Australian Energy Market Commission

Advice in response to MCE Request for Advice on Cost Recovery for Mandated Smart Metering Infrastructure

Allens Arthur Robinson
Level 27
530 Collins Street
Melbourne VIC 3000 Australia
Tel +61 3 9614 1011
Fax +61 3 9614 4661
www.aar.com.au

Table of Contents

ADVICE IN RESPONSE TO MCE REQUEST FOR ADVICE ON COST RECOVERY FOR MANDATED SMART METERING INFRASTRUCTURE

1. Overview

1.1 Pursuant to section 6(b) of the *Australian Energy Market Commission Act 2004* (SA), the Ministerial Council on Energy (***MCE***) has requested advice[1] from the Australian Energy Market Commission on whether Chapter 6 of the National Electricity Rules (***NER***) efficiently accommodates cost recovery for smart meter trials/assessments and the installation of smart metering infrastructure, as mandated by jurisdictional Ministerial determinations made under Part 8A of the National Electricity Law (***NEL***). Under Part 8A, jurisdictional Ministerial determinations ("Ministerial smart metering determinations") can be made which impose on electricity distributors mandatory obligations in relation to the conduct of smart meter trials and/or the undertaking of smart meter assessments ("Ministerial pilot metering determinations") and in relation to the provision of smart metering services ("Ministerial smart meter rollout determinations"). Chapter 6 of the NER allows distributors to recover the cost of providing distribution services through, among other things, their revenue requirements established for the purposes of their periodic distribution determinations using a building block approach and the cost pass through provisions contained in clause 6.6.1 of the NER. The MCE's Request for Advice is focused on whether the mechanisms for cost recovery as set out in the NER appropriately accommodate the recovery of such costs as may be imposed on distributors by Ministerial smart metering determinations made under Part 8A of the NEL.

1.2 Pursuant to section 15 of the MCE's Request for Advice, the Commission is required to publish and invite public comment on its draft advice in response to the Request for Advice. This document sets out the Commission's draft advice for this purpose.

1.3 Sections 8 to 12 of the MCE's Request for Advice identify a number of specific issues that are to be considered by the Commission. Broadly speaking these issues relate to the following matters:

- the recovery of costs arising from smart meter roll outs and pilots under distribution determinations and the cost pass through provisions of the NER, having regard to the classification of distribution services;
- whether it is appropriate to unbundle metering services and charges from other distribution services and charges;
- the obligation and ability of the Australian Energy Regulator (***AER***) to take into account network benefits in determining the efficient cost of smart meter roll outs and pilots;

[1] The MCE's Request for Advice can be downloaded from the AEMC's website: http://www.aemc.gov.au/Media/docs/MCE%20Request%20for%20Advice-405f484c-48dd-4df5-8c1b-bb6f5d454456-0.PDF.

- the specific operation of the cost pass through provisions in clause 6.6.1 of the NER in the context of smart meter roll outs and pilots;
- the application of incentives under the regulatory regime to the provision of smart metering services; and
- mechanisms to smooth the impact of smart meter roll out costs on tariffs over time.

1.4 In preparing this draft advice the Commission has sought legal advice from Allens Arthur Robinson (***AAR***). For these purposes, the Commission has requested AAR to address a number of questions that relate to each of the matters referred to above. This advice has been provided to the Commission solely for the purposes of assisting it to prepare its response to the Request for Advice and may not be relied upon or used by any other person for any purpose whatsoever.

1.5 Sections 2 and 3 of this draft advice set out some background information that is relevant to the recovery of costs for smart meter roll outs and pilots. Section 4 sets out the Commission's response to each of the matters it is required to address pursuant to the MCE's Request for Advice. Section 4 addresses each of these matters in the following manner:

- it identifies the matter;
- it summarises the Commission's assessment of how Chapter 6 of the NER and the NEL would apply to that matter; and
- it sets out a series of specific questions pertaining to the matter, together with the legal analysis provided by AAR in response to each of those questions.

2. Smart meter rollout

2.1 Under the NEL, the Minister of a participating jurisdiction may make a "Ministerial pilot metering determination" that requires a specified regulated distribution system operator (***DNSP***), or a specified class of DNSPs, in that jurisdiction to conduct "smart meter trials" (ie. trials of smart metering infrastructure and other related technologies) and/or to undertake a "smart meter assessment" (ie. an assessment of the costs and benefits and/or of the operational performance of different smart metering infrastructure and other related technologies) (NEL, ss.118B(1), (3), 118F(1); see also s.118B(4)).

2.2 Under the NEL, the Minister of a participating jurisdiction may also make a "Ministerial smart meter rollout determination" that requires a specified DNSP, or a specified class of DNSPs, in that jurisdiction to provide "smart metering services" to specified classes of distribution customers over a set period of time (NEL, ss.118D(1), (4), 118F(1); see also s.118D(5)). "Smart metering services" are services specified as such in the NER that are provided by smart metering infrastructure that is specified as "required smart metering infrastructure" under the NER (NEL, s.118A).

2.3 Under proposed Ministerial amendments to the NER, the responsible person for a small customer's meter installed pursuant to a Ministerial smart meter rollout determination will be the DNSP that is required to provide the relevant smart metering services (NER, cl.11.28.2, 11.28.3, 11.28.4)[2]. As such, that DNSP will be required to provide, install and maintain the meter (NER, cl.7.2.1). Moreover:

- the DNSP must select the person who is to be engaged by AEMO to provide the agency data collection systems (used to collect, process and transfer metering data from a meter to AEMO) and the agency metering database (NER, cl.7.3.5(c), 7.9.1(b), 11.28.5(a)); and
- the DNSP (and not AEMO) will be responsible for the remote acquisition of metering data from such a meter and the provision of that data to AEMO (NER, cl.7.9.2(a), 11.28.6).

3. Cost recovery

3.1 A distribution service may be a direct control service, a negotiated distribution service or (if it is neither of these) an unregulated service. Direct control services are further divided into standard control services and alternative control services. Except to the extent the NER requires that a particular classification be assigned to a distribution service, the classification of distribution services for a regulatory control period is determined by the AER as part of its distribution determination for the relevant DNSP (NER, cl.6.2.1, 6.2.2, 6.2.3; NEL, s.2B). While direct control services and negotiated distribution services are regulated under the NEL, NER and AER distribution determinations, unregulated services are not regulated at all.

3.2 A distribution determination is therefore confined to dealing with direct control services and negotiated distribution services. The AER must make such a distribution determination in a way that will or is likely to contribute to the achievement of the national electricity objective (***NEO***) (NEL, s.16(1)(a); see also NEL, ss.2, 7). Moreover, in so far as the distribution determination relates to direct control services (as opposed to negotiated distribution services), the AER must, in making that distribution determination, take into account the revenue and pricing principles (NEL, s.16(2)(a)(i)). These principles include the requirement that a DNSP should be provided with a reasonable opportunity to recover at least the efficient costs it incurs in providing direct control services and complying with a "regulatory obligation or requirement" (NEL, s.7A(2)). A "regulatory obligation or requirement" includes an obligation or requirement under the NEL or NER (NER, Ch.10; NEL, ss.2, 2D(1)(b)(i)). The requirement imposed on a DNSP to comply with a Ministerial pilot metering determination or a Ministerial smart meter rollout determination is a requirement imposed under the NEL (NEL, s.118F(1)), and is therefore a "regulatory obligation or requirement".

3.3 In addition, in making a distribution determination, the AER is required to (and must only) accept a DNSP's proposed forecast operating or capital expenditure for a regulatory control period if it is satisfied that such amount reasonably reflects:

[2] The proposed Ministerial amendments to the NER will need to be renumbered from clause 11.28 to a later clause reference due to the subsequent insertion in the NER of savings and transitional provisions relating to other matters.

- the efficient costs of (among other things) complying with all applicable "regulatory obligations or requirements" associated with the provision of standard control services;

- the costs that a prudent network operator in the circumstances of the DNSP would require for that purpose; and

- a realistic expectation of the cost inputs required for that purpose (NER, cl.6.5.6(a)(2), (c), 6.5.7(a)(2), (c)).

In deciding whether it is so satisfied, the AER must have regard to the benchmark operating or capital expenditure that would be incurred by an efficient DNSP over the regulatory control period (NER, cl.6.5.6(e)(4), 6.5.7(e)(4)). If the AER is not satisfied as described above it must substitute its own forecasts of the DNSP's operating or capital expenditure (NER, cl.6.12.1(3), (4)).

3.4 It should be noted that these provisions only relate to standard (as opposed to alternative) control services. The imposition of these requirements in relation to the regulation of standard control services follows from the fact that the NER requires the AER to apply a CPI-X form of control mechanism to standard control services which is based on a building block approach. Two of the relevant building blocks are:

- a return on capital – this return is calculated by reference to the value of the regulatory asset base, and a component of the regulatory asset base is forecast capital expenditure; and

- forecast operating expenditure (NER, cl.6.2.6(a), 6.4.3(a)(2), (7), (b)(2), (7), 6.5.1(a), (b), (e)(2), (f), S6.2.3(c)(1)).

In contrast, the control mechanism for alternative control services is not specified in the NER – it merely may, but need not, be based on a (modified) building block approach (NER, cl.6.2.6(b), (c)).

3.5 In so far as the prices for negotiated distribution services are concerned, those prices are required to be based on the costs incurred in providing the relevant service, and must be between the avoided cost of not providing the service and the cost of providing the service on a stand alone basis (NER, cl.6.2.7, 6.7.1(1), (2)). Moreover, the price for a negotiated distribution service must be such as to enable the DNSP to recover the efficient costs of complying with all "regulatory obligations or requirements" (see paragraph 3.2 above) associated with the provision of the service (NER, cl.6.7.1(7)). This price must also be the same for all distribution network users unless there is a material difference in the cost of providing the service to different users or classes of users, and must be adjusted over time to the extent assets used to provide the service are subsequently utilised by other persons (NER, cl.6.7.1(5), (6); see also cl.6.7.5(c)(3)).

<u>Cost pass through event</u>

3.6 By definition a distribution determination is forward looking: it regulates revenues and prices on the basis of forecasts. However, the NER also contain a mechanism to enable DNSPs to recover certain costs that arise during a regulatory control period where these costs are not included in the forecasts used to determine the DNSP's allowable revenue.

This mechanism is the "pass through event". More specifically, where a pass through event occurs during a regulatory control period, the affected DNSP may be permitted to pass through to distribution network users the increased costs associated with that event. Pass through events include:

- a "regulatory change event", which is a change in a "regulatory obligation or requirement" (see paragraph 3.2 above) that occurs during the course of a regulatory control period, that substantially affects the manner in which the DNSP provides direct control services, and that materially increases the costs of providing those direct control services;
- a "service standard event", which is a legislative or administrative act or decision that (among other things) alters the nature or scope of direct control services provided by the DNSP during the course of a regulatory control period and that materially increases the costs of providing those direct control services; and
- any other event nominated in a distribution determination as a pass through event (ie. an additional pass through event) (see also NER, cl.6.12.1(14)).

A pass though event that is a service standard event or an additional pass through event will not be a regulatory change event. The concept of "materially" is not defined, save that it is said to have its "ordinary meaning" (NER, Ch.10). While the AER has the power to publish guidelines as to its likely approach to determining materiality in the context of possible pass through events (NER, cl.6.2.8(a)(4)), it has not done so. Instead, it has specified materiality thresholds for different pass through events in its distribution determinations. If the AER were to publish such guidelines in the future, the AER would not be bound by them; however, if the AER were to make a distribution determination that was not in accordance with such guidelines, it would be required to state (in its reasons for the distribution determination) the reasons for departing from the guideline (NER, cl.6.2.8(a)(4), (c)).

3.7 The maximum amount that may be passed through by the DNSP in consequence of a pass through event is the increase in costs in the provision of direct control services that the DNSP has incurred and is likely to incur until the end of the regulatory control period in which the pass through event occurred (NER, cl.6.6.1(c)(3), (4), (j)(2); definition of "eligible pass through amount", Ch.10). In determining this amount, the AER is required to take into account (among other things) the "efficiency of the [DNSP's] decisions and actions in relation to the risk of" the pass through event (NER, cl.6.6.1(j)(3)). Although the pass through amount is calculated by reference to the regulatory control period in which the event occurs, this does not mean that the DNSP cannot recover the costs it incurs in respect of that event after the end of the regulatory control period. On the contrary, at least in the case of standard control services, such recovery occurs through the building block process for the next regulatory control period. For example, if a pass through event occurs in the last year of a regulatory control period, the DNSP will only be able to pass through those costs it incurs (or is likely to occur) in that last year; however, as part of the distribution determination process for the next regulatory control period, the DNSP will be able to seek recovery (through the forecast operating and capital expenditure building blocks) of the costs that are likely to be incurred during that subsequent regulatory control period as a result of the pass through event. The AER determines both the total amount of the pass through and the proportion of that amount that may be passed through in each regulatory year of the regulatory control period (NEL, cl.6.6.1(d)). However, the manner in which these amounts is recouped from distribution network users through tariffs for direct control services is largely left to the DNSP in its annual pricing proposals for direct control services (NER, cl.6.18.1, 6.18.2) (see paragraph 3.9 below).

