



Jemena Electricity
Networks (Vic) Ltd
ABN 82 064 651 083

321 Ferntree Gully Road
Mount Waverley VIC 3149
Locked Bag 7000
Mount Waverley VIC 3149
T +61 3 8544 9000
F +61 3 8544 9888
www.jemena.com.au

By email: submissions@aemc.gov.au

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Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449,
SYDNEY SOUTH NSW 1235

Dear Mr Pierce

**AEMC Draft Report - Request for Advice on Cost Recovery for
Mandated Smart Metering Infrastructure**

Jemena Electricity Networks (Vic) Ltd (JEN) is one of five licensed electricity distribution networks in Victoria and is currently rolling out smart metering infrastructure (SMI) in accordance with a mandate and cost recovery arrangements already established by the Victorian Government.

JEN appreciates the Commission's recognition of our difficulty in making a timely submission to this review, given our priority in responding to the AER's draft decision for the Victorian EDPR.

As the draft report notes, the AEMC's proposed amendments are not applicable to Victoria, as the existing legislative arrangements for the advanced metering infrastructure (AMI) roll-out, including those relating to the recovery of the costs of the AMI roll-out, will continue to apply.

Even so, JEN appreciates the opportunity to provide its views on optimal industry outcomes, especially considering the many complex issues raised in the draft report.

JEN has been involved in the development of the National Stakeholder Steering Committee (NSSC) submission on the draft report, and endorses that response. JEN also fully supports the submission from the Energy Networks Association (ENA), which offers a carefully considered network view of the extent to which the National Electricity Rules should be modified to accommodate SMI cost recovery, and the limits of the discretion which should be given to the AER to interpret and apply those rules.

JEN looks forward to participation in further stages of the review. If required, I can be contacted on (02) 9270 4512 or email: sandra.gamble@JEN.com.au.

Yours sincerely

A handwritten signature in black ink that reads "Sandra Gamble". The script is cursive and elegant, with the first letters of each word being capitalized and prominent.

Sandra Gamble
Group Manager Regulatory

AEMC Draft Report - Request for Advice on Cost Recovery for Mandated Smart Metering Infrastructure

1. Introduction

JEN contributed to the AEMC Consultation on its draft statement of approach on SMI cost recovery on 5 February 2010. Our comments included:

- *Preservation of Chapter 6* – Chapter 6 of the National Electricity Rules (NER) already contains an economic regulatory system that allows for recovery of efficient distributor costs. The economic integrity of that framework should be preserved.
- Chapter 6 of the NER, as it currently stands, relies on businesses and regulators having a good level of certainty on forecast costs. While pilots and trials will increase certainty of the costs of smart metering for the purposes of a Minister gaining confidence that the benefits outweigh the costs, they may not—on their own—allow the estimation of costs precisely enough for the purpose of a making a regulatory determination or securing business approvals and financing.

JEN therefore recognises that the less certain nature of some SMI costs will need to be accommodated within the current Chapter 6 framework.

JEN agrees with the draft report's opening comments that the framework for cost recovery is only one of the many factors within the wider context that will collectively shape the impact on consumers from a roll-out of SMI.¹ The potential benefits of smart metering have been widely canvassed, and are well set out in the draft report's Appendix B ('The costs and benefits of SMI').

JEN also agrees with draft report's observation that the successful capture of the benefits associated with SMI will depend on the willingness and ability of participants, including DNSPs, to pursue such opportunities. As an example, the draft report cites flexible tariff frameworks which allow variability in tariffs, but importantly, also provide adequate customer protection.² JEN further agrees that how well market participants innovate and engage with customers will also determine the quantum of SMI benefits available to customers.

JEN recognises and supports the Commission's general view 'that the existing processes for cost recovery are reasonably adequate and have the potential to accommodate the recovery of the efficient costs of SMI mandated by Ministerial determination'.³

At the same time, JEN re-iterates the need for policy and regulatory certainty, especially when private investor capital is funding a rollout of SMI. Ministerially-determined rollouts mean that government policy is being implemented by obligations on commercial businesses. The Commission should therefore be mindful of long-term regulatory certainty where financial markets are being asked to fund mandatory rollouts made by Ministerial order. This unique kind of obligation is best discharged through reliance on stable, incentive-based regulation.

¹ AEMC Draft Report: *Request for Advice on Cost Recovery for Mandated Smart Metering Infrastructure*, 18 June 2010, p. i.

² Ibid.

³ Ibid.

