: Where there is uncertainty around the costs and benefits of SMI when a distribution determination is made, the current process may not promote recovery of the efficient costs of mandated smart meter roll-outs.

We do not agree with this finding and particularly disagree with the inference that the risk is asymmetric – ie that allowed expenditure forecasts are likely to be higher than out-turn efficient costs. We also consider that the issues of forecasting uncertainty is not specific to smart meter infrastructure and the issue of forecast costs and future benefits is a critical issue of engagement between regulator and regulated business during the distribution determination process.

The comments in the draft report stating that the DNSP can build in contingencies that may result in windfall gains⁷ fails to appreciate the level of scrutiny undertaken by the AER in determining efficient and prudent costs. To suggest that there is a potential for in-built contingencies that may result in windfall gains seems to suggest that there is a failure in the regulatory process under Chapter 6.

These suggestions are unfounded and not evidence based. We are concerned that the AEMC appears to have based recommendations on these unfounded suggestions. In our view, the unfounded conclusion about the potential for windfall gains leads to an equally set of unfounded solutions that circumvent what we consider important reforms to regulatory design over the last 5 years.

In our view, regulatory outcomes from investments with uncertain costs and benefits are likely to be more unfavourable to the DNSP and have a higher risk of not allowing an appropriate return for the uncertainty inherent in an investment if the regulator is provided more open discretion to determine what forecast costs and benefits are likely to be and what incentives will apply.

Draft Finding 4: The AER potentially has an ability to request information on the costs and benefits of mandated SMI under the NEL, subject to such information being required to assist make a cost recovery decision.

Our comments on the AEMC's conclusions and recommendations on information powers are provided in response to question 1.2 below.

⁶ AER, Draft decision for Victorian DNSPs, June 2010, p405

⁷ AEMC draft report page 20

Draft Finding 5: DNSPs have an ability to recover efficient third party costs under the distribution determination process that may be incurred in undertaking a mandated smart meter pilot or trial.

We agree that a cost provided to a third party to meet a Ministerial obligation would be a cost incurred in providing a standard control service. However, we do not believe that this extends as far as passing through directly third party costs – ie these costs would be subject to the same considerations as any other forecast submitted to the AER.

Question 1.1 Should the AER be able to apply the proposed mechanisms to address remaining uncertainty (ie the roll-forward of the RAB on the basis of forecast depreciation and the cost sharing mechanism) to other distribution investments, where the potential costs and benefits of such investments are uncertain at the time a distribution determination is made?

We disagree with the AEMC's proposed solutions to address what we believe to be an incorrect finding in relation to the existing regulatory framework. They should not be applied to mandated smart meter roll-outs or any other network investment. This applies to all the changes recommended by the AEMC.

Recommended changes to address perceived incentive to delay investment

We find no basis for the AEMC's findings that placing open ended discretion with the AER to choose the level of incentive to apply to businesses assists in the promotion of recovery of costs and benefits which are uncertain.

Such a regime allows the regulatory discretion to set a zero incentive for volume variance but a potentially high powered variance for cost variance. It also ignores the fact that where fewer meters are rolled out, per unit costs may increase. Open ended discretion gives the incentive for the regulator to make no allowance for this fact but make negative adjustments for volume difference.

While the AEMC proposes a fixed/variable cost differential it also proposes to confer complete discretion upon the AER as to how it is applied and therefore only adds to uncertainty and ambiguity. If such a framework is to work at all, it should be prescribed and the cost impact limited to per unit materials costs.

The revenue adjustment incentive exposes the DNSP to risk of delay due to factors beyond its control. In these instances, DNSPs may incur higher costs. There is no discussion about resetting cost differences, so the DNSP is subject to the AER's unit cost forecast, irrespective of whether the AER's forecast is efficient or not.

The AEMC's proposed incentive therefore creates a "double hit", penalising the DNSP for timing delay and out-turn costs which are above AER forecasts.

As a minimum, the rules should be explicit in restricting the incentive so that costs (such as planning, back office systems etc) not dependant on the number of meters rolled out should not be included in any revenue adjustment.

Recommended changes to address the perceived uncertainty regarding SMI investment

There is no demonstrable evidence suggesting a remote meter investment is subject to any more or less certainty than other types of infrastructure and enabling investment undertaken by a DNSP. However, this should not be seen as an opportunity to apply proposed changes to the

Rules more broadly. On the contrary, we believe to the extent the proposed changes can be subject to other types of network investment it should be subject to wider considerations and outside the scope of this particular review.