3.8 While the substantive provisions of the NER cost pass through provisions relate to standard control services (the pass through provisions are included in Part C of Chapter 6 of the NER), pass through events can also be applied to alternative control services[3]. This can be achieved through the AER applying the pass through provisions of Part C of Chapter 6 to alternative control services as part of the control mechanism for those services (this control mechanism being able to be based on a (modified) form of Part C) (see NER, cl.6.2.6(c) and the note to that clause). Alternatively the AER has the discretion to simply develop its own cost pass through arrangements in relation to alternative control services as part of a control mechanism that does not apply the Part C provisions.

Tariffs

3.9 Generally speaking, customers with similar characteristics in relation to electricity (eg. usage and connection) are required to be assigned to the same tariff class, although there must be separate tariff classes for standard control services and alternative control services (NER, cl.6.18.3(c), (d), 6.18.4(1), (2)). Indeed, the NER expressly provides that a basis for assigning customers to a tariff class may be the installation at the customer's premises of remotely-read interval metering (or other similar metering technology) where that has been installed as a result of "regulatory obligation or requirement" (see paragraph 3.2 above) (NER, cl.6.18.4(a)(1)(iii)). The revenue expected to be recovered from any such tariff class is required to be between the avoidable cost of not serving the customers in that tariff class and the stand alone cost of serving those customers (NER, cl.6.18.5(a)). In addition, the tariff must take into account the long run marginal cost for the relevant service and must be determined having regard to whether the relevant customers are able or likely to respond to price signals (NER, cl.6.18.5(b)(1), (2)(ii)). Finally, a CPI+2% side constraint applies to tariffs for standard (as opposed to alternative) control services (NER, cl.6.18.6). It is the case that compliance with this side constraint is to be determined without regard to any pass through amount (NER, cl.6.18.6(d)(1)) and that the side constraint does not apply to preclude the variation of tariffs for customers with remotely-read interval metering (or similar technology) to the extent the tariff varies according to the time or other circumstances of the customer's usage. However, the non-application of the side constraint in these circumstances does not mean that a DNSP is permitted to recover more than its allowed revenue requirement for the relevant regulatory year (NER, cl.6.12.1(11), (13), 6.18.2(b)(4), (7), 6.18.8(a)(1)). Having said this, to the extent there is any pass through amount associated with the service provided under the relevant tariff, that amount is recoverable in addition to the allowed revenue requirement.

[3] Although the definitions of the pass through events in Chapter 10 of the NER refer to direct control services, the fact that the operative pass through provisions are contained in Part C of Chapter 6 means that they strictly only apply to standard control services (unless those provisions are applied as part of the control mechanism for alternative control services).

4. Assessment and questions

4.1 It is against this background that the assessments, questions and responses below are set out. As previously stated, this section is structured in accordance with the issues identified by the MCE in its Request for Advice. For each such issue this draft advice sets out the Commission's assessment and (where relevant) additional questions and the response of AAR to those additional questions.

Item 8.1 of the MCE's Request for Advice

The interaction of the obligations imposed on distribution network service providers under sections 118B and 118D of the NEL with the revenue and pricing principles in the NEL and the operating expenditure objectives and capital expenditure objectives in clauses 6.5.6(a) and 6.5.7(a) of the NER.

<u>Assessment of how Chapter 6 of the NER and the NEL would apply</u>

- For standard control services, the AER must have regard to both the revenue and pricing principles in the NEL and the operating and capital expenditure objectives in the NER in making a distribution determination. For alternative control services, the AER must have regard to the revenue and pricing principles, but is not required to (but has the discretion to) consider the operating and capital expenditure objectives, as these are located in Part C of the NER, which relates to standard control services.

- The revenue and pricing principles relate to promoting economic efficiency in the provision of regulated network services. The operating and capital expenditure objectives also seek to promote economic efficiency in the costs of providing distribution network services, along with prudency and a realistic expectation of demand forecasts and cost inputs. Moverover in deciding whether or not it is satisfied in relation to the operating or capital expenditure objectives, the AER must have regard to the benchmark operating or capital expenditure that would be incurred by an efficient DNSP. We consider that the revenue and pricing principles and the operating and capital expenditure objectives interact to require the AER to provide for the recovery of the efficient costs of providing regulated network services.

  We note that DNSPs would be required to demonstrate to the AER that any costs incurred under a mandated smart meter roll-out or pilot/trial achieve the operating and capital expenditure objectives. We consider the most relevant operating and capital expenditure objective for these costs would be complying with “all applicable regulatory obligations or requirements associated with the provision of standard control services”. "Regulatory obligations or requirements" is defined under section 2D of the NEL.

- The AER is required to accept a DNSP’s forecasts of operating and capital expenditure if the AER is satisfied that the total of the forecasts reasonably reflects the operating and capital expenditure criteria having regard to the operating and capital expenditure factors. Under clause 6.12.3(d) of the NER, the AER is required to approve the total revenue requirement for a regulatory control period, set out in the DNSP’s regulatory proposal, if the AER is satisfied the amounts have been properly calculated using the post tax revenue model on the basis of amounts determined under the requirements of Part C of Chapter 6 of the NER.

- Under the NEL, the AER must also perform or exercise its economic regulatory functions or powers in a manner that will or is likely to contribute to the achievement of the National Electricity Objective (***NEO***).
- We note that the AER is not required to have regard to the operating and capital expenditure objectives in making a cost pass through determination.

AEMC Question 1

4.2 *How would the operating expenditure objectives and capital expenditure objectives in clauses 6.5.6(a) and 6.5.7(a) of the NER apply to costs incurred under a mandated smart meter roll-out compared to a mandated smart meter pilot/trial? Is there a relevant materiality threshold in complying with "regulatory obligations or requirements" under clauses 6.5.6(a)(2) and 6.5.7(a)(2) of the NER and as defined under section 2D of the NEL? If so, would this materiality threshold limit or prevent cost recovery for mandated smart metering costs?*

4.3 There would be no difference in applying the operating and capital expenditure objectives to costs incurred under a mandated smart meter roll out compared to a mandated smart meter pilot/trial as both are regulatory obligations or requirements (NER, cl.6.5.6(a)(2), 6.5.7(a)(2), Ch.10; NEL, ss.2, 2D(1)(b)(i); see also paragraph 3.2 above).

4.4 Section 2D(1)(b)(v) of the NEL imposes a materiality threshold; however, this section relates to jurisdictional legislation, not national electricity legislation (which includes the NEL). Because compliance with a Ministerial pilot metering determination or a Ministerial smart meter rollout determination is required under the NEL (NEL, s.118F(2)), the requirement to comply with such determinations falls under section 2D(1)(b)(i). No materiality threshold applies under that section.

AEMC Question 2

4.5 *Under the NER, would the AER be required to classify a smart meter pilot as a separate service? Or would the AER be able or required to classify a smart meter pilot as part of distribution use of system services? Are there any risks for cost recovery for pilots under the distribution determination process? We note that the operating expenditure objectives and capital expenditure objectives in clauses 6.5.6(a) and 6.5.7(a) of the NER refer to the forecast operating expenditure and capital expenditure needed to provide "standard control services".*

4.6 The term "distribution use of system services" is defined in Chapter 10 of the NER, but has limited operation in Chapter 6. The relevant terms used in Chapter 6 are "direct control services", "standard control services", "alternative control services" and "negotiated distribution services" (NER, cl.6.2.1, 6.2.2, Ch.10).

4.7 Unless the NER requires that a particular classification be assigned to a distribution service the AER has the discretion, acting in accordance with the relevant criteria set out in the NER, to determine the service to be a direct control service, being either a standard control service or an alternative control service, or a negotiated distribution service (NER, cl.6.2.1(a), (c), (e), 6.2.2(a), (c), (e); NEL, s.2B). Alternatively, the AER could decide not to classify a distribution service, in which case it would not be regulated under the NER or a distribution determination. The important point to note is that, to be regulated under a distribution determination, the service must be able to be characterised as an "electricity network service", ie. "a service provided by means of, or in connection with, a … distribution system" (NEL, s.2). While the undertaking of a smart meter pilot is not a service provided to distribution network users, it is an electricity network service because (like metering itself) it is a service that is provided in connection with a distribution system – this service is required to be provided by DNSPs and is closely associated with the operation of the distribution system. As such, the AER may choose to classify a smart meter pilot as a direct control service or a negotiated distribution service. As far as the NER are concerned, there is no particular need to further categorise a service beyond being a standard control, alternative control or negotiated distribution service. However, as a practical matter, in making a distribution determination the AER is likely to separately consider all elements of the service offering, including the constituent services.

4.8 Apart from the risk of error in forecasting operating and capital expenditure for a smart meter pilot, there is little risk relating to cost recovery if the smart meter pilot is classified as a standard control service, provided that the DNSP can satisfy the AER that the forecast costs associated with the pilot are efficient and prudent costs. This is because the AER is required to accept such costs as part of the DNSP's forecast operating and capital expenditure. Even if the smart meter pilot is classified as an alternative control service, the AER is still required to structure the applicable control mechanism so that the DNSP has a reasonable opportunity to recover the efficient costs it incurs in connection with the pilot (NEL, ss.7A(2)(b), 16(2)(a)(i)). If cost recovery is to be by way of a pass through event then, depending on the nature of the pass through mechanism, there may be a risk that a materiality threshold applies which results in full cost recovery being denied. In addition, while a pass through may relate to actual costs incurred, it also typically relates to future (estimated) costs. As such it entails similar risks to the risk of under-forecasting which arises under the building block approach.

4.9 It seems that the smart meter pilot should be classified as either a standard control or alternative control service. This is because DNSPs will be required to participate in, and will not be competing in providing services relating to, the smart meter pilot. It is therefore not necessary to consider risks that may arise if it were to be classified as a negotiated distribution service or not regulated at all.

<u>*AEMC Question 2 – Supplementary Question*</u>

4.10 *Would a DNSP be able to seek cost pass through for a smart meter pilot under clause 6.6.1 of the NER, if it is required to undertake this pilot mid way through a regulatory control period? In particular, if the AER has determined not to apply the cost pass through provisions to alternative control services, and as the pilot would not have been classified because the pilot is a new activity and occurs part way through a regulatory control period, how would the AER determine whether the pilot costs would be eligible for pass through (noting that only standard control services are eligible for pass through)?*

4.11 This question presupposes that a Ministerial pilot metering determination is made after the commencement of a regulatory control period and requires smart meter pilots to be undertaken during that period[4]. The issue is then whether the pilot can be said to fall within the scope of a service that has been classified for the purposes of the distribution determination for that regulatory control period (such as metering and metering development). If it does not, then it will be an unregulated service and no cost pass through provisions will apply to it. If it does, the next issue is whether the classification of that existing service is a standard control service or an alternative control service. If the relevant classification is that of a standard control service, the cost pass through provisions in clause 6.6.1 of the NER will apply to the costs incurred by the DNSP in fulfilling its obligations under the Ministerial pilot metering determination (the relevant pass through event will be the "regulatory change event" or, possibly, the "service standard event": see paragraph 3.6 above). If the relevant classification is that of an alternative control service, the extent to which the DNSP will be able to pass through its costs will depend how the distribution determination deals with pass through events relating to alternative control services. For example, the distribution determination might apply clause 6.6.1 of the NER to alternative control services or provide for an additional pass through event that applies to those kinds of costs (see paragraph 3.8 above).

4.12 These potential problems can be overcome in relation to smart meter pilots by the following means:

- a Ministerial pilot metering determination is made in sufficient time prior to the commencement of the relevant DNSP's regulatory control period during which the pilot is to be undertaken to enable the AER to classify the associated services as standard or alternative control services and to enable the forecast expenditures in relation to it to be included in the DNSP's allowable revenue for that period; or
- both of the following occur:
    - o the NER are amended to specify the classification of services associated with the pilot or the AER, in its distribution determination, specifies the scope of existing services that it classifies sufficiently broadly to encompass the services associated with the pilot; and
    - o if the applicable classification is that of alternative control services, the AER applies the Part C pass through provisions in its distribution determination to alternative control services – alternatively, the AER could specify an additional pass through event in its distribution determination which is specific to smart meter pilots (in which case, to the extent the pilot metering-related services are alternative control services, the pass through would not need to apply clause 6.6.1 of the NER).

<u>AEMC Question 2 – Clarification Question</u>

[4] In theory, if the Ministerial pilot metering determination was made prior to the relevant regulatory control period, the forecast capital and operating expenditures incurred during the relevant regulatory control period in complying with it would be included in the building block determination for that period. In fact, this would only be the case if the Ministerial pilot metering determination was made prior to the making of the final distribution determination for that period (ie. at least 2 months before the commencement of the relevant regulatory control period: NER, cl.6.11.2).

4.13 *It is stated that a smart meter pilot would be considered a service to be regulated under a distribution determination as it meets the NEL definition of an "electricity network service", i.e. "a service provided by means of, or in connection with, a…distribution system". Under the amendments to the NEL, the Minister may also require DNSPs to undertake trials of smart metering infrastructure and other related technologies, including devices designed to enable direct load control (see definition of "smart meter trials" in section 118A of the NEL). Direct load control would allow DNSPs to remotely vary or disconnect the energy use of customers during peak load periods, e.g. by remotely switching off the compressors in air conditioners. Although under these trials the DNSP would be providing this service, we consider it unclear as to whether this service is in connection with a distribution system. Would a trial of direct load control also be considered a "electricity network service" under the NEL (and able to be regulated under a distribution determination)?*

4.14 The answer to this question depends upon whether direct load control entails the DNSP using the distribution system in any way or can only be implemented by distributors by virtue of them being the operators of the distribution system. So, for example, if the direct load control switch is part of the distribution system or utilises communications that are part of that system, the provision of direct load control would be an electricity network service.