This is not to say that no changes to the Chapter 6 Rules should be made in order to achieve efficient outcomes. JEN considers that mandated smart meter obligations, including the required investment and its timing, can be facilitated under some of the proposed changes to Chapter 6 identified by the Commission. However, certain of the Commission's draft proposals would, in JEN's view, conflict with the incentive properties of the Chapter 6 Rules. JEN does not consider that smart meter infrastructure differs fundamentally from other network assets, and therefore it does not require different regulatory treatment.

2. Support for specific draft findings and recommendations

JEN supports several of the Commission's specific findings and draft recommendations, notably:

- A revenue adjustment mechanism could be used at the next distribution determination to account for variance in the timing of a rollout (the difference between the forecast profile of installation and the actual timing of the rollout). This mechanism should be revenue-neutral for the DNSP.
- Ministerial rollout determinations should preferably be aligned with the start of the distribution determination process.
- The cost pass through arrangements in chapter 6 of the Rules are adequate (with minor variation) to promote recovery of efficient costs of mandated smart meter pilots and trials.
- Cost recovery associated with mandated pilots or trials made within the last 13 months of a regulatory control period (the 'dead zone') is currently prevented by the cost pass through rules. These rules should be changed to allow such cost recovery, and this amendment would apply to all pass through events, and not just smart meter pilots and trials.

In JEN's view, the above proposals are straightforward, and require minimum change to the structure and intent of the Chapter 6 Rules.

3. Major JEN concerns

JEN's concerns with some of the draft report's proposals centre on:

- The potential for recommended Rules changes to extend beyond smart metering
- Lack of detail in some of the draft report's proposed Rules changes, which is compensated for in the draft report by proposing to give the AER increased discretion
- Provision for ex-post review in the Rules.

We discuss these issues below.

3.1 Potential for recommended Rules changes to extend beyond smart metering

The draft report recommends a number of proposed changes to the existing Chapter 6 framework which transcend the issues specified by the MCE request for advice.

These changes include altering the future depreciation arrangements of all short-lived (15 years or less) assets, inserting new regulatory guidance on AER cost pass through assessments, and allowing inter-period shifting of cost recovery (such as deferred recovery of pass through costs). These changes have much wider application than smart metering, and JEN comments further on some of them below.

JEN acknowledges that there is merit in extending some proposed changes beyond smart metering (for example, removing the 'dead zone' in the cost pass through arrangements). Nevertheless, JEN submits that the draft report's focus should be on smart metering and not extend to other network investments.

3.2 RAB assets and AER discretion

The draft report proposes to address uncertainty in relation to efficient costs as follows:

Where there is a substantive degree of uncertainty regarding the efficient costs and expected benefits of SMI at the time the AER makes a distribution determination, the AER should be provided with the discretion to apply one of the following mechanisms in making a distribution determination:

- Rolling forward the regulatory asset base (RAB) on the basis of forecast depreciation for assets with economic lives of 15 years or less. For asset with lives of more than 15 years, the AER could maintain higher powered incentives for efficiencies by rolling forward the RAB on the basis of actual depreciation; or
- A cost sharing mechanism, which would allow the AER to vary the proportion of any underspend or overspend which is retained by DNSPs and shared with customers, according to the extent of uncertainty the AER considers remains in relation to the costs and benefits of SMI. This mechanism would only apply to expenditure which is specifically required or mandated SMI.⁴

JEN submits that stipulating an artificial division of the RAB into assets above and below 15 years to allow roll forward under either actual or forecast depreciation adds unnecessary administrative complexity to the roll forward model.

Short asset life is not a contributing factor to uncertainty in the costs and benefits of a mandated rollout of smart metering. A sizeable amount of other business as usual (BAU) network investment has a short economic life, involves new technology, and can be demonstrated to have long run benefits for both the network and consumers.

The proposal is a significant change in the roll forward model for assets which comprise a relatively small proportion of the total value of network assets.

The roll forward model has been the subject of wide consultation, including consideration of rolling forward the RAB on the basis of forecast depreciation. This option was not adopted for solid reasons including that rolling forward the RAB on the basis of forecast depreciation provides no incentive for DNSPs to exceed the forecast, even where there may be very good reasons for actual expenditure to exceed forecast (for example, to accommodate unexpected but likely permanent increases in consumer demand).

There are other, less complex, incentives available to ensure that DNSPs' forecasts of network investment can be accepted by the AER as reasonable.

⁴ AEMC draft report, p. 12.

The alternative mechanism proposed by the Commission (variable cost sharing) would still impose an administrative burden on a DNSP. However, of the two options, variable cost sharing results in less additional complexity than an artificial division of RAB assets with different depreciation.