There may be benefit in reviewing the depreciation incentive for short-life assets but this should not be confined to review solely in the context of mandates for SMI roll-out. The AEMC should subject this to wider review if it believes there is benefit to the regulatory framework as a whole. In any case both proposed incentive mechanisms add additional complexity and regulatory uncertainty.

We see no benefit in open ended discretion on the application of high powered and low powered incentives. If the AEMC believes there is sufficient uncertainty to adopt lower powered incentives for mandated SMI investment it should apply a blanket transitional arrangement to mandated SMI roll-outs or adopt a more fit for purpose decision making framework which places guided discretion and accountability on the AER for any decision it makes.

Providing the AER increased discretion creates investment uncertainty in the short-term, and significantly complicates the regulatory process. Separating SMI assets with lower economic lives (compared to other assets) could be problematic and result in distortionary and inefficient outcomes. It is also not clear whether the intention is for the incentive to apply to beginning economic life or remaining economic life. Open ended and unguided discretion could also mean that the AER could apply a high powered mechanism for under 15 year assets and a low powered for above 15 years which would be contrary to the intended outcomes.

Question 1.2 Do you consider that a specific information provision requirement should be included in the Rules to require DNSPs to provide annual information on the costs and operational benefits of mandated smart meter roll-outs, pilots and trials? Or do you consider that the AER's current information gathering powers under the NEL are sufficient?

EnergyAustralia strongly opposes the imposition of any additional information gathering powers in the absence of a clear demonstration that the existing powers are inadequate. The existing information gathering provisions under the Rules are far reaching and provide the AER with the power to require any network service provider or indeed any person to provide it with information if it believes that person is capable of providing information that the AER requires for the performance or exercise of a function or power conferred by the NEL or the Rules. The AER's powers are even more extensive in relation to network service providers in that NSPs can be required to collect and maintain information in a particular form even if it does not normally collect and maintain that information. The AER has clear powers in relation to all aspects of the economic regulation of distribution services provided by network services and it is therefore not apparent how it could be necessary to enhance these powers further.

The Commission's report appears to indicate that the advice provided by AAR supports the need for increased information gathering powers, whereas it is clear from that advice that the AER has the power to require a DNSP to provide any information it requires for the performance of its powers and that the best approach would be for the AER to include its requirements in this regard in a regulatory information order so that it is provided periodically by the DNSPs. There is no suggestion in the AAR advice that these powers are in any way limited. EnergyAustralia is very concerned at a growing tendency for policy makers to recommend the imposition of additional reporting obligations as a "just in case" measure without proper consideration being

given to the costs and benefits of the imposition of such an obligation. The DNSP bears the risks and costs of the obligation and almost always absorbs these hidden costs.

Once information gathering and reporting powers are conferred there is no accountability placed on regulators, or policy makers, for the information requirements they impose. There is rarely a consideration of the costs incurred. In reality the collection and reporting of information is costly for a DNSP particularly if required in a format prescribed by the AER that requires systems, internal controls audit requirements and management sign off on the basis of accuracy and completeness.

Consequently we strongly submit that the AER's existing powers to request information are more than sufficient to allow DNSP SMI expenditure to be scrutinised. If the AEMC still considers that

- A further layer of information powers is necessary; and
- that annual reporting requirements would deliver information that is accurate, meaningful, and useful,

it would be important for the AEMC to clarify the context of those information powers under the Rules against the wide ranging powers to obtain information through a regulated information instrument under the NEL or other head of power.

Mid-period cost recovery for mandated roll-outs

Draft Finding 6: The current timing of the distribution determination cycles provides each relevant jurisdictional Minister with a reasonable opportunity to coincide a Ministerial roll-out determination with the start of the next distribution determination process. We advise that, where possible, jurisdictional Ministers should seek to align the timing of a Ministerial roll-out determination with the distribution determination process, so that expenditure for a mandated roll-out commences with the start of the next regulatory control period. There are significant benefits in aligning the consideration of mandated smart meter roll-out expenditure with the distribution determination process. In particular, aligning the timing between these processes would remove the need (and associated costs) for separate arrangements to operate within a regulatory control period.

We accept and strongly support the AEMC's preference for Ministerial determinations to coincide with existing regulatory timetables as this minimises the need to amend the existing regulatory framework. However we simply do not agree with the AEMC's next best solution to defer the AER's decision on expenditure to the end of the period in which the expenditure takes place⁸ and for it to perform an ex-post review on the efficiency of the incurred expenditure.