AEMC Question 3

4.15 *In the making of a distribution determination, how would the AER's requirement to have regard to the NEO and the revenue and pricing principles in the NEL interact with the operating expenditure objectives and capital expenditure objectives in clauses 6.5.6(a) and 6.5.7(a) of the NER? If there is a conflict in these requirements, how would the AER manage such conflicts? (e.g. Do the requirements in the NEL take precedence over requirements in the NER?) What other factors is the AER required to have regard to in making a distribution determination? (e.g. submissions etc).*

4.16 There is no necessary conflict between the NEO, the revenue and pricing principles, and the operating and capital expenditure objectives. On the contrary, a principal focus of the NEO and the revenue and pricing principles in the NEL (NEL, ss. 7, 7A), and the operating and capital expenditure objectives in the NER (NER, cl, 6.5.6, 6.5.7), is on the need for a DNSP to be able to recover its efficient costs. However, if there was to be a conflict, the NEL requirements would take priority over the NER requirements.

4.17 The other factors that the AER is required to have regard to in making a distribution determination are the information included in or accompanying a DNSP's building block proposal, submissions received in the course of consulting on the building block proposal, and analysis undertaken by or for the AER and published before the distribution determination is made (NER, cl.6.5.6(e)(1)-(3), 6.5.7(e)(1)-(3)). However, these sources of information are not the only sources to which the AER may have regard. It can also draw on its existing regulatory expertise.

AEMC Question 4

4.18 *DNSPs will be required to fulfill obligations under a Ministerial determination and incur costs in doing so. How would this regulatory obligation interact with the revenue and pricing principles in the NEL and the operating expenditure objectives and capital expenditure* *objectives in clauses 6.5.6(a) and 6.5.7(a) of the NER, in relation to the recovery of costs incurred as a result of a Ministerial determination?*

4.19 The recovery of efficient costs incurred as a result of complying with a regulatory obligation imposed under a Ministerial smart metering determination is consistent with both the revenue and pricing principles in the NEL and the operating and capital expenditure objectives in the NER. As stated above, both a Ministerial pilot metering determination and a Ministerial smart meter rollout determination will impose "regulatory obligations and requirements" on DNSPs because compliance with them is an obligation under the NEL (NEL, ss.2D(1)(b)(i)). Both the revenue and pricing principles and the operating and capital expenditure objectives require that a DNSP be able to recover its efficient costs in complying with regulatory obligations and requirements (NEL, s.7A(2)(b); NER, cl.6.5.6(a)(2), (c)(1), 6.5.7(a)(2), (c)(1)).

AEMC Question 5

4.20 *Do the NEO and the revenue and pricing principles in the NEL and the operating expenditure objectives and capital expenditure objectives in clauses 6.5.6(a) and 6.5.7(a) of the NER apply to alternative control services, negotiated services and unregulated services?*

4.21 The NEO, the revenue and pricing principles and the operating and capital expenditure objectives do not apply in relation to unregulated services because such services are not subject to the NEL, the NER or AER distribution determinations.

4.22 The NEO applies to all AER regulatory functions or powers, including the functions and powers performed and exercised by the AER in making a distribution determination (NEL, ss.2, 16(1)(a)). This means that the AER must regulate alternative control services and negotiated distribution services in a manner that will or is likely to contribute to the achievement of the NEO. It is also noted that a Ministerial smart meter rollout determination and a Ministerial pilot metering determination must themselves have regard to the NEO (NEL, ss.118B(2)(a), 118D(2)(a)).

4.23 The AER is required to take into account the revenue and pricing principles when exercising a discretion in making those parts of a distribution determination that relate to direct control services, including alternative control services (NEL, s.16(2)(a)(i); NER, cl.6.2.1, 6.2.2, Ch.10)). Conversely, the AER may (but is not required to) take into account the revenue and pricing principles when performing or exercising any other AER economic function or power, such as functions and powers relating to the regulation of negotiated distribution services (NEL, ss.2, 16(2)(b)).

4.24 In deciding on the control mechanism for alternative control services that is to be included in a distribution determination, the AER may (but need not) utilise elements of Chapter 6, Part C of the NER, which includes the operating and capital expenditures objectives (NER, cl.6.2.5(a), 6.2.6(c)). The operating and capital expenditure objectives do not apply to negotiated distribution services.

AEMC Question 6

4.25 *Is the AER able to or required to consider any network operational benefits that may accrue following a smart meter roll-out (e.g. reduced operational expenditure from a* *reduction in meter reads) in determining whether it is satisfied or not that the capital and operating expenditure criteria have been met? If so, what limitations are there on the AER's ability to consider potential network operational benefits?*

4.26 The AER has the ability to consider network operational benefits that may accrue in consequence of a smart meter rollout in determining whether it is satisfied or not that the capital and operating expenditure criteria have been met. This follows from the requirement that the forecast operating and capital expenditure must include the efficient costs of the DNSP (NER, cl.6.5.6(c)(1), 6.5.7(c)(1)). This is a reference to the DNSP's net costs assessed on an overall basis. For example, in determining the costs that the DNSP is to be able to recover in connection with the installation of smart meters, the AER must not just consider the costs of installing those meters but also any cost savings likely to accrue to the DNSP as a result of the installation of those meters (eg. the reductions in meter reading costs because the meters can be remotely, rather than manually, read). That said, the network operational benefits would need to be able to be expressed in dollar terms and would need to accrue to the DNSP. This means that more generalised benefits (eg. benefits to the environment by virtue of reduced electricity consumption) cannot be taken into account: those benefits cannot be quantified in monetary terms and do not reduce the DNSP's costs.

<u>AEMC Question 6 - Clarification Question</u>

4.27 *It is stated that as more generalised network operational benefits (e.g. environmental benefits) cannot be quantified in monetary terms, they do not reduce the DNSP's costs. We note that environmental benefits cannot be quantified at this time, but if there was a price on carbon that these benefits could be quantified. We also note that if the AER included performance measures relating to smart meters (e.g. targets for reconnection times) in its Service Target Performance Incentive Scheme, that DNSPs would receive a monetary benefit from meeting any such performance targets.*

4.28 To the extent that a carbon cost is imposed on a DNSP (either directly because the DNSP is liable under a scheme such as the CPRS or indirectly because the DNSP uses energy or emissions intensive inputs), and the introduction of smart meters reduces that carbon cost, then that cost reduction should be taken into account in assessing the DNSP's operating and capital expenditure allowances.

4.29 The interaction of the expenditure allowances and the service target performance incentive scheme needs to be carefully considered. While the rewards and penalties form part of the building blocks (NER, cl.6.4.3(a)(5), (b)(5)), it may be considered that expenditures directed at exceeding the performance targets should only be undertaken if there is a net benefit to the DNSP in doing so independently of the DNSP's ability to recover those costs through the building blocks (ie. that those expenditures should not be included in the building blocks). This is a matter for the design of the service target performance incentive scheme.

<u>AEMC Question 7</u>

4.30 *If the AER is not satisfied that the operational expenditure and capital expenditure criteria have been met, and at the time of making of the final determination AER remains dissatisfied with the DNSP's forecasts for operational and capital expenditure, is the AER* *able to substitute its own figure as to the appropriate operational expenditure and capital expenditure that should be approved? If the AER considers that it does not have sufficient information to substitute its own figure, what options are available to the AER in making its distribution determination? (e.g. can the AER substitute a figure of zero if it considers that it does not have sufficient information to make a decision).*

4.31 If it is not satisfied that the DNSP's forecast operating or capital expenditure meets the operating or capital expenditure criteria (including the requirement that they reasonably reflect the DNSP's efficient costs), the AER not only may, but must, reject that forecast (NER, cl.6.5.6(d), 6.5.7(d)). In these circumstances, the AER must then substitute its own assessment of the DNSP's forecast operating or capital expenditure (NER, cl. 6.12.1(3)(ii), 6.12.1(4)(ii)).

4.32 This does not entitle the AER, without more, to simply substitute a zero figure because the AER considers that it is unable to determine an appropriate forecast of the DNSP's operating or capital expenditure. However, the AER could substitute a zero figure if it also provided in the distribution determination for a cost pass through event to enable the DNSP to recover its costs during the regulatory control period. In these circumstances, a zero figure would be justified to avoid double recovery by the DNSP. This would only work if the Ministerial determination that triggers the pass through event occurs in that regulatory control period.

AEMC Question 7 – Clarification Question

4.33 *It is stated above that the AER could "substitute a zero figure [in considering forecast expenditure for smart meters] if it also provided in the distribution determination for a cost pass through event to enable the DNSP to recover its costs during the regulatory control period". What boundaries are there on the AER's ability to do this? For instance, would it only be allowed to do this if it knew that a Ministerial determination was going to be made during the regulatory control period, but it had not been made at the time the AER makes its distribution determination? We note that it is also stated above that the AER is not entitled to substitute a zero figure if it considers it is unable to determine an appropriate forecast.*

4.34 This alternative was raised in the context of a scenario where the AER is not satisfied that the DNSP's forecast operating or capital expenditure meets the operating or capital expenditure criteria, eg. because there is a significant degree of uncertainty as to whether the relevant costs will be incurred. Uncertainty as to whether or not a Ministerial determination will be made which requires a smart meter roll out during a forthcoming regulatory control period would be an example of just such a situation. In these circumstances, the inclusion of a smart meter pass through event would be appropriate because it would ensure that, if (and only if) the Ministerial determination were made, the DNSP could recover the associated costs for that regulatory control period. If the smart meter pass through event was not triggered then there would be no difference from the situation in which no allowance for those costs was made in the DNSP's operating and capital expenditure forecasts. The point is that the use of the pass through mechanism caters for the situation where an expenditure cannot properly be included in a forecast (because the risk of the expenditure not being required, and the DNSP therefore making a windfall gain, is significant), but where the occurrence of the event requiring the expenditure would leave the DNSP inappropriately "out of pocket" for that regulatory control period. This approach is entirely consistent with the position that the AER cannot "without more" substitute a zero figure if it considers it is unable to determine an appropriate forecast because the use of the pass through mechanism is an alternative to the forecast. However, because cost pass throughs are generally inconsistent with incentive-based regulation, the AER is likely to be conscious of the need to tightly scope any such cost pass through provisions.

<u>AEMC Question 8</u>

4.35 *Would a DNSP be required to include in its regulatory proposal for a distribution determination, the costs and an estimate of any network operational benefits (i.e. cost savings in other categories of expenditure) associated with meeting its obligations under a Ministerial determination?*

4.36 A DNSP will have a natural incentive to include in its regulatory proposal details of the costs associated with meeting its obligations under a Ministerial smart metering determination. This is because it needs to satisfy the AER of those costs so they can be included in the DNSP's forecast operating and capital expenditure. Conversely, the DNSP will have no natural incentive to reveal the value of the network operational benefits arising from the installation of smart meters. However, the AER could specify in a regulatory information instrument that such information must be included in a DNSP's regulatory proposal (NER, cl.6.8.2(d)).

Item 8.2 of the MCE's Request for Advice

The interaction of the obligations imposed on distribution network service providers under sections 118B and 118D of the proposed NEL amendments and the definition of 'regulatory change event' for the purposes of the cost pass through provisions in clause 6.6.1 of the NER.

<u>Assessment of how Chapter 6 of the NER and the NEL would apply</u>

- The AER has recently approved a specific nominated ‘smart meter’ pass through event in the distribution determinations for New South Wales and Australian Capital Territory DNSPs (and in the draft distribution determinations for South Australian and Queensland DNSPs). This event was proposed by DNSPs in their regulatory proposals and approved by the AER through the distribution determination process.
- The specific nominated ‘smart meter’ pass through event has been defined in recent determinations by the AER as follows:

  “A smart meter event is an event which results in an obligation being externally imposed on [DNSP] to install smart meters for some or all of its customers, or to conduct large scale metering trials during the course of the next regulatory control period, regardless of whether that requirement takes the form of a statutory obligation or not, and which:

  (a) does not fall within the following:

    (i) the definition of ‘regulatory change event in the NER (read as if paragraph (a) of the definition was not part of the definition)

    (ii) any other category of pass through event

(b) materially increases the cost of the DNSP providing direct control services."

- Subject to the next dot point, there is also the potential for DNSPs to seek pass through for mandated smart metering costs under the "regulatory change" pass through event in Chapter 10 of the NER.
- If the effect of smart metering related amendments to the NER (eg. to specify the smart metering infrastructure to be installed) and/or a Ministerial smart meter rollout determination is to alter the nature or scope of a DNSP's metering services and/or to impose minimum service standards in relation to metering, then this will constitute a "service standard event" (NEL, Ch.10). A service standard event is stipulated in the NER as a pass through event for direct control services. The significance of this is that, to the extent it is a service standard event, it will not be a regulatory change event because a regulatory change event is defined to be a change in a regulatory obligation or requirement that "falls within no other category of pass through event" (NER, Ch.10). In practice, whether the event is a service standard event or a regulatory change event is likely to be immaterial, providing the materiality thresholds that apply to recovery for those events is the same.
- This issue is of more significance where a distribution determination includes a smart meter event as an additional pass through event. In this regard it is noted that a potential issue with the AER's formulation of its smart meter event is that it does not apply to the extent the event can be characterised as either a service standard event or a regulatory change event. Because the mandated piloting and rollout of smart meters pursuant to a Ministerial smart metering determination is a regulatory change event (and might constitute a service standard event), there will be no scope for the application of the smart meter event. This issue is compounded because the materiality threshold for the smart meter event is considerably below that of those other two kinds of pass through events. Given the specific nature of the smart meter event, it would seem to make more sense for the smart meter event to apply in priority to a service standard event or regulatory change event that is based on the same underlying circumstances. This could be achieved by removing the provisions that subordinate it to other pass through events. While a regulatory change event would then become subordinate to the smart meter event, the NER do not accord priority as between a service standard event and an additional pass through event (such as the smart meter event). However, for so long as:
    - the materiality threshold for the smart meter event is below that of the service standard event; and
    - the scope of the smart meter event is at least as broad as that of the service standard event,

  DNSPs would be expected to choose to recover their costs under the smart meter event pass through.
- A materiality threshold applies to pass through events and this threshold is determined at the discretion of the AER. The AER has provided guidance on materiality thresholds for pass through events in its distribution determinations. The AER's guidance on materiality

for a nominated ‘smart meter’ pass through event has been stated as “the administrative costs of assessing an application relating to specific nominated events”.