The cost sharing mechanism

While the draft report canvasses a cost sharing mechanism, it does not specify how this would work in practice.

This lack of definition of the parameters of the mechanism should be addressed by the Commission through draft rules. Design of the mechanism should not be left to the AER's discretion. In addition, guidance should be given to the AER in determining whether there is a 'substantive degree of uncertainty regarding the efficient costs and expected benefits at the time the AER makes a distribution determination'.

A note on 'depowering'

The Commission's assessment of options for dealing with uncertain efficient costs and benefits includes lowering the power of the existing capital expenditure incentive mechanism for SMI and kindred assets.⁵

This option would significantly 'de-power' the incentive framework for all short-lived assets covered by the existing rules. JEN considers this suggestion has major implications for other elements of the Chapter 6 regime which have not been addressed in the draft report. Without adequate analysis, JEN submits that this proposal is a high-risk one for both DNSPs and consumers.

3.3 Provision for ex-post review in the Rules

The Commission is proposing that:

The Rules should be amended to include a new mid period mechanism to accommodate the recovery of the efficient costs of a mandated smart meter rollout.

Under this mechanism, where a Ministerial roll-out determination is made subsequent to a distribution determination process and has triggered expenditure which has not been incorporated in a relevant distribution determination, the AER's decision on the allowed level of expenditure would be deferred until the next distribution determination process. At this time, the AER would perform an ex-post review on the efficiency of the incurred expenditure.

Principles to guide the AER's ex-post review should be inserted in the Rules and the AER should be required to publish a guideline outlining its approach to ex post reviews for mandated smart meter roll-out expenditure. The AER would have the discretion to allow temporary interim increases in prices in accordance with a defined methodology within a regulatory control period, if it considers there is a material cash flow risk for the DNSP.⁶

⁵ AEMC, *Assessment of Options: Cost Recovery Mechanisms for Mandated Smart Meter Roll-out Expenditure Supplementary Paper to the Draft Report for the Request for Advice on Cost Recovery for Mandated Smart Metering Infrastructure*, 18 June 2010, p. 24.

⁶ AEMC draft report, p. 33.

The Commission argues that deferring a review of expenditure is necessary for a number of reasons, including:

- timeframes in the rules do not appear adequate to accommodate an AER cost pass through determination given the potential scope and complexity of mandated smart meter rollouts
- the criteria in the cost pass through provisions for assessing a DNSP's expenditure forecasts are not as clearly specified as the criteria for assessing expenditure forecasts in the distribution determination process.

JEN submits that the Commission's proposals do not overcome the acknowledged difficulties in ex post regulation, nor do the inherent characteristics of smart meter infrastructure investment reduce the potential risks and costs of employing an ex-post cost of service review. The introduction of ex-post reviews would be a significant shift away from the current regulatory framework which is based on ex-ante incentive arrangements.

JEN considers that ex-post reviews

- provide less incentive to drive efficiency (as the ex ante incentive mechanisms are unable to apply)
- create considerable uncertainty and regulatory risk
- create unbalanced incentives for DNSPs who would be driven to focus on cost recovery rather than investments which would maximise benefits to consumers. Ex-post reviews would remove the flexibility in the current framework to encourage DNSPs to make the best investment choices for the benefit of consumers.

The draft report proposes that a 'no hindsight' rule would guide the AER's ex post determination. However, JEN questions whether a 'no hindsight' rule can ever be practically applied.

It is inevitable that ex-post regulatory judgements will rely on information not clear at the time of investment, take account of subsequent experience and information, and involve subjective assessments. Unlike the DNSP, a regulator is not responsible for carrying out large commercial projects against fixed timelines and with restricted information. Regulatory decisions made in this environment will be informed by ex-post experience.

For the above reasons, JEN submits that essentially the same kind of review for a mandated smart meter rollout should be undertaken whether this is undertaken at the time of the distribution determination (ex-post) or mid period (ex-ante). JEN does not support either deferring consideration of SMI expenditure until the next determination or ex-post review.

3.5 SMI investment uncertainty

The draft report says little on the issue of investment certainty. The draft report proposes that discretion to be given to the AER to assess the level of 'cost and benefit uncertainty' on a case by case basis, and decide the appropriate mechanism to deal with it. This is likely to make a DNSP's investment decision framework

significantly less predictable, especially if distributors are required to commit funding before the AER makes a decision.

JEN submits that the Commission should look at whether the current regulatory framework can be adapted to preserve SMI investment certainty.

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