The AEMC's recommendation:

- Creates considerable uncertainty and regulatory risk, with no proposed compensation.
- Burdens the DNSP with the financing costs during the period with the added uncertainty of the regulatory risk at the end of the period of having the investment "optimised".
- Moves toward a cost to serve mentality for SMI infrastructure.
- Incentivises investment by DNSPs to maximise the likelihood of cost recovery rather than investment to maximise benefits to consumers (for example a DNSP may not pursue a more costly investment that would offer benefits to consumers if there is a risk that this additional cost may not be recoverable). Ex-post reviews would incentivise risk minimisation which is not necessarily in the long-term interest of consumers.
- Provides less incentive to drive efficiency.

⁸ Draft report page iv and 34

- Is no less complex than an ex-ante cost pass through as the same information and analysis would be required.

We do not consider that proposed AER guidelines or the inclusion of a "no hindsight" rule are sufficient to avoid substantial regulatory uncertainty and perverse incentives for the regulator to minimise impacts to customers at the expense of prudent investment returns.

We are particularly concerned with the AEMC's policy direction which advocates open ended discretion for the regulator to choose the power of the incentive that may apply to a network in respect of an SMI investment. We think such an approach only adds to regulatory uncertainty and creates incentives for perverse regulatory behaviour.

In a climate where the AER will be under pressure to minimise price impacts for customers, it might be very tempting for the AER to effectively adopt a "heads I win tails you lose" approach to ex-post review claiming any under-spend is related to timing but any overspend is related to efficiency.

We do not accept the AEMC's claim that this approach avoids additional regulatory costs. Rather than assess a total forecast expenditure requirement, the AER must make further assessment of a particular segment of historic capex and opex. There is no avoidance of additional regulatory costs. If anything, the proposed arrangements create additional burdens on the regulator and regulated business in a relatively streamlined process.

We note the AEMC's comment:

*"We have also considered amending the current cost pass through provisions to address the issues we have identified. However, we consider that to adequately adapt the current provisions to promote the recovery of efficient costs would result in a fundamental re-drafting of the current provisions. As there is no justification to amend the provisions for other cost pass through events to the same extent, this would result in a separate arrangement for mandated smart meter roll-outs in any event."*⁹

However, we see the proportionate impact of changes to pass through provisions much less significant than the proposed approach advocated by the proposed changes, as it does not as substantially impact the incentive properties inherent in the determination process. In contrast, we see inclusion of an ex-post review mechanism and a set of principles for ex-post review mechanism a fundamental redrafting of the current provisions.

Draft Finding 7: A Ministerial roll-out determination is consistent with the definition of a service standard event and would permit a DNSP to seek cost recovery through the current pass-through provisions. Hence, it is not essential for the AER to nominate a separate smart meter event to facilitate cost recovery of mandated smart meter roll-outs.
We support the AEMC's position.

Draft Finding 8: The current pass through provisions would not adequately accommodate the recovery of the efficient costs of a mandated smart meter roll-out. The timeframes for the cost pass through process are not appropriate for mandated smart meter roll-outs given the scope and complexity of a roll-out. The AER's criteria for assessing expenditure, including the ability to take into account off-setting benefits, is not clearly specified in the

⁹ Draft Report, p44

Rules. The Rules need to be amended to include a new mid period cost recovery mechanism to accommodate the recovery of the efficient costs of mandated smart meter roll-outs.

We strongly support the AEMC's recommendation that Ministerial determinations align with regulatory control periods to avoid complications with mid-period cost recovery. However we do not understand or support the AEMC's narrow interpretation of the AER's ability to assess costs in relation to a pass through application in the Rules. We note that the pass through amounts are required to represent the incremental costs which would necessitate the offsetting of any benefits associated with investment.

In any case, we note the AEMC's view that "We also note that in the initial years of a roll-out), ...the extent of off-setting benefits may be limited, as benefits are only expected to accrue in line with the number of meters that are rolled-out."¹⁰ So to the extent that the pass through provisions do not cater for the ability to take into account offsetting benefits, the AEMC acknowledges that the impact of this is unlikely to be significant.

If the timing of a Ministerial determination necessitates mid-period cost recovery, we recommend that the AEMC should consider alternative arrangements that provide DNSPs investment certainty whilst allowing the AER sufficient time to assess efficient costs. This could involve extending timeframes to allow the AER to assess efficient costs and benefits.