- If a pass through event occurs in the last regulatory year of a regulatory control period but the costs for that event are incurred in the following regulatory period, DNSPs may be unable to recover costs arising from that event which are incurred in the following regulatory control period. This issue (“the dead zone”) was raised by EnergyAustralia under the recent NSW distribution determination process and was also considered by the Australian Competition Tribunal following an appeal by EnergyAustralia of the AER’s distribution determination.
- Specifically, the "dead zone" issue appears to arise where the distribution determination for a regulatory control period (and, possibly, the next regulatory control period) includes a pass through event mechanism, and that pass through event mechanism is triggered by the occurrence of an event in the current regulatory control period in circumstances where:
    - costs as a result of that event will be incurred in the next regulatory control period; and
    - the event occurs so close to the commencement of the next regulatory control period that those costs are not included in the forecast operating or capital expenditure for that next regulatory control period (eg. as where a Ministerial smart meter rollout determination is made after the final distribution determination for the next regulatory control period is published or, possibly, after the close of submissions on the draft distribution determination).

  The problem is that, under clause 6.6.1 of the NER, the DNSP is only able to recover costs associated with the pass through event that have been incurred and are likely to be incurred by the DNSP until the end of the regulatory control period in which the pass through event occurs (see the definition of "eligible pass through amount" in Ch.10).
- This "dead zone" problem can be avoided if any such Ministerial determination is made sufficiently in advance of a final distribution determination for a DNSP to enable the expected costs associated with it to be built into the DNSP's forecast operating and capital expenditure for that regulatory control period.
- There is no specific cost pass through provision for negotiated services and unregulated services.

<u>Item 8.2 of the MCE's Request for Advice – AEMC Clarification Question</u>

4.37 *Do the pass through events in Chapter 10 of the NER take precedence over any additional pass through events approved by the AER in a distribution determination? If so, would a DNSP be required to demonstrate that a Ministerial smart metering determination was not a regulatory change event or a service standards event, before it could seek pass through under a smart meter event approved in a distribution determination? Must the AER specify in its distribution determination that a Ministerial smart metering determination would be treated as a smart meter event to avoid this issue arising?*

4.38 The term 'pass through event' that is used in clause 6.6.1 of the NER is defined in Chapter 10 to mean a regulatory change event, a service standard event, a tax change event and a terrorism event (each of which is defined in the NER), as well as any additional event that is nominated in a distribution determination as a pass through event.

4.39 Subject to one exception, there is no hierarchy of precedence in relation to these pass through events, including as between those which are defined in the NER and those which are specified in a distribution determination. The exception is that a 'regulatory change event' is expressly defined not to include a change in a regulatory obligation or requirement that falls within any other category of pass through event (ie. irrespective of whether that other pass through event is one defined in the NER or one specified in a distribution determination).

4.40 Accordingly it is not open to the AER to purport to specify a pass through event in a distribution determination that applies to the exclusion of a NER-defined pass through event (apart from a regulatory change event), although it could specify that such an additional pass through event only applies where no other NER-defined pass through event applies.

4.41 Where a smart meter-related event could be both a service standard event and an additional pass through event, it is only if the latter is more favourable than the former that, as a practical matter, the specific smart meter pass through event will apply to the exclusion of the service standard event (see the assessment above relating to item 8.2 of the MCE's Request for Advice above).

<u>AEMC Question 9</u>

4.42 *If a Ministerial determination was made to roll-out smart meters or to undertake a smart meter pilot/trial, given the information above, how would nominated smart meter pass through events under distribution determinations interact with the 'regulatory change' pass through event in Chapter 10 of the NER? Is there any risk that these events would cancel each other out and result in DNSPs being unable to seek cost recovery during a regulatory control period?*

4.43 The interaction between the nominated (or "additional") smart meter event and the regulatory change event under clause 6.6.1 of the NER has been discussed in the assessment relating to item 8.2 of the MCE's Request for Advice above. There is no risk that such events would cancel each other out. However, to the extent a service standard event (or a regulatory change event) on the one hand, and a nominated smart meter event, on the other hand, are capable of applying to the same underlying circumstances, there is the potential for some double recovery, eg. as where the scope of the pass through events differs or the pass through events are subject to different materiality thresholds. Assuming that the smart meter event is the event that is intended to apply, that its scope is at least as great as that of the potentially applicable service standard event, and that its materiality threshold is no higher than that applying to the service standard event, DNSPs are likely to elect to proceed under the smart meter event. In any event, to the extent there is the potential for double recovery (in the sense of the DNSP being compensated for more than the costs that it has incurred and is likely to incur), the AER can take this into account in considering any cost pass through application (NER, cl.6.6.1(j)(8)).

<u>AEMC Question 10</u>

4.44 *Do the cost pass through provisions in clause 6.6.1 of the NER apply to alternative control services? We note that the definition of a “positive change event” in Chapter 10 of the NER refers to “direct control services”, but that clause 6.6.1 of the NER is in Part C of Chapter 6, which only relates to standard control services.*

4.45 While the pass through events are defined in terms of direct control services, the better view is that the pass through mechanism contained in clause 6.6.1 of the NER only automatically operates in relation to standard control services. This is because clause 6.6.1 is contained in Part C of Chapter 6 which sets out the control mechanism for standard control services (see NER, cl.6.2.6(a) cf. cl.6.2.6(b), (c)). Consistently with this, the cost pass through mechanism in clause 6.6.1 of the NER will only apply to alternative control services if, in deciding on the control mechanism for such services, the AER utilises that particular element of Part C of Chapter 6 of the NER (see NER, cl.6.2.6 (note)). Of course, given the wider discretion that the AER has in determining the control mechanism for alternative control services, as compared to standard control services, the AER can include in a distribution determination pass through arrangements for alternative control services that are quite separate from the clause 6.6.1 mechanism.

<u>AEMC Question 11</u>

4.46 *If a smart meter pilot or trial is not classified as a separate service but is included in distribution use of system services, could a DNSP recover the costs of a pilot/trial under the pass through provisions in clause 6.6.1 of the NER under either a smart meter event under a distribution determination or as a regulatory change event (noting that any costs would also be subject to a materiality threshold)?*

4.47 Refer to the discussion in paragraphs 3.6 to 3.8 and 4.5 to 4.12 above.

4.48 It is noted that the smart meter event set out in the assessment relating to item 8.2 of the MCE's Request for Advice above clearly contemplates a smart meter pilot or trial.

<u>AEMC Question 11 – Supplementary Question</u>

4.49 *Following on from the supplementary question to AEMC Question 2, if the pilot is treated by the AER as a "metering service" and these services were classified as alternative control services in the making of a distribution determination at the start of the regulatory control period, then is it correct to say that DNSPs would be unable to seek cost pass through under clause 6.6.1 of the NER?*

4.50 The result of the smart meter pilot related services being treated as alternative control services is that, unless the AER in its distribution determination applies the clause 6.6.1 pass through mechanism to alternative control services (or at least metering services as alternative control services), the costs of the pilot will not be able to be passed through utilising the clause 6.6.1 pass through mechanism (see the discussion in paragraphs 3.6 to 3.8 and 4.5 to 4.12 above).

<u>AEMC Question 12</u>

4.51 *If a Ministerial determination is made in the last year of a regulatory control period and a DNSP does not have sufficient time to include forecast capital and operational expenditure to meet its obligations in its regulatory proposal, is the DNSP able to include these forecasts in a revised regulatory proposal and/or a submission to the AER’s draft* *determination? Is the AER required to consider these forecasts in they are included in a revised regulatory proposal or submission?*

4.52 A DNSP's revised regulatory proposal can only respond to the AER's draft distribution determination and, specifically, may only make such revisions to the DNSP's original regulatory proposal as are necessary to incorporate the substance of any changes required to address matters raised by the draft distribution determination or the AER's reasons for it (NER, cl.6.10.3(b)). The AER must consider any revised regulatory proposal in making its final distribution determination (NER, cl.6.11.1; see also cl.6.12.1(3), (4)). Accordingly, the extent to which a revised regulatory proposal can include revisions of forecast capital and operating expenditure necessary to accommodate costs resulting from a Ministerial smart metering determination will depend on whether the AER's draft distribution determination requires it to do so.

4.53 However, in addition to any revised regulatory proposal, a DNSP is able to make such submissions in response to the AER's draft distribution determination as it thinks appropriate (NER, cl. 6.10.2(c)). A submission could include information on the forecast capital and operating expenditure required to comply with a Ministerial smart metering determination and, provided it is made on time, the AER must consider any such submission in making its final distribution determination (NER, cl.6.11.1; NEL, s.28ZC). The AER may, but is not required to, consider any submission made pursuant to an invitation for submissions after the time for making the submission has expired (NER, cl.6.14(a); NEL, s.28ZC).

4.54 This issue could be avoided if any Ministerial smart metering determination is issued in sufficient time before a final distribution determination is made to allow the costs associated with it to be included in the DNSP's operating and capital expenditure forecasts as contained in the regulatory proposal that it is required to submit at least 13 months before the commencement of the relevant regulatory control period (NER, cl.6.8.2(b)(1)).

<u>AEMC Question 13</u>

4.55 *Under clause 6.6.1 of the NER, do the following need to occur within a single regulatory control period: the pass through event, application by the DNSP to the AER for cost pass through, the AER’s decision on the pass through amount; and any pass through of costs to consumers? Could any of these events occur within the following regulatory control period under clause 6.6.1 of the NER? (e.g. could a pass through event occur in one regulatory control period and could the DNSP apply for pass through in the following period?)*

4.56 A "pass through event" must occur within the regulatory control period for which the cost pass through is sought (see the definitions of "service standard event" and "regulatory change event" in NER, Ch.10), and the DNSP is only able to pass through costs that it has incurred and is likely to incur until the end of that regulatory control period (see the definition of "eligible pass through amount" in NER, Ch.10; NER, cl.6.6.1(c), (d), (e)). However, the application by a DNSP to the AER, the AER's determination of that application and the actual pass through to distribution network users can take place in the next regulatory control period. For example, if a pass through event occurs on the last day of a regulatory control period, the DNSP will be able to make an application to pass through the costs relating to that day at a point in time that is during the course of the next regulatory control period, provided that it lodges its application within 90 days of the pass through event occurring (NER, cl.6.6.1(c)). Once the application has been lodged the AER will have 60 days to make its determination (NER, cl.6.6.1(e)).

4.57 It is noted that, under clause 6.6.1(d)(2), the AER must determine the amount of any "approved pass through amount that should be passed through to Distribution Network Users <u>in</u> each regulatory year during the regulatory control period". While this may be read as requiring the actual pass through to occur within a regulatory year of the then current regulatory control period, the manner in which the time limits operate (see paragraph 4.56 above) suggests that the better interpretation is that the pass through can occur in a subsequent regulatory control period provided the passed through costs only relate to the current regulatory control period. However it would be desirable to remove this ambiguity so that clause 6.6.1(d)(2) refers to the "approved pass through amount that should be passed through for Distribution Network Users <u>for</u> each regulatory year during the regulatory control period" (a similar change should be made to cl.6.6.1(e)(2), 6.6.1(g)(2)(ii), 6A.7.3(d)(2), 6A.7.3(e)(2) and 6A.7.3(g)(2)(ii)).

<u>AEMC Question 14</u>

4.58 *Is the AER able to consider different cost categories (e.g. reductions in different types of operational expenditure) when considering the relevant factors to determine the approved pass through amount, if these different cost categories have not been addressed in a DNSP's written statement made under clause 6.6.1(c) of the NER?*

4.59 In making a determination relating to a cost pass through application, the AER must take into account increases in costs, the efficiency of the DNSP's decisions and actions in relation to the risk of the relevant pass through event, and any other factors the AER considers relevant (NER, cl.6.6.1(j)(2), (3), (8)). There is no requirement that the AER should not consider all relevant cost categories when determining a pass through application. Consistently with this, the reference to costs is a reference to the net costs of the DNSP assessed on an overall basis. Accordingly the AER would be required to take into account cost savings, as well as cost increases, resulting from the pass through event. Even if the AER were not required to do so, it would have the discretion to do so (NER, cl.6.6.1(j)(8)). Moreover, the AER is not limited to the information provided to it in the DNSP's pass through application. In particular:

- if no (or insufficient) information on cost savings was provided, the AER could request the DNSP to provide such information, failing which the AER (presumably not being satisfied with the costs claimed) would allow a lower pass through amount; and
- the AER could issue a regulatory information instrument requiring cost pass through applications to be accompanied by information relating to associated cost savings (see NER, cl.6.6.1(c)(7)).

