SA Power Networks - Regulatory Proposal July 2015 to June 2020

AGL submission to the Australian Energy Regulator

30 January 2015

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1. Comments

AGL Energy Ltd (AGL) appreciates the opportunity to provide comments to the Australian Energy Regulator (AER) on the SA Power Networks (SAPN) Regulatory Proposal for the period 1 July 2015 to 30 June 2020.

AGL is one of Australia's leading integrated energy companies and largest ASX listed owner, operator and developer of renewable energy generation in the country. Drawing on over 175 years of experience, AGL operates retail and merchant energy businesses, power generation assets and an upstream gas portfolio. AGL has one of Australia's largest retail energy and dual fuel customer bases in including over 400,000 customers in the South Australian retail electricity market.

In the Australian energy market, network charges are passed through to customers through retail electricity prices. Therefore, while changes in network charges have limited impact on retailers, they can have significant impact on customers' bills, the customers' experience and energy affordability.

Retailers do not have the resources nor expertise to review the enormous amount of information submitted by the DNSPs in support of the cost components in their Regulatory Proposals. However, AGL does seek to comment on areas where it has some knowledge such as the energy and demand growths, the implications of these forecasts on operating and capital expenditure and a review of proposed services. As a general comment, the large amount of material provided by SAPN makes it difficult for AGL to review its regulatory proposal properly in great depth.

AGL does note that in recent years SAPN has been one of the most efficient DNSPs in the National Electricity Market (NEM). SAPN has illustrated that it has been a prudent operator in the past through its lower spending on capital, the lower growth rate in its asset base, an encouraging total factor productivity comparison and by the very fact that the oldest assets are producing some of the most efficient outcomes. The past performance of SAPN to date has therefore been noteworthy and its safety record excellent.

SAPN has also appear been engaging comprehensively with South Australian consumers over a number of years. SAPN should be commended for behaving in a responsible manner towards South Australian consumers.

Therefore, viewing the SAPN regulatory proposal through this lens, it is surprising to see such large increases proposed in both capital and operating expenditure. It is clear that SAPN's proposal has been shaped by a perceived need for renewal of assets, and incorporates many aspects of customers' views on what SAPN should look like and deliver.

However, given the absence of any forecast growth in energy consumption and peak demand over the next 5 years, it is difficult to reconcile how the significant increases in capital and operating expenditure proposed by SAPN can be justified. The AER should ensure that these expenditures are efficient but also importantly, that they are prudent.

AGL notes that the safety and technical regulation and service standards are set by other regulators (namely the Office of the Technical Regulator and the Essential Services Commission of South Australia) and are an assumed input into this regulatory review. Some areas of proposed increased expenditure are related to safety, and it is unclear to AGL whether these increases are mandated by the OTR, or in addition to the agreed safety standards.

Whilst the SAPN regulatory proposal has been presented as resulting in price increases of less than 1 per cent per annum, it ignores the alternative scenario where spending

remains moderate and consumers experience significant price reductions. AGL cautions against large investment in network assets experiencing flat or declining consumption and peak demand, and also asks whether a customer's willingness to pay is a reliable input to this decision.

In saying this, AGL would highlight its support for the price smoothing process proposed by SAPN, based on the revenue in its regulatory proposal, which is less volatile and results in lower price increases from 2016-17 onwards. This approach would result in less customer concern with the changes in energy prices. Once the final revenue is determined by the AER, AGL would support a similar price smoothing that moderates any first year decrease to minimise annual increases over the period.

AGL disagrees with the approach that SAPN has taken to metering as an alternate service in its regulatory proposal but recognises that the proposal was submitted prior to the AER's draft decision in NSW which in AGL's view, clarifies the concerns regarding treatment of stranded meter assets and exit fees.

These comments are explained more fully in the body of this document.

1.1 Transitional process

AGL understands that the delayed timetable for the AER consultation on the SAPN proposal means that network revenues and prices for 2015-16 will be based on the AER Draft Decision with "true-ups" to adjust for differences from the Final Decision.

AGL would highlight its concern with this process if there any large variations between the AER's Draft Decision and Final Decision which have the potential to create significant network price instability in 2016-17.

AGL would encourage the AER to:

- ensure the process for true-up is fully explained in its Draft Decision including which cost elements are included or excluded; and
- consider whether the allowances for 2015-16 should be set according to the Draft Decision or whether a more conservative methodology is used to eliminate the risk of price instability arising in the second year. AGL note that under the revenue cap framework, the networks would not be financially disaffected by a conservative process.

1.2 Submission Structure

AGL's submission highlights its concerns with SAPN's proposal in the following sections:

- Section 2 makes comment on Customer Engagement and the ability and willingness of SA customers to fund significant increases in SAPN spending;
- Section 3 discusses the energy and demand forecasts
- Sections 4 and 5 separately consider the capital and operating expenditure forecasts for 2015-20 period including the impact on the Regulated Asset Base;
- Section 6 makes some comment on the derivation of weighted average cost of capital;
- Section 7 highlights AGL's views on Metering Contestability; and
- Section 8 comments on the network pricing.

2. Customer Engagement and "Willingness to Pay"

Much of SAPN's increases in capital and operating expenditure is predicated on what customers indicated that they wanted from SAPN. SAPN's customer engagement is the critical process that distils the customers' views into actions and associated cost.

On a cursory glance, it would appear that SAPN has conducted a comprehensive engagement process but as AGL was not part of the customer engagement process, we cannot comment first-hand. However, we do highlight that although many Australians will agree with the need for fair and equitable energy supply, and nominally agree to pay increased charges, we ask whether some classes of consumer really do understand the overall impact of these changes.

SAPN continually highlights itself as a prudent, highly reliable DNSP. SAPN clearly has had the management skills required to operate efficiently. It comes, therefore, as a surprise that SAPN would be seeking to make such large increases in their capital and operating spend for the next Regulatory period. Much of