This could involve a two-step cost recovery pass through process where the AER would approve expenditure for 12 months, which would then provide the AER time to undertake a thorough assessment of efficient costs and benefits to apply for the remainder of the regulatory control period.

Alternatively, amending rules to allow the AER to reopen a determination for a mandated roll-out could be considered.

Both of these options create far less distortion to the existing regulatory framework than the alternative proposed by the AEMC. The AEMC's proposed approach is a significant reversal of previous Commission and regulatory decisions regarding incentive regulation. There has not been sufficient justification regarding why a different approach should apply to SMI. We are substantially concerned the AEMC is creating rules which allow the AER to consider offsetting benefits after the fact and with the benefit of hindsight.

Question 2.1 Would an interim adjustment in prices be required prior to the next distribution determination, where a DNSP is required to roll-out smart meters within a regulatory control period? If so, should this adjustment be based on the forecast costs and benefits outlined in the relevant Ministerial roll-out determination or on the DNSP's own forecasts?

In our view it is important for revenue recovery to commence as close as possible to the incurrance of costs which would further support a within period adjustment as opposed to an end of period look back.

Question 2.2 Are there any other principles the AER should be required to take into account when undertaking its ex-post review?

Note our comments above opposing the introduction of ex-post arrangements.

¹⁰ Draft Report, p44

Mid-period cost recovery for mandated pilots and trials

Draft Finding 9: The ability of DNSPs to seek cost pass through will depend on whether mandated smart meter pilots and trials fall under a pre-existing classification of a service. If so, DNSPs would have the ability to apply for cost pass through for mandated smart meter pilots and trials under a service standard event.

We find the AEMC's discussion on Ministerial mandates to roll-out infrastructure somewhat confusing. It is unclear whether the AEMC is advocating that the arrangement between the Minister and the DNSP is a separate service to other distribution services provided or whether the mandate to roll-out infrastructure is in the capacity of the DNSP's provision of distribution services to customers.

We note the AEMC's comments on the potential functionality of a smart meter:¹¹

"Smart meters refer to meters which are capable of two-way communications... SMI includes the smart meter and the required communications and IT equipment which connects the smart meter to a distribution network. Smart meters can significantly expand the range of functions that traditional meters can provide and ... provide opportunities for improved efficiency in the use and management of the electricity network, and also provide customers with a greater capacity to manage their electricity consumption."

We generally agree with this assessment. Meters are essentially the cash registers of a DNSPs business. Traditionally they have only been able to perform that function, but additional technology allows this infrastructure to complement the basic cash register service, while also allowing different possibility for when and how meters are read.

It is easy to be distracted by the potential opportunities for new technology in delivering benefits to customers and networks, thereby losing sight of the continuing core "cash register" service that these new opportunities will complement.

There is a real need for policy makers to ensure there is an appropriate distinction between the basic service that networks currently provide to all customers (at least those customers below a certain threshold) which naturally should continue to form part of the standard control service, and other discretionary services that may be facilitated through new technology that may or may not be subject to standard control regulation.

In any case, we believe that a Ministerially imposed obligation to roll-out smart meter infrastructure should be considered primarily a standard control service, with the flexibility to allow cost recovery via way of other services through appropriate cost allocation principles.

Draft Finding 10: The Rules provide the AER with sufficient flexibility to determine an appropriate materiality threshold for mandated smart meter pilots and trials.

We raise in other areas of our submission the issue that open ended discretion can lead to increased regulatory uncertainty.

In respect of pass through, this can be seen in the AER's application of different materiality considerations in each of its recent distribution mechanisms. Different approaches have applied in each jurisdiction.

¹¹ AEMC draft report page 1.

Therefore while flexibility exists for the AER to exercise its discretion to include or exclude pass through costs, this only adds uncertainty to DNSPs in pass through arrangements as the AER has made passing comments in determinations that are inconsistent with other decisions on pass through arrangements.

Draft Finding 11: The timeframe for DNSPs to submit an application for cost pass through are sufficient for mandated smart meter pilots and trials.

EnergyAustralia supports this finding.

Draft Finding 12: The timeframe for the AER to make its cost pass through determination may not be sufficient for mandated smart meter pilots and trials, where there is limited reliable information available on costs.

We accept that the AER may need longer than 60 business days to assess the efficient costs. However, we also accept that the existing Rules allow extensions where necessary.