4.60 In passing, the restricted application of the provision that refers to the efficiency of the DNSP's decisions and actions (NER, cl.6.6.1(j)(3)) is noted. This provision, which refers to the efficiency of those decisions and actions "in relation to the risk of the positive change event", seems to be directed at matters that the DNSP should have anticipated, rather than more generally directed to the requirement that the DNSP's costs incurred in response to the pass through event should be efficient costs. While the AER could consider the efficiency of the costs incurred or likely to be incurred by the DNSP in responding to a pass through event as another "relevant factor" (NER, cl.6.6.1(j)(8); see also paragraph 4.71 below), it might be considered appropriate to include the requirement that the costs be efficient as an express factor that the AER must take into account.

AEMC Question 15

4.61 *Are DNSPs able to submit multiple pass through requests to the AER in regards to a single pass through event? We note that the AER is able to extend the period of time for a DNSP to apply for cost pass through under clause 6.6.1(k) of the NER.*

4.62 DNSPs are only able to submit one pass through application in relation to a pass through event (NER, cl.6.6.1(c)). Moreover, the application must set out a once off assessment of the actual and likely increase in costs as a result of the relevant pass through event (NER, cl.6.6.1(c)(3), (6)).

4.63 However, the AER must extend the period of time for a DNSP to apply for a cost pass through if the AER is satisfied that the difficulty of assessing or quantifying the effect of the relevant pass through event justifies the extension (NER, cl.6.6.1(k)). It is noted that this is a mandatory requirement, as opposed to merely a discretion that is conferred on the AER. A DNSP is not prejudiced by any such extension of time as, in making a cost pass through determination, the AER must also take into account the time cost of money based on the weighted average cost of capital for the DNSP for the regulatory control period (NER, cl.6.6.1(j)(4)). The 60 business day period for the AER's determination of the cost pass through application runs from the time the DNSP's application is submitted under the extended timetable.

AEMC Question 16

4.64 *Is the AER required to take into account the NEO and the revenue and pricing principles in the NEL in making a cost pass through determination? We note that under Section 16 of the NEL the AER is required to take the principles into account when exercising discretion in making a distribution determination but may take them into account when performing or exercising any other AER economic function or power?*

4.65 An "AER economic regulatory function or power" includes (NEL, s.2):

- a function or power performed or exercised by the AER under the NER that relates to the economic regulation of services provided by a DNSP by means of or in connection with a distribution system; and
- a function or power performed or exercised by the AER under the NER that relates to the making of a distribution determination.

A "distribution determination" is quite broadly defined to include a determination of the AER under the NER that regulates the revenue a DNSP may earn from the provision of services provided by means of or in connection with a distribution system where those services are subject to economic regulation under the NER (NEL, s.2). The potential range of decisions that may constitute a distribution determination under the NEL is suggested by the fact that a "reviewable regulatory decision" is defined to include not just a distribution determination that sets a regulatory period (as is the case with a distribution determination under the

NER) but also "any other distribution determination … or decision of the AER under the [NER]" that is prescribed by regulation (NEL, s.71A). The better view is that the determination by the AER of a cost pass through application can be characterised as an "AER economic regulatory function or power" under both of these heads. The making of a cost pass through determination:

- "relates to" the economic regulation of distribution services; and
- constitutes the making of a distribution determination as it is a determination that regulates the DNSP's allowed revenue.

In both cases a cost pass through determination allows the DNSP to earn revenues in excess of its previously determined allowed revenue. In saying this it is noted that, when referring to a distribution determination, the NER are clearly referring only to the periodic regulatory reset determination.

4.66 The AER is required, in performing or exercising an AER economic regulatory function or power, to perform or exercise that function or power in a manner that will or is likely to contribute to the achievement of the NEO (NEL, s.16(1)(a)). Accordingly, the AER is required to determine a cost pass through application in a manner that will or is likely to contribute to the achievement of the NEO.

4.67 The AER is only required to take into account the revenue and pricing principles when exercising a discretion in making a distribution determination (NEL, s.16(2)(a)(i)). For the reasons given in paragraph 4.65 above, the better view is that the determination of a cost pass through application is the making of a distribution determination for the purposes of the NEL (albeit not the NER), although there are contrary arguments. On the basis of this view, the AER would be required to take into account the revenue and pricing principles in making a cost pass through determination. However, if this view is not correct (and it might be desirable to clarify this in the NEL), the AER would still have a discretion to take these principles into account in determining a cost pass through application (NEL, s.16(2)(b); NER, cl.6.6.1(j)(8)).

<u>AEMC Question 16 – Clarification Question</u>

4.68 *We note that AAR considers that a cost pass through determination comprises part of a distribution determination. We understand that distribution determinations are subject to merits reviews, but cost pass through determinations are only subject to judicial review. As AAR considers that cost pass through determinations comprise part of a distribution determination, would cost pass through determinations also be subject to merits review?*

4.69 As stated above, the better view is that a determination by the AER of a cost pass through application made by a DNSP pursuant to clause 6.6.1 of the NER is a 'distribution determination' for the purposes of the NEL. Based on this conclusion, a cost pass through determination is a 'reviewable regulatory decision' (NEL, s.71A) and, accordingly, subject to merits review. Of course the availability of merits review depends on the satisfaction of certain prerequisites in the particular case (see NEL, ss.71C, 71D, 71E, 71F, 71H). The most significant of these is the requirement in section 71F(2) of the NEL that the amount that is specified in or derived from the pass through decision must exceed the lesser of $5,000,000 or 2% of the average annual regulated revenue of the DNSP. This may well mean that, while merits review is technically available in respect of cost pass through decisions, as a practical matter such merits review is precluded because pass through applications do not typically meet this threshold criterion.

<u>AEMC Question 17</u>

4.70 *Is the AER required to determine the efficient costs of a pass through event in determining a pass through amount under clause 6.6.1 of the NER?*

4.71 The NEO is focussed on efficiency, and a cost pass through determination is required to contribute to the achievement of the NEO. Moreover if, as is the better view, the AER is required to take into account the revenue and pricing principles in determining a cost pass through application, then it must make that determination in such a way as to enable the DNSP to recover its efficient costs. If this view is incorrect, there is no specific requirement that the AER must only allow the efficient costs of a DNSP to be passed through where a pass through event occurs. As previously noted, clause 6.6.1(j)(3) only focuses on a particular aspect of efficient costs. Nonetheless, the AER may choose to take into account efficient costs as another "relevant factor" (NER, cl.6.6.1(j)(8); see also paragraphs 4.59 and 4.60 above).

<u>AEMC Question 18</u>

4.72 *We understand that under Section 14B of the NEL, failure by a DNSP to comply with its distribution determination is a breech of a civil penalty provision. Is failure of a DNSP to comply with a cost pass through determination also a civil penalty provision?*

4.73 Section 14B of the NEL obliges a DNSP to comply with a distribution determination and a civil penalty may be imposed for any non-compliance. If it is correct that a cost pass through determination is a distribution determination for the purposes of the NEL (see paragraph 4.65 above), then a failure to comply with a cost pass through determination would be a breach of section 14B that attracts a civil penalty. If this view is incorrect, then this result does not follow unless the distribution determination itself mandates compliance with an AER cost pass through determination. In this regard a court might consider compliance with a cost pass through determination to be implicit in a distribution determination.

Item 8.3 of the MCE's Request for Advice

Whether the provisions of Chapter 6 of the NER allow a distributor to enter into a contract (or other arrangement) with a retailer for the provision of retail services used in smart meter and direct load control pilots or trials and then allow the distributor to recover the associated fees charged by the retailer.

<u>Assessment of how Chapter 6 of the NER and the NEL would apply</u>

- It is likely that DNSPs will be required to contract retailers in fulfilling their obligations under a mandated smart meter pilot/trial or smart meter roll-out. The MCE Standing Committee of Officials considers that, as retail price regulation is a jurisdictional responsibility, the recovery of any retailer costs incurred by DNSPs in undertaking a pilot should be recovered through distribution charges.[5]

- Under the operating and capital expenditure criteria in clauses 6.5.6(c) and 6.5.7(c) of the NER, the AER is required to be satisfied that the forecast operating and capital expenditure proposed by the DNSP reasonably reflect the costs of achieving the operating and capital expenditure objectives and are efficient, prudent, and based on a realistic expectation of the demand forecast and cost inputs. In considering the prudency of the forecast expenditure, the AER is required to consider the circumstances of the relevant DNSP. In the case of a mandated smart meter pilot, this may include the timing of a DNSP's obligation to undertake a pilot and the degree of choice in terms of the retailers the DNSP can contract in fulfilling its obligations.
- In making a distribution determination, under the operating and capital expenditure factors, the AER is also required to have regard to whether the forecast operating and capital expenditure relates to arrangements which do not reflect arm's length terms.
- Under the cost pass through provisions in clause 6.6.1 of the NER, the AER is able to determine the appropriate pass through amount, having regard to the factors in clause 6.6.1(j) of the NER, which includes the efficiency of the DNSP's decisions and actions and "any other factors the AER considers relevant".

<u>AEMC Question 19</u>

4.74 *Is there a risk that any retailer costs that are incurred by a DNSP in fulfilling its obligations under a Ministerial determination may not be able to be passed through under clause 6.6.1 of the NER? We note that under clause 6.6.1 of the NER a pass through event is defined as an event that materially increases the cost of providing direct control services, which is defined in Section 2B of the NEL to include an electricity network service, being in turn defined in Section 2 of the NEL as a service being provided by means of or in connection with a distribution system. Does this definition of "direct control services" limit/prevent the recovery of retailer costs under clause 6.6.1 of the NER?*

4.75 It is understood that the services that DNSPs are likely to request from retailers for the purposes of enabling them to perform their obligations under a Ministerial smart metering determination are ancillary services such as customer liaison and interface. The regulatory obligation or requirement is that the DNSP must comply with a Ministerial smart metering determination. The undertaking of smart meter trials and the rollout of smart meters is an electricity network service (ie. these services are provided by means of or in connection with a distribution system). The DNSP is entitled to recover the reasonable costs of providing those services, even if their provision requires the DNSP to contract for the provision of some ancillary services from a retailer. Accordingly, a DNSP should be able to recover the costs charged to it by retailers for such services to the extent those costs satisfy the AER's requirements for pass through (eg. that they are reasonable, efficient etc: see NER, cl.6.1.1(j)).

---

[5] MCE Standing Committee of Officials, 2009, *National Electricity Amendment Bill – Smart Meters: MCE Standing Committee of Officials Policy Response,* June, p. 24.

AEMC Question 20

4.76 *If a DNSP is required to contract a retailer to fulfill its obligations under a Ministerial determination and there are a limited number of retailers in the relevant geographic area which result in the contracted retailer charging the DNSP monopoly rent for its services, is there a risk that these retailer costs may not be recovered by the DNSP under either the distribution determination process and the cost pass through process? If the contracted retailer is a related party to the DNSP, does this relationship affect the AER's considerations or the possibility of cost recovery under the distribution determination process and cost pass through process?*

4.77 The matters that the AER must be satisfied of in order to accept a DNSP's proposed forecast operating or capital expenditure for a regulatory control period are discussed in paragraph 3.3 above. If a DNSP can satisfy the AER that it has no choice but to pay a retailer monopoly rent for services that it requires in order to fulfil its obligations under a Ministerial smart metering determination, then it should be entitled to recover those retailer charges under either a distribution determination or by way of a cost pass through. However, if the DNSP could have obtained those services from another provider, could have negotiated lower charges for those services, or could have found an alternative and more cost effective way of complying with the Ministerial smart metering determination that did not require the retailer services, then its costs risk being considered not to be reasonable, efficient and/or prudent. In such circumstances the AER could deny full cost recovery to the DNSP.

4.78 The AER must accept a DNSP's forecast operating or capital expenditure if it is satisfied that, among other things, the total of the forecast operating or capital expenditure for the regulatory control period reasonably reflects prudent and efficient costs, having regard to (among other matters) the extent the forecast operating or capital expenditure is referable to arrangements with a person other than the provider that do not reflect arm's length terms (NER, cl.6.5.6(e)(9), 6.5.7(e)(9)). This allows the AER to reduce a DNSP's forecast expenditure where, for example, the AER considers the related party (such as a related retailer that provides the DNSP with services ancillary to its compliance with a Ministerial smart metering determination) is charging a non-arm's length (ie. inflated) price for those services. In reaching this view, the AER would consider matters such as the actual costs of the retailer in providing the services, the price for similar services charged by retailers who are unrelated to DNSPs, and whether the DNSP has competitively tendered for the services etc.

4.79 Moreover, to the extent the DNSP recovers a return on the expenditure comprised in the related retailer's charges (through those charges being included in the building blocks) and those charges include a profit margin for the retailer, the AER may well take the view that there is an element of double recovery and so refuse to allow the DNSP to include the retailer's margin as part of its forecast expenditure.

Item 8.4 of the MCE's Request for Advice

The implications for cost recovery of services being categorized as alternative control services rather than standard control services, and whether any modifications to the NER are required to *ensure recovery of efficient costs and whether it is appropriate to unbundle metering services from distribution use of system charges.*

Assessment of how Chapter 6 of the NER and the NEL would apply

- Section 2B of the NEL defines direct control services.
- The AER is required to classify direct control services as either standard control services or alternative control services through its distribution determination process. The AER is required to have regard to the factors outlined in clause 6.2.2.(c) of the NER in determining whether to classify direct control services as standard control services or alternative control services.
- Under clause 6.2.6(b) of the NER, the AER is able to exercise discretion in determining the form of control that applies to alternative control services through its distribution determination process. Clause 6.2.6(c) of the NER provides that the control mechanism for alternative control services may use elements of the building block approach used for standard control services, with or without modification.
- Part C of Chapter 6 of the NER, which includes the cost pass through provisions, relates only to standard control services and sets out how building block determinations for standard control services must be made.
- The revenues and prices that DNSPs are able to recover for both standard control and alternative control services are determined through the distribution determination process.
- We note under a mandated roll-out of smart meters, there is the potential for the AER to classify multiple smart metering services, and that different services may have different classifications.

AEMC Question 21

4.80 *For alternative control services, what implications are there for cost recovery under a distribution determination and cost pass through determination compared to standard control services (eg. factors the AER is required to consider, amount of discretion provided to the AER etc)?*

4.81 Reference is made to paragraphs 3.4, 3.8, 4.20 to 4.24 and 4.44 to 4.45 above. As for standard control services, the AER must apply the NEO and the revenue and pricing principles in regulating alternative control services (NEL, ss.2, 16(1)(a), (2)). The AER may also choose to utilise elements of Chapter 6, Part C (which includes clause 6.6.1 relating to cost pass through) in the control mechanism for alternative control services (NER, cl.6.2.6(c)). To the extent the AER applies the Part C cost pass through mechanism to alternative control services, that mechanism will apply in the same way as for standard control services.

AEMC Question 22

4.82 *Can different alternative control services each have their own control mechanism?*

4.83 There is no provision in the NER that would prevent different alternative control services from each having their own control mechanism (NER, cl.6.2.5(b)(6), 6.2.5(d), 6.2.6).

AEMC Question 23

4.84 *Is the AER able to reclassify services or classify new services within a regulatory control period (eg. during a cost pass through determination)? If not, how would smart metering services be classified if a DNSP was required to roll-out smart meters within a regulatory control period?*

4.85 A classification of distribution services forms part of a distribution determination and operates for the regulatory control period for which the distribution determination is made (NER, cl.6.2.3). It follows from this that the AER cannot reclassify services during a regulatory control period.

4.86 In this regard it is noted that:

- a "framework and approach paper" published by the AER in anticipation of a distribution determination is required to set out the AER's likely approach to the classification of distribution services (NER, cl.6.8.1(a), (b)(1)), and a DNSP's regulatory proposal must include a classification proposal showing how its distribution services should, in its opinion, be classified (NER, cl.6.8.2(c)(1));
- a distribution determination is predicated on a decision by the AER on the classification of services to be provided by a DNSP during the regulatory control period (NER, cl.6.12.1(1)); and
- the classification of services adopted in a distribution determination must be as set out in the relevant framework and approach paper unless the AER considers that, in light of the DNSP's regulatory proposal and the submissions received, there are good reasons for departing from that classification (NER, cl.6.12.3(b)).

All of these provisions are designed to ensure that there is certainty of service classification for the entirety of the regulatory control period. If the service classification could be changed during that period, then it would potentially result in the control mechanisms not applying properly (eg. if a service ceased to be a standard control service then the DNSP's expenditure allowances would be overstated). Although a cost pass through determination is considered to be a distribution determination under the NEL, it would not be a distribution determination as that term is used in the NER (where it clearly refers to the periodic regulatory reset). Accordingly, those NER provisions that require or entitle the AER to classify distribution services as part of a distribution determination would not apply to a cost pass through determination. Even if this were not the case, the context in the NER makes it clear that a cost pass through determination is not a determination that may deal with the classification of services (NER, cl.6.6.1).

4.87 If a Ministerial smart metering determination is made during a regulatory control period, and (for example) standard control services relating to metering are broadly classified in the relevant distribution determination, the cost pass through provisions in clause 6.6.1 of the NER would automatically apply in respect of the costs incurred by a DNSP in fulfilling its obligations under that Ministerial determination.

4.88 However, an issue would arise if standard control services relating to metering are defined in such a way that they do not extend to smart metering services that a DNSP is required to provide under a Ministerial determination. Specifically, the relevant smart metering services, not falling within a pre-existing classification under the distribution determination, would be unregulated services and so outside Chapter 6 of the NER altogether (NER, cl.6.2.6; see also paragraphs 4.11 and 4.12 above).

AEMC Question 24

4.89 *Could the AER apply different weighted average cost of capital (**WACC**) values to alternative control services compared to standard control services? Is the AER able to apply different WACC values to different standard control services?*

4.90 The better view is that it is not possible to apply different WACC values to different standard control services. This is because the NER only contemplate there being a single regulatory asset base for each DNSP that is adjusted (both within and between regulatory control periods) strictly in accordance with the requirements set out in Schedule S6.2 of the NER (see NER, cl.S6.2.1(c), (e), S6.2.3). The NER then provide for a rate of return on that regulatory asset base (NER, cl.6.4.3(a)(2), (b)(2), 6.5.2(a); see also cl.6.5.4(e)(1)). It is difficult to see how these provisions can accommodate different WACCs for standard control services, these services being the subject of this approach.

4.91 Conversely, the AER has considerably greater discretion in determining the control mechanism for alternative control services. In the exercise of this discretion the AER could conceivably apply a WACC for alternative control services that differed from the WACC applied to standard control services or to other alternative control services (NER, cl.6.2.6). However, such different returns would have to be justified by the different risk levels attaching to the different categories of services.

AEMC Question 25

4.92 *For there to be a separate line item on customer bills for mandated smart meter costs, one of these approaches would need to be adopted:*

(a) Requiring smart metering services to be classified as alternative control services, which would result in a separate price for smart metering services and a separate price for distribution use of system services.

(b) Allowing smart metering services to be classified as standard control services, but requiring the AER to develop a separate building block for smart metering services. This would result in two building blocks and two separate prices, one for distribution use of system services and one for smart metering services.

(c) Requiring DNSPs to charge a separate tariff for smart metering services.

Please provide advice on whether the three above policy options could be accommodated under the current NER, and what changes to the NER may be necessary to accommodate each option. In particular, we note that in relation to option b) under clause 6.5.9(b)(3)(ii) of the NER, the potential for separate X factors for different standard control services is anticipated, but under 6.2.5 and 6.2.6 of the NER, only a single control mechanism is referred to.

4.93 Option (a): the AER cannot require a DNSP to have a separate tariff (and therefore line item) for smart metering services if it is consistent with the tariff assignment principles (see NER, cl.6.18.4) for the DNSP to do otherwise and the DNSP does otherwise. Having said this, a DNSP is required to have separate tariffs for standard control services ("distribution use of system services") and alternative control services (such as smart metering services) (NER, cl.6.18.3(c)). Moreover, customers are required to be assigned to a tariff class on the basis of similar characteristics, which may include the use of mandated smart meter technology (NER, cl.6.18.4(a); see esp. cl.6.18.4(a)(1)(iii)).

4.94 Option (b): the mere fact that there may be a separate building block for smart metering services does not mean that there would necessarily be a separate tariff or line item for smart metering services, as different standard control services could conceivably be grouped together under the same tariff (NER, cl.6.18.3, 6.18.4). Again the issue is whether the DNSP's tariff structure is consistent with the tariff assignment and tariff pricing principles (see paragraph 4.93 above and NER, cl.6.18.5).

4.95 Option (c): as stated above, DNSPs have a significant amount of discretion in formulating their tariffs (NER, cl.6.18.3(d), 6.18.4(a)(1), (2); see also paragraph 3.9 above). If it is desired to constrain DNSPs so that they must have a separate tariff for smart metering services then this should be stated in the NER.

4.96 In short, if the AER is to be required to develop a separate building block for smart metering services (Option (b)), and if DNSPs are to be required to have a separate tariff for smart metering services in circumstances where they would not otherwise be required to do so within the general constraints of the tariff assignment and pricing principles, the NER would need to be amended to impose these requirements. It seems that different X factors could be applied to different categories of standard control services (NER, cl.6.5.9(b)(3)(ii)). This is still consistent with the control mechanism for standard control services being required to be of the CPI-X form (NER, cl.6.2.6) – it is just that the X factor varies. This is also consistent with just having a single regulatory asset base (see paragraph 4.90 above).

Item 8.5 of the MCE's Request for Advice

The implications for the recovery of efficient costs of implementing a future Ministerial pilot metering determination which may include direct load control and/or a Ministerial smart meter rollout determination for distribution price determinations that have already been made by the AER prior to the NEL amendments, including whether the costs of alternative control services can be recovered under the cost pass through mechanism if this was not anticipated in the determination.

Assessment of how Chapter 6 of the NER and the NEL would apply

- DNSPs are able to apply for pass through for a smart meter roll-out or smart meter pilot/trial under specific nominated ‘smart meter’ pass through events as approved by the AER in distribution determinations or under the ‘regulatory change event’ in Chapter 10 of the NER. A service standard event could also arise in connection with the mandated rollout of smart meters.

- The AER has recently approved specific nominated ‘smart meter’ pass through events in the distribution determinations for New South Wales and Australian Capital Territory DNSPs (and in the draft distribution determinations for South Australian and Queensland DNSPs). Tasmanian DNSPs are not yet subject to Chapter 6 of the NER and remain regulated under jurisdictional instruments, and expenditure associated with the mandatory roll-out of smart meters in Victoria is exempt from the provisions in Chapter 6 of the NER.

- Cost pass through events are subject to a materiality threshold under clause 6.6.1 of the NER, and the AER has discretion to determine the appropriate materiality threshold for different pass through events. In its recent NSW distribution determination, the AER indicated that a smart meters pass through event will be considered material if "the costs of the event exceed the reasonable costs incurred in assessing the pass through application".[6] However, the AER also noted that it will:

  > "generally consider that a pass through event will have a material impact if the costs associated with the event would exceed 1 per cent of the smoothed forecast revenue specified in the final decision in the years of the regulatory control period that the costs are incurred".[7]

  It appears that this is the materiality threshold that would apply to a 'regulatory change event'.

- It is likely that a smart meter roll-out would meet the materiality threshold of both a smart meters pass through event and a regulatory change event. It is uncertain whether a smart meter pilot or trial would meet either materiality threshold.

- Under Chapter 6 of the NER, the cost pass through provisions in clause 6.6.1 of the NER do not apply to alternative control services. However, the AER has the discretion to apply the cost pass through provisions to alternative control services in determining the form of control that will apply to alternative control services through its distribution determination process. If the application of the cost pass through provisions to alternative control services was not anticipated in a distribution determination, DNSPs would not be able to apply for cost pass through for those services for the relevant regulatory control period.

<u>AEMC Question 26</u>

4.97 *Could the NER apply retrospectively, if a Ministerial determination is made prior to the making of any NER changes by the Commission on cost recovery for mandated smart metering infrastructure?*

4.98 Clause 33 of Schedule 2 to the NEL provides that the amendment of a provision of the NER does not:

(a) affect the previous operation of the provision or anything suffered, done or begun under the provision; or

(b) affect a right, privilege or liability acquired, accrued or incurred under the provision.

Moreover the application of this provision cannot be displaced by a contrary intention appearing in the NER (NEL, s.3; Sch 2, cl.1(2)).

4.99 This provision reflects the general rule of statutory interpretation that:[8]

> a statute changing the law ought not, unless the intention appears with reasonable certainty, to be understood as applying to facts or events that have already occurred in such a way as

[6] AER, *Final Decision: New South Wales Distribution Determination 2009-10 to 2013-14*, April 2009, p. 285.

[7] AER, *Final Decision: New South Wales Distribution Determination 2009-10 to 2013-14*, April 2009, p. 280.

[8] *Maxwell v. Murphy* (1957) 96 CLR 261, at p.267.

to confer or impose or otherwise affect rights or liabilities which the law has defined by reference to past events.

4.100 This presumption is equally applicable in so far as rules or regulations made under a statute are concerned.

4.101 The situation that both clause 33 of Schedule 2 to the NEL and the common law presumption against retrospectivity is directed at is where legislation confers, imposes or otherwise affects rights or obligations that have already come into existence or purports to change things that have already been done under a law.[9] The better view is that an amendment to the NER that allowed DNSPs to recover costs for mandated smart metering infrastructure incurred before the amendment would not be retrospective in this sense (and so ineffective), providing it does not purport to "undo" or change things that have been done, but merely to allow the recovery in the future of costs that have been incurred in the past. By way of analogy, a NER amendment that purported to preclude a distributor from recovering incurred costs which it has already recovered in accordance with a principle set out in the NER, and that required the DNSP to refund those costs, would be prohibited. However, the mere fact that an amendment to the NER confers on DNSPs the right to recover costs they have incurred in the past is not in breach of these requirements.

Item 9.1 of the MCE's Request for Advice

Whether there is an obligation under the NEL and the NER for the AER to take into account 'reasonably achievable network operational benefits' in determining efficient costs.