There was obviously a clear intention from policy makers to limit timeframes for pass through application and approval. Extending the timeframe for the AER to make a cost pass through decision extends the period of uncertainty for distributors. The AER should be required to make a cost pass through decision as quickly as possible (having regard to the complexity of the decision). The AEMC should have regard to the period of investment uncertainty for DNSPs in recommending an extension to the time period for making a determination to a maximum of 6 months.

If the AEMC considers that the level of uncertainty in smart meter frameworks necessitates an assessment period of 6 months, it should consider other options such as a reopener provision. The main difficulty in assessing incremental expenditure arises due to the fact that forecasts for the entire project must be demonstrated on the basis of one trigger. The AEMC may wish to consider a different approach to triggering pass through of costs which would allow a staged approach to forecasts and assessment for forecasts.

Draft Finding 13: Under the current cost pass through provisions it is not certain that the AER would conduct an efficiency assessment as the criteria for assessing expenditure are not clearly specified. As a result, the cost pass through provisions may not accommodate the recovery of the efficient costs of a mandated smart meter pilot or trial.

We believe it was the intent of the policy makers to require the AER to consider the overall expenditure requirements using the capex and opex criteria set out in the Rules, and a similar assessment process for pass through arrangements was intentionally left out of the pass through provisions. Instead the AER is required to pass through incremental costs associated with the pass through event. This is sufficient for the AER to make a decision on most pass through items.

To the extent that the forecast of costs incremental to the mandated investment subject to pass through arrangements, the AER should consider another avenue focussed on reopening the determination.

Draft Finding 14: DNSPs would be able to recover retailer costs under the cost pass through provisions, as long as DNSPs demonstrate that these costs are a consequence of a Ministerial determination and these costs satisfy the AER requirements for pass through. However, given the current lack of specification on the criteria the AER may

apply in making its cost pass through determination, the cost pass through provisions may not provide for the recovery of efficient retailer costs.

Note our comments in relation to draft finding 5.

Draft Finding 15: If a Ministerial determination is made in the last 13 months of a regulatory control period but costs are not incurred until the next regulatory control period, DNSPs may be unable to seek cost recovery for mandated smart meter pilots and trials under either the cost pass through provisions or the distribution determination process. This issue which is referred to as the "dead zone" is a common problem for cost pass events.

Question 3.1 Are any further amendments to the cost pass through provisions required to provide for the recovery of the efficient costs of mandated smart meter pilots and trials?

As outlined above, as a general principle we do not consider it is good regulatory practice to recommend amendments to the treatment of non-SMI assets in this review. This is to ensure that proper consideration can be given to the costs and risks of extending amendments to non-SMI assets (rather than in the context of mandated SMI).

We wish to point out that decisions by the AER on cost pass throughs under clause 6.6.1 of the Rules are currently subject to merits review as they have been prescribed as reviewable regulatory decisions under clause 9 the National Electricity Regulations. This issue arises in the context of the AAR advice at p.23 and the discussion as to whether cost pass through determinations are only subject to judicial review or are also subject to merits review.

Questions 3.2 Should our proposed amendments to the cost pass through provisions, to extend the AER's decision making timeframe and require the AER to consider the efficient and prudent costs of a mandated smart meter pilot or trial, be extended to all pass through events?

We do not support extending these amendments to all pass through events as this is outside scope and should be subject to a separate review or rule change. Extending the timeframe for the AER to make a cost pass through decision extends the period of uncertainty for DNSPs. Given the potential impact of this decision, we do not consider it would be good regulatory practice for such a decision to be an outcome of a mandated SMI cost recovery review. The decision to extend these amendments to all pass through events should follow an appropriate process where the cost and impacts of the decision can be appropriately assessed and the appropriate stakeholders engaged in the process.

As outlined above, as a general principle we do not consider it is good regulatory practice to recommend amendments to the treatment of non-SMI assets in this review. This is to ensure that proper consideration be given to the costs and risks of extending amendments to non-SMI assets (rather than in the context of mandated SMI).

For example EnergyAustralia has previously recommended addressing the "dead-zone"¹² and agree with the AEMC's recommendations. We consider this was an oversight when establishing Chapter 6 of the Rules. We consider addressing the "dead-zone" is an administrative correction and as such we support addressing the "dead-zone" for all pass through events. However, as it applies more generally to the regulatory framework for distribution and transmission investment, we would recommend that any Rule changes be subject to consultation that is broader than one intended for the specific issue of smart meter infrastructure.