Assessment of how Chapter 6 of the NER and the NEL would apply

- The AER is required to consider the efficient level of costs that would be incurred by a prudent operator in the circumstances of the relevant DNSP in assessing whether a DNSP's regulatory proposal meets the capital and operating expenditure criteria when making a distribution determination. The AER must also have regard to the NEL revenue and pricing principles in making a distribution determination, which ensures that DNSPs will have a reasonable opportunity to recover at least the efficient costs of providing direct control services and complying with a regulatory obligation.
- The cost pass through provisions in clause 6.6.1 of the NER do not explicitly require the AER to determine the efficient costs associated with a pass through event in determining a pass through amount.
- We note that the AER has the potential to include performance requirements for DNSPs in meeting their obligations under a Ministerial determination in a service target performance incentive scheme. However, it may not make sense to include such performance requirements in a service target performance incentive scheme to the extent that the manner in which DNSPs are required to fulfil their obligations for a smart meter rollout is set out in the relevant Ministerial determination. In this regard it is noted that the principal

[9] *Maxwell v Murphy* (1957) 96 CLR 261, at p.267; *Geschke v Del-Monte Home Furnishers Pty Ltd* [1981] VR 856; *Walton v McBride* (unreported, NSW Supreme Court, 3 October 1989); *La Macchia v Minister for Primary Industries* (1986) 72 ALR 23; *Coleman v Shell Company of Australia Ltd* (1943) 45 SR (NSW) 27, at p.31 applied in *Reid v Secretary, Department of Family and Community Services* (2001) 109 FCR 477.

performance criterion appears to be likely to be meeting a Ministerially determined timetable (NEL, s.118D(5)).

AEMC Question 27

4.102 *What penalties would apply if a DNSP breached the requirements in a Ministerial determination, noting that a Ministerial determination would be made under the NEL?*

4.103 Section 118F(1) of the NEL requires DNSPs to comply with a Ministerial smart metering determination. A failure to do so will therefore be a breach of the NEL. Only the AER may make an application to a court for an order declaring that a DNSP is in breach of section 118F (NEL, ss.59, 61(1)). Such an order may include one or more of the following:

- an order that the DNSP ceases, within a specified period, the act, activity or practice constituting the breach (NEL, s.61(2)(b));
- an order that the DNSP take such action, or adopt such practice, as the court requires for remedying the breach or preventing a recurrence of the breach (NEL, s.61(2)(d));
- an order that the DNSP implement a specified program for compliance with the NEL (NEL, s.61(2)(c)).

4.104 Further, the Court may, on the application of the AER, grant an injunction restraining the DNSP from engaging in the conduct or requiring the DNSP to do something (NEL, s.61(3)).

AEMC Question 28

4.105 *Is there a difference in the AER's obligation or discretion to consider network operational benefits in making a distribution determination compared to a cost pass through determination, noting the AER's differing legal obligations regarding factors it must consider when it determines the appropriate level of expenditure?*

4.106 Reference is made to paragraphs 4.20 to 4.26, 4.58 to 4.60 and 4.64 to 4.71. Although there is arguably more of an emphasis on efficiency (which would extend to network operational benefits) in those provisions of the NER that relate to the making of a distribution determination (eg. cl.6.5.6 and 6.5.7) compared to the cost pass through provision (NER, cl.6.6.1), it is considered that in practice this is not likely to make a substantive difference.

Item 9.2 of the MCE's Request for Advice

Whether the NER provide the ability for the AER to take into account 'reasonably achievable network operational benefits' either during the distribution determination process or in making a pass through determination or both, and to request information sufficient for this purpose.

Assessment of how Chapter 6 of the NER and the NEL would apply

- In making a distribution determination, the AER has the ability to take into account 'reasonably achievable network operational benefits' in considering the "benchmark operating expenditure that would be incurred by an efficient DNSP over the regulatory control period" under the operating expenditure factors (clause 6.5.6(e)(4)). The AER would must also be satisfied that the forecast operating expenditure proposed by the

DNSP reflects the efficient costs that a prudent operator in the circumstances of the DNSP would require to meet the operating expenditure objectives, under the operating expenditure criteria.

- In making a cost pass through determination, the AER is able to consider 'reasonably achievable network operational benefits' if it considers these benefits are relevant to its determination under clause 6.6.1(j)(8) of the NER.
- In making a distribution determination, the AER has the ability to make a relevant regulatory information instrument to request specific information from a DNSP on the following matters:
  - requirements for the making of a building block proposal;[10]
  - requirements for the required operating and capital expenditure that is to be included in a building block proposal;[11]
  - requirements for the regulatory proposal;[12]
  - requirements for a revised regulatory proposal.[13]
- The AER is able to make a number of specific guidelines as well as a guideline on any other matter relevant to Chapter 6 of the NER.[14] The making of these guidelines allows the AER to set out its information expectations on specific matters as required to be provided by DNSPs under the NER. However, the guidelines are not mandatory on either the DNSPs or the AER, although where the AER deviates from a matter contained in its guidelines it must state the reasons for that deviation.[15]
- As noted under item 12.3 of the MCE's Request for Advice (see below), under the NEL the AER also has the ability to request information from DNSPs it considers necessary for the performance or exercise of its functions or powers under the NEL or the NER.

Item 9.3 of the MCE's Request for Advice

Whether the framework provides for the efficient allocation of costs of a smart meter roll out, which may include apportioning costs against something other than a standardised cost per customer.

<u>Assessment of how Chapter 6 of the NER and the NEL would apply</u>

- In general, costs of standard control services would be expected to be recovered through DUOS tariffs paid by all or most customers, whereas costs of alternative control services would be expected to be recovered from individual customers receiving those services.

[10] Clause 6.3.1(c)(2) of the NER.

[11] Clauses 6.5.6(b)(1) and 6.5.7(b)(1) respectively of the NER.

[12] Clause 6.8.2(d) of the NER.

[13] Clause 6.10.3(c) of the NER.

[14] Clause 6.2.8 of the NER.

[15] Clause 6.2.8(c) of the NER.

- Under clause 6.18.2 of the NER, DNSPs are required to submit a pricing proposal to the AER for each regulatory year of the regulatory control period. The information that a pricing proposal must contain is outlined in clause 6.18.2(b) of the NER, and includes (amongst other information), the tariffs and tariff classes that will apply for the relevant regulatory year.
- Separate tariff classes must apply for customers of standard control services and alternative control services.[16] The AER is required to formulate provisions in its distribution determinations, in accordance with defined principles in the NER, which govern how customers should be assigned or re-assigned to tariff classes.[17]
- Pricing principles set out in clause 6.18.5 of the NER outline how revenue should be recovered for each tariff class and tariff.
- Under clause 6.18.8 of the NER, the AER is required to approve a DNSP's pricing proposal if the forecasts in the proposal are reasonable and if the proposal complies with the pricing rules in Part I of Chapter 6 of the NER and any applicable distribution determination. If the AER considers that a pricing proposal does not meet the relevant requirements in the NER, it may ask the DNSP to re-submit its proposal or it may amend the proposal itself.
- The cost allocation requirements in Part F of Chapter 6 of the NER may operate as potential constraints in regards to establishing a tariff class related to the provision of a smart metering service. This is because where there is a smart metering tariff, the cost allocation principles require that:
    - only costs which are directly attributable to the provision of smart metering services may be allocated to the smart metering tariff;[18]
    - costs which are not directly attributable to the provision of smart metering services, but which are incurred in providing those services, must be allocated to the smart metering tariff using an appropriate allocator.[19] This allocator must be:
        - an allocator that is causation based; or
        - to the extent the cost is immaterial or a causal based method of allocation cannot be established without undue cost and effort, an allocator that accords with a well accepted cost allocation method.
- Costs which have been allocated to a particular service cannot be reallocated to another service during the course of a regulatory control period.[20]

[16] Clause 6.18.3(c) of the NER.

[17] Clause 6.18.4 of the NER.

[18] Clause 6.15.2(3)(i) of the NER.

[19] Clause 6.15.2(3)(ii) of the NER.

[20] Clause 6.15.2(7) of the NER.

Item 10.1 of the MCE's Request for Advice

Whether there is sufficient flexibility provided under the NER for the AER to determine an appropriate materiality threshold for the pass through of distributor costs associated with a Ministerial pilot metering determination.

Assessment of how Chapter 6 of the NER and the NEL would apply

- Chapter 6 of the NER does not include a specific materiality threshold for pass through events. However, in the context of the pass through events that are specified in the NER (most relevantly the "service standard event" and "regulatory change event"), "materiality" has its ordinary meaning (NER, Ch.10). In this regard, it is noted that a commonly accepted materiality threshold is 5% of net assets or EBIT. Having said this, the AER has tended to consider 1% of the smoothed revenue requirement as the cost materiality threshold for such events. In contrast, the materiality threshold which the AER may adopt for any additional cost pass through event that is nominated in a distribution determination is not specified (NER, Ch.10). Indeed, there is no requirement to include such a threshold although the AER is likely to do so.
- We note that under clause 6.2.8(4) of the NER, the AER is able to publish guidelines on its likely approach to determining materiality in the context of possible pass through events. To date, the AER has not published a guideline on this matter, but has outlined its approach to materiality thresholds in its distribution determinations.

Item 10.2 of the MCE's Request for Advice

Whether the timeframes in the current NER for pass through applications and determinations are appropriate, in the context of a Ministerial pilot metering determination and/or a Ministerial smart meter rollout determination.

Assessment of how Chapter 6 of the NER and the NEL would apply

Under clause 6.6.1(c) of the NER, DNSPs must submit a written statement to the AER seeking cost pass through within 90 business days of the relevant positive change event occurring. Under clause 6.6.1(k) of the NER, the AER must extend this timeframe, if it considers that the difficulty of assessing or quantifying the effect of the pass through event justifies the extension. There is no limit to the amount of time that the AER may extend the DNSP's 90 business day timeframe by. There is also no restriction on the number of times that the AER may extend this timeframe (ie. the AER is able to approve multiple time extensions).

- Under clause 6.6.1(e) of the NER, the AER must make a determination on the DNSP's written statement within 60 business days of receiving the statement. There is no ability to extend the AER's 60 business day timeframe under the NER. If the AER does not make a determination within this timeframe, the AER will be taken to have approved the positive pass through amount and the timing for the positive pass through amount to be passed through, as proposed in the DNSP's written statement. Time begins to run in respect of the 60 business day period only once the DNSP has lodged its written application (NER, cl.6.6.1(c), (e)). This is the case regardless of whether or not the time by which the DNSP has to lodge its written application is extended. So, for example, if a DNSP is given 20 additional business days, beyond the 90 business day period in clause 6.6.1(c), in which to lodge its written application, and it lodges that application on the 19th day of the extended period, it is only on that 19th day that time will begin to run in respect of the 60 business day period within which the AER must determine the application.

Item 11.1 of the MCE's Request for Advice

Whether an efficiency benefit sharing scheme as provided for under clause 6.5.8 of the NER is appropriate for an accelerated roll out of smart meters, given the MCE decision that the efficiencies gained from a roll out are to be passed on to customers 'promptly'.

<u>Assessment of how Chapter 6 of the NER and the NEL would apply</u>

- The AER is required to develop and publish the Efficiency Benefit Sharing Scheme (***EBSS***) that provides for a fair sharing between DNSPs and the DNSP's network users of the efficiency gains and losses derived from the operating expenditure of the DNSP being less than or more than the forecast operating expenditure accepted or substituted by the AER over the DNSP's regulatory control period.
- The AER is able to determine how the EBSS applies to each DNSP through its distribution determination process. In recent distribution determination processes (eg. NSW), the AER has allowed DNSPs to propose exclusions from the EBSS and has made a decision as to whether to approve these exclusions in its distribution determination.
- Under clause 6.5.8(d) of the NER, the AER is able to amend or replace the EBSS in accordance with the distribution consultation procedures. It is important that a DNSP has certainty in relation to the form of the EBSS early in the distribution determination process. This is because the form of the EBSS will affect the DNSP's regulatory proposal (NER, cl.6.4.3, 6.8.1(b)(3), (f), 6.12.1(9)). However it is noted that, unlike for transmission (see NER, cl.6A.6.5(f), (h)), there is no express constraint on the AER amending the EBSS such that the amendments apply to a DNSP with effect from that amendment (even if that time is during a regulatory control period or after a DNSP has lodged its regulatory proposal for a regulatory control period).

<u>AEMC Clarification Question regarding item 11.1 of MCE's Request for Advice</u>

4.107 *It is stated above that the AER is able to amend the EBSS and that the amended EBSS would apply to DNSPs immediately, even if a DNSP was in the midst of a regulatory control period. Wouldn't there be issues of retrospectivity, as the DNSP's distribution determination and associated revenue allowance, would have been based on the version of the EBSS that was current at the time the determination was made? Would an amended Service Target Performance Incentive Scheme also apply to DNSPs as soon as it had been amended?*

4.108 There is no express constraint on the AER amending the EBSS such that the amendments apply to a DNSP with effect from those amendments (even if that time is during a regulatory control period). This statement is also true in relation the service target performance incentive scheme (NER, cl.6.6.2 cf. cl.6A.6.5(h)). If the AER were to amend the EBSS or service target performance incentive scheme applicable to a DNSP in circumstances where those amendments take effect in respect of that DNSP during the course of a regulatory period, then this is likely to give rise to complex issues. As a matter of good regulatory practice, it would be expected that the AER would not adopt this approach other than in exceptional circumstances (eg. where there is a clear error in relation to the scheme). Moreover, it is emphasised that the AER can defer the application of the amendments in relation to DNSPs so that, for example, they only apply to DNSPs for their next distribution determination.