¹² EnergyAustralia regulatory proposal June 2008, p161

Cost recovery for mandated smart metering services which are classified as alternative control services

Draft Finding 16: The current distribution determination process will provide for the recovery of the efficient costs of mandated smart metering services which are classified as alternative control services, as the AER is required to have regard to the NEL Revenue and Pricing Principles and the NEO when determining the revenue requirement for alternative control services. Modifications to the Rules are not required.

Draft Finding 17: There is a possible risk that in the event that mandated smart metering services are classified as alternative control services and the Minister makes a pilot determination during a regulatory control period, that DNSPs may not be able to recover their costs. This may occur if the applicable control mechanism does not contain adequate pass through provisions. However, this is a small risk and is only applicable to future regulatory periods, as there are already adequate cost pass through provisions in current distribution determinations. We advise that minor amendment to the Rules is necessary to require the AER to consider the need for cost pass through arrangements for mandated pilot expenditure when making a distribution determination.

Draft Finding 18: Further consideration of the impact of the classification of commercial services associated with mandated SMI expenditure is recommended once the nature of the services is better known and a decision on contestability in smart metering services has been made by the MCE.

Question 4.1: Is greater prescription required in the Rules to provide for the recovery of the efficient costs of mandated smart metering services, where these services are classified as an alternative control service?

We refer to our comments in respect of service classification above. It would help our understanding of the issues if the AEMC could clarify whether it perceived the mandate itself as a service provision between DNSP and Minister or whether the mandate imposed on a business in its capacity as DNSP with the infrastructure, once installed, providing services to customers.

In our view, the future classification of services provided by smart meters through a DNSP is unclear, but should be resolved by policy makers through enabling statutory rules governing the obligation and roles of market participants in meter service provision. However, this is mutually exclusive of a Ministerially imposed mandate to roll-out infrastructure across a network, which in our view should be classified as a standard control service.

We firmly believe that there must be appropriate prescription and delineation separating basic functional services we are obliged to provide customer, from other discretionary arrangements we may wish to have with customer and which make use of new and enabling technologies.

Incentives under the current regime

Draft Finding 19: The EBSS is appropriate for a mandated smart meter roll-out. However, the AER should retain its current discretion to determine whether the EBSS should be applied to expenditure associated with a mandated smart meter rollout, where there is significant uncertainty in relation to that expenditure.

In principle we accept the AEMC's position, although reiterate our concerns with open discretion provided to the AER in determining what operating expenditure is controllable and non-controllable. However, this issue applies to EBSS generally and is not within the scope of the AEMC's review.

We understand it is normal practice for the AER to exclude pass through costs from EBSS on the basis that it did not form part of the original forecast. However other cost categories may also be impacted where a mandated roll-out is commenced mid period. While this will be taken into account when the AER assesses incremental cost impact, there may be issues associated with the reconciliation of particular cost categories for the purposes of EBSS.

Unfortunately these policy decisions are left to the AER to determine on a case by case basis, so there is little opportunity for the AEMC to address these issues without first codifying the EBSS (which is likely to be outside the scope of this review).

Draft Finding 20: The incentives in the Rules are appropriate for the competitive purchase of meters and metering services under the distribution determination process, under the Commission's recommended changes to the Rules.

EnergyAustralia agrees with this finding

Draft Finding 21: The incentives in the Rules are appropriate for the management of technology risks by DNSPs, as many of these risks will be addressed by the MCE and NSSC processes which would result in obligations on the DNSP. It is expected that the materiality of these risks are likely to be reduced prior to a mandated smart meter roll-out.

We do not agree with this statement. In our view many aspects of the regulatory framework imposed, including incentive arrangements, recovery of costs and benchmark returns on investment were established without more "risky" technologies being considered. We remain concerned that the AEMC's conclusions regarding DNSP incentives and the appropriateness of open AER discretion ignores these risks completely or, alternatively create additional risk¹³.

While we do not go as far as agreeing that these risks will be addressed through MCE and NSSC processes, we accept that the magnitude of technology risk can only be properly determined once MCE and NSSC processes are more progressed.

Question 5.1 Are any changes to the Rules required to ensure the incentives under the current regulatory regime are appropriate for mandated SMI?

We have no further recommendations to those outlined in response to the AEMC's findings.

Tariff issues and smart meter infrastructure investments

Draft Finding 22: The current Rules are based on the 'causer pays' principle. This principle may not be applicable to mandated SMI costs and therefore may not provide for the efficient allocation of costs. Instead, the 'beneficiary pays' principle may be more appropriate. This would result in the bulk of mandated SMI costs being allocated to the individual customer (as the main beneficiary), and the remaining proportion being allocated to the general customer base through the DUOS charge, as some types of network operational benefits would be common to all network customers. However,

¹³ We note particularly the AEMC recommendation to include an end of period expost review of expenditure which has the potential to strand investment.

consideration of the administrative costs involved in applying the beneficiary pays principle would be needed, as well as the difficulty of separately identifying SMI costs.

At this stage we remain unconvinced of the arguments as to why the Rules regarding pricing need to be amended to accommodate the specific and unique circumstances of a mandated smart meter roll-out. Many of the arguments raised by the AEMC could equally apply to other investments. To the extent that the AEMC is recommending changes to the pricing framework for distribution services, this should be considered as part of a separate review.

While we accept that there is potential for future reclassification of metering services to a contestable framework, we are not sure whether a separate set of rules for the pricing of a mandated roll-out provides any benefit for customers prior to issues of contestability being properly considered.

We do not believe the causer pays and beneficiary pays principles are well understood in the context of a distribution or transmission network. However, we do agree that there needs to be a balance between efficient price signalling and the relative cost of providing that signal.

At the moment, most customers receive a single electricity bill incorporating a charge representing retail, distribution and transmission components, so it is difficult to apply this recommendation without considering first the broader implications of unbundling generally. We should also consider what is being unbundled:

- is it the cost of the meter, the meter service or the roll-out that the AEMC wishes to separate out from the rest of the electricity bill?
- is it the cost of all metering services or only the metering services involving a smart meters (and legacy meter infrastructure remains bundled).

While we accept that price signalling may be appropriate in a contestable market, there will be no contestability for SMI provision during the period of a mandated roll-out, hence unbundled tariffs would be of limited interest to potential competitive entrants, and when/if contestability occurs there may be other less complex approaches to information provision. In any case, retailers currently compete in NEM markets based on a bundled bill of network and retail costs.

We therefore see this issue of whether to unbundled tariffs as an important consideration once the roll-out is finalised (and decisions on contestability are made) but not before.

Draft Finding 23: As the costs of a mandated roll-out would involve fixed costs that would not vary with consumption, the costs of a roll-out should be recovered through a fixed charge per customer. This charge should not necessarily be in the form of a standardised charge per a customer and could vary by location, depending on whether the costs and benefits of the roll-out can be attributed to a specific group of customers.

We question the merits of a standardised fixed cost per customer approach for this particular piece of infrastructure. Most network assets are fixed and do not vary with changes in consumption.

We also question the validity of interacting standardised fixed charges with the idea of providing specific customer and locational signals in the circumstance of a network wide roll-out of smart meters.

For example, using the AEMC's argument for a "beneficiary pays" approach to cost allocation, larger customers are able to benefit more from SMI than smaller customers (because they have greater potential to save through lower energy costs) and therefore should be allocated a greater proportion of the costs. On this basis a variable charge to customers could be justified. Alternatively, some larger customers would pay no charge as the DNSP is not responsible for their metering service. This would result in a larger proportion of costs being allocated to small residential customers.

Draft Finding 24: The current Rules may not provide for the efficient allocation of the costs of a mandated roll-out, under the beneficiary pays principle. It is also unclear whether the Rules would result in a fixed charge that could vary by location.

We reiterate our comments regarding the AEMC's beneficiary pays principle and note, to the extent that their concerns equally apply generally to network pricing approaches, should be considered as part of a wider review.

Draft Finding 25: In principle, there are clear net economic benefits from unbundling the tariffs for a mandated smart meter roll-out from DUOS charges. Such unbundling should occur at the start of a roll-out, because it would provide transparency regarding the costs of a roll-out and facilitate greater regulatory scrutiny. Unbundling would also provide useful information for potential competitive entrants if contestability occurs. However it is difficult at this stage to be prescriptive on what assets/services should be unbundled given that the MCE is yet to make a decision on future contestability and there is uncertainty on the range of smart metering services that would be provided.

We remain unconvinced that the unbundling of costs associated with a mandated roll-out of smart meters from a bundled bill which incorporates all other retail transmission and distribution network costs provides sufficient economic benefits to customers, taking into account the likely costs of implementing such an arrangement. We do not see how this provides and further regulatory scrutiny to what is already allowed under the regulatory framework and question the relevance of price transparency of allocated network wide roll-out costs to potential new entrants, prior to issues of service definition and contestability being decided.