4.109 In terms of retrospectivity, an amendment to the EBSS or service target performance incentive scheme would not be retrospective provided that it does not purport to change vested or accrued rights or obligations (see paragraphs 4.98 to 4.101 above). The mere fact that the amendments may affect the ability of a DNSP to recover its annual revenue requirement in the future (albeit during the course of the relevant regulatory control period) does not make them retrospective in a legal sense.

Item 11.2 of the MCE's Request for Advice

Whether the current incentive mechanisms incorporated in the NER are sufficient to realize the competitive purchase of meters and metering services.

<u>Assessment of how Chapter 6 of the NER and the NEL would apply</u>

- The incentives for efficiencies in capital expenditure are provided for on the basis on which expenditure is rolled into the regulatory asset base (***RAB***). These capital expenditure incentives include:
  - Actual capital expenditure is rolled-in at the time of the next regulatory reset, there is no clawing back of the allowed return on capital over the period if actual capital expenditure is lower than forecast;
  - In undertaking the roll forward, depreciation is re-calculated based on actual expenditure. This means that an under-spend in relation to capital expenditure will result in less depreciation being deducted in rolling forward the RAB than the amount that was allowed for in regulated revenues during the previous period, resulting in a benefit to the business.
- The incentives for efficiencies in operational expenditure are provided for by:
  - The five year regulatory control period, with no claw back of efficiency gains within this period;
  - the EBSS, which allows DNSPs to retain a portion of efficiency gains beyond the end of the regulatory control period, rather than passing all of the gains to consumers.
- DNSPs also have an incentive to maximize the competitive purchase of meters and metering services through the distribution determination process. Under the distribution determination, the AER is able to reject the DNSP's proposed expenditure if it considers it does not meet the capital and operating expenditure criteria. We note that under the cost pass through process the AER is able to determine the pass through amount that should be passed through, but the AER is not required to specifically consider the competitiveness or efficiency of the proposed costs to be passed through.

AEMC Question 29

4.110 *Is the AER able to impose a different regulatory treatment on different kinds of capital expenditure in rolling forward the RAB)? (eg. rolling forward the RAB on the basis of actual capital expenditure for all other expenditure other than smart meter related expenditure, and using forecast capital expenditure for smart meter related expenditure).*

4.111 In respect of standard control services, the provisions of the NER relating to the rolling forward of the regulatory asset base are very prescriptive, and do not permit the different treatment of actual and forecast capital expenditure as between different categories of standard control services (NER, cl.6.5.1(f), S6.2.1, S6.2.3).

Item 11.3 of the MCE's Request for Advice

Whether Chapter 6 of the NER provides appropriate incentives for a distribution network service provider to manage technology risks for the long term benefit of consumers without a re-examination of the WACC, which is outside the scope of this review. The risks to be managed include premature failure of a new technology.

Assessment of how Chapter 6 of the NER and the NEL would apply

- Excluding the WACC, there are no specific incentives on DNSPs in the NER to manage technology risks for consumers.
- Under the distribution determination process, the AER is required to consider the prudency and efficiency of the proposed expenditure under the capital and operating expenditure criteria. In considering the prudency of the proposed expenditure, the AER may be able to consider the management of technology risks by the DNSP in selecting its preferred technology.
- Under the cost pass through process, the AER would have the discretion to consider the management of technology risks in making a cost pass through determination, if it considered it relevant.

Item 12.1 of the MCE's Request for Advice

Whether clause 6.5.5 of the NER in relation to depreciation requires modification, to allow the AER to require a distributor to modify its proposed depreciation schedules in order to smooth the tariff impact of a smart meter roll out decision (this includes the depreciation of existing accumulation meter assets that are being replaced before the end of their economic life).

Assessment of how Chapter 6 of the NER and the NEL would apply

- Under clause 6.5.5(b) of the NER, DNSPs' depreciation schedules must conform to the following requirements:
    - o the schedules must use a profile that reflects the nature of the assets over their economic life;
    - o the sum of depreciation over the economic life of the assets must be equivalent to the value of that asset initially included in the RAB; and

- o the economic life and the depreciation method and rates must be consistent with those determined for the same assets on a prospective basis in the distribution determination for that period.

- The AER's roll forward model uses a straight line depreciation method as a default position, but DNSPs may propose depreciation profiles other than the straight line method, subject to meeting the requirements in clause 6.5.5(b) of the NER. Where a depreciation schedule nominated by a DNSP does not conform to these requirements, the AER is able to determine the schedule that will apply.
- Depreciation schedules are approved in the distribution determination process by the AER and can not be varied within a regulatory control period.
- We note that if DNSPs were required to replace existing accumulation meters and roll-out smart meters, the economic life of the existing accumulation meters would end prematurely. Under clause 6.5.5(b) of the NER, DNSPs may be required to accelerate the depreciation of the existing accumulation meters in the following regulatory control period to reflect the shortened economic life of the accumulation meters.

<u>AEMC Question 30</u>

4.112 *Is the AER able to approve different depreciation schedules for different assets under clause 6.5.5(b) of the NER? If so, what constraints is this approval subject to? Is the AER able to require DNSPs to adopt specific depreciation schedules?*

4.113 The AER can approve different depreciation schedules for different assets, based on their nature and economic life (NER, cl.6.5.5(b)). For this purpose, assets can be categorised by reference to commonly accepted asset classes or category drivers (NER, cl.S6.1.3(12)).

4.114 Provided that a DNSP's depreciation schedules conform with the requirements of clause 6.5.5(b) of the NER, the AER cannot require a DNSP to adopt specific depreciation schedules (NER, cl.6.5.5(a)(2)(i)). It is only to the extent that a DNSP's depreciation schedules do not conform with those requirements that the AER can determine the depreciation schedules (NER, cl.6.5.5(a)(2)(ii)).

<u>AEMC Question 31</u>

4.115 *Do the rules for depreciation in clause 6.5.5 of the NER apply to alternative control services?*

4.116 The control mechanism for alternative control services may (but need not) utilise the depreciation provisions in clause 6.5.5 of the NER (which are included in Part C of Chapter 6) (NER, cl.6.2.6(c); see also paragraphs 3.3 and 3.4 above).

<u>AEMC Question 32</u>

4.117 *What is the framework for negotiated services, with respect to depreciation provisions?*

4.118 Depreciation is not specifically dealt with in the NER in relation to negotiated distribution services. However, the cost of such services presumably includes depreciation. In this regard, it is noted that the NER contains the following principles relating to negotiated distribution service prices:

- the price should be based on the costs incurred in providing the service, (determined in accordance with the DNSP's approved Cost Allocation Method) (NER cl.6.7.1(1)); and
- the price should be at least equal to the cost that would be avoided by not providing the service but no more than the cost of providing the service on a stand alone basis (NER, cl.6.7.1(2)).

Item 12.2 of the MCE's Request for Advice

*The need to minimise potential price impacts on customers caused by paying for the Smart Metering Infrastructure (**SMI**) roll out before benefits are realized.*

Assessment of how Chapter 6 of the NER and the NEL would apply

- The AER is able to smooth the tariff impact on customers through the profile of X factors under clause 6.5.9 of the NER but is not explicitly required to consider the tariff impact on customers when determining the value of X factors. The allows the tariff impact on customers to be smoothed within a regulatory control period, but, excluding the use of depreciation profiles, there are currently no mechanisms in the NER to provide for the smoothing of tariffs between regulatory control periods.
- Clause 6.18.6 of the NER outlines the side constraints on tariffs for standard control services, which limits the increase in revenue that can be raised from a tariff class between regulatory years. The side constraints for standard control services only apply as between regulatory years in the same regulatory control period, and do not apply as between the final regulatory year in one regulatory control period and the first regulatory year in the next regulatory control period (see NER, cl.6.18.6(b)).
- Under clause 6.18.6 of the NER the expected weighted average revenue which can be raised from a tariff class can not exceed the weighted average revenue for the previous year by more than the greater of:
    - the CPI-X limitation on any increase in the DNSP’s expected weighted average revenue between the two regulatory years plus 2%; or
    - CPI plus 2%.
- Under clause 6.18.8 of the NER, the AER is required to approve a DNSP’s pricing proposal if the forecasts in the proposal are reasonable and if the proposal complies with the pricing rules in Part I of Chapter 6 of the NER and any applicable distribution determination. If the AER considers that a pricing proposal does not meet the relevant requirements in the NER, it may ask the DNSP to re-submit its proposal or it may amend the proposal itself.
- Clauses 6.18.8(a)(1) and (2) of the NER set out the matters that the AER needs to be satisfied of in order to approve a DNSP's pricing proposal. Tariff smoothing is not such a factor (except to the extent the side constraint in cl.6.18.6 applies).
- The side constraint is expressed not to limit the variation of smart meter tariffs to the extent they vary "according to the time or other circumstances of the customer's usage" (NER, cl.6.18.6(e)). The meaning of this qualification is unclear as the amount paid under a tariff will often depend upon energy use, and this is the case even if the tariff is not a smart

meter tariff. Conversely, a change in the structural elements of the tariff (eg. increasing the fixed connection charge or the variable peak/off-peak charge) is presumably intended to be subject to the side constraint.

- Clause 6.18.6(d)(1) of the NER allows tariffs to vary by more than the side constraints provided for in clause 6.18.6(c) of the NER to allow the pass through of cost pass through amounts approved by the AER.

AEMC Question 33

4.119 *How do the side constraints on tariffs apply to time of use tariffs under clause 6.18.6(e) of the NER?*

4.120 Refer to the sixth bullet point of the assessment relating Item 12.2 of the MCE's Request for Advice above. In addition it is noted that the side constraints only apply to time of use tariffs where the smart metering services are standard control services.

AEMC Question 34

4.121 *How do the pricing rules in Part I of Chapter 6 of the NER apply to alternative control services? Do any side constraints apply to alternative control services?*

4.122 Part I of Chapter 6 of the NER is expressed to apply to all direct control services (which include alternative control services) (NER, cl.6.18.1). Accordingly, the pricing rules in Part I apply to alternative control services except where those rules are clearly confined to standard control services. The side constraint in clause 6.18.6 is an example of the latter kind of provision and does not apply to alternative control services.

Item 12.3 of the MCE's Request for Advice

Whether the framework allows the AER to obtain the necessary information to ensure benefits are being realised within a reasonable timeframe.

Assessment of how Chapter 6 of the NER and the NEL would apply

- There is no generic provision in Chapter 6 of the NER to enable the AER to require information from a DNSP during a regulatory control period, for the purpose of reviewing expenditure relevant to the DNSP's distribution determination.
- However, the AER has the ability to serve a regulatory information notice on regulated network service providers or make a general regulatory information order under Section 28F of the NEL if it considers the information is necessary for the performance or exercise of its functions or powers under the NEL or the NER. We note that under a general regulatory information order, regulated network service providers may be required to provide the AER with information and/or prepare, maintain or keep information in a manner and form specified.

AEMC Question 35

4.123 *Under the NEL or NER, in making a distribution determination, is the AER able to request information from other DNSPs in other jurisdictions to assist it to make its determination?*

4.124 Section 28 of the NEL provides that:

> If the AER has reason to believe that a person is capable of providing information or producing a document that the AER requires for the performance or exercise of a function or power conferred on it under [the NEL or the NER], the AER may, by notice in writing, serve on that person a notice [to provide or produce that information or document].

4.125 Further, if the AER considers it reasonably necessary for the performance or exercise of its functions or powers under the NEL or the NER, it may:

- serve a regulatory information notice on a DNSP; or
- make a general regulatory information order (NEL, ss.28C, 28D, 28F).

4.126 The AER may use information provided to it in compliance with a section 28 notice, a regulatory information notice or a general regulatory information order "for any purpose" connected with the performance or exercise of a function or power of the AER under the NEL or the NER (NEL, s.28ZD).

4.127 While the AER could, in purported utilisation of these powers, seek to obtain information from DNSPs in other jurisdictions to assist it in making a distribution determination for a DNSP in a particular jurisdiction, those other DNSPs may well object on the basis that:

- their actual expenditure is not a reasonable guide to whether the particular DNSP's expenditure is reasonable or efficient (eg. given their different circumstances), and so that information is not (reasonably) required for the AER to make a distribution determination for that DNSP; and
- in the case of a regulatory information notice or general regulatory information order, the costs of complying with it outweigh the benefit of the AER in being provided with the information (NEL, s.28F(2)).

4.128 A better approach would be to include such information as may be required in a general regulatory information order so that it is provided periodically (and in the ordinary course) by all DNSPs. That information can then be used by the AER for a specific regulatory reset (NEL, s.28ZD). Alternatively, the NER could be amended to require DNSPs to provide periodic information to the AER (see NEL, s.35; Sch 1, item 34B).

<u>AEMC Question 35 – Clarification Question</u>

4.129 *If the AER requested information from a DNSP to assist it to make its distribution determination or cost pass through determination and the DNSP did not provide this information, would the DNSP be able to request a merits review on the distribution determination or cost pass through determination (even if it was seeking review on areas unrelated to the area the AER was seeking information on)?*

4.130 The Australian Competition Tribunal has a discretion to refuse an application for merits review by a DNSP if it is satisfied that the DNSP, without reasonable excuse, failed to comply with a request by the AER to provide it with information required to make the distribution or cost pass through determination (NEL, s.71H(2)(a)). However, this is a discretionary power and the Tribunal would be highly unlikely to refuse (and probably precluded by law from refusing) an application for merits review on this basis where the matters in respect of which merits review is sought are matters upon which that information has no bearing.