The discussion on page 28 regarding the application of costs of smart meter roll-outs to customers who have received a fully functioning meter is unworkable in the current framework and requires further consideration. Apart from providing a separate bill for meters, EnergyAustralia believes it would be very difficult in the existing network pricing framework to apply this approach.

Draft Finding 26: The current Rules may not achieve unbundling if the mandated smart metering services are classified as standard control services. Under the current Rules, unbundling would only occur if mandated smart metering services are classified as alternative control services by the AER.

At this stage we have not considered the full implications of this approach. However, we think there are broader implications of a separate classification of services for customers which would need to be considered in the context of tariff design, customer segmentation and pricing approval.

Draft Finding 28: Under the current Rules, DNSPs would be able to recover the stranded costs of existing accumulation meters through accelerated depreciation. This could significantly increase the initial tariff impact of a mandated roll-out on consumers.

We do not fully agree with this statement. The Rules (appropriately) allow for the AER to determine the appropriate depreciation provide for standard control services, according to the factors set out in 6.5.5(b) of the Rules.

We do not agree that it is automatic that a DNSP would seek accelerated recovery of the costs of existing accumulation meters or that the AER would seek to allow this accelerated recovery.

We do accept that if legacy meter infrastructure is subject to accelerated depreciation, that there will be additional price pressures for customers. Nevertheless, in making a decision to prevent the accelerated depreciation of accumulation meters the AEMC should consider that preventing accelerated depreciation of accumulation meters:

1. shifts cost recovery to a future period which creates the potential for price shocks in the future; and
2. increases the complexity and overall cost of recovering the cost of accumulation meters.

The AEMC recommends specific rule changes to deal with the accelerated depreciation of legacy metering infrastructure to continue to be recovered “through DUOS charges over their existing (in-service) lives”. The AEMC claims this is an equitable outcome “...as long as there is sufficient certainty in the Rules for DNSPs to continue to recover these stranded costs through DUOS charges.”¹⁴

We are not convinced that the AEMC has done enough to ensure that DNSPs are not subject to stranded investment. Before rushing into amendments which limit depreciation profiles, the AEMC must ensure the existing rules framework will ensure any legacy infrastructure disposed of to accommodate a mandated roll-out is capable of being recovered into the future.

Draft Finding 29: The AER currently has the ability to smooth the tariff impact of a mandated roll-out within a regulatory control period. However, under the current Rules the AER does not have the ability to require a DNSP to modify its proposed depreciation schedules, to smooth the tariff impact of a mandated roll-out between regulatory control periods.

We appreciate the desire to minimise the initial price impact of mandated SMI. However, we find it difficult to reconcile the AEMC's findings on the recovery of legacy and mandated metering services and the findings earlier in its report regarding the need for efficient and transparent price signals and cost allocation arrangements.

It is unclear how this recommendation promotes the NEO and what positive economic benefits arise from further deferring or back-ending returns.

Question 6.1 What principles should the AER be required to have regard to for the efficient allocation of costs and in determining whether to require a DNSP to unbundle mandated smart metering services from DUOS charges?

We consider the existing rules already provide principles by which the AER should consider a DNSP's pricing proposal.

There is insufficient justification why the Rules should be changed only to extract out of an existing bundled charge (for all network and retail services), a notional “SMI” charge representing

¹⁴ Draft report, p96

part or all of a mandated roll-out of smart meter costs. It would be very difficult to explain to any customer what these two separate charges actually represent.

This is particularly the case if issues of contestability and service definition remain to be resolved and if the AEMC is considering modifying the rules so that the recovery of costs for these services is deferred to future years.

Question 6.2 Should Rules on the unbundling of mandated smart metering services be made at this time, in light of the current uncertainty regarding the future contestability of smart metering services?

No.

Question 6.3 Is it appropriate to allow the AER to back end depreciation? What factors should the AER be required to have regard to when determining to back end depreciation for mandated SMI assets?

The AEMC would be aware that the existing returns from stranded control assets are already back-ended in that the difference between the nominal cost of capital and the real cost of capital is returned to the DNSP by way of adjusting the value of the asset base (and therefore returned over the remaining life of the assets). The AEMC's recommendations would create a further deferral in returns for DNSPs which we do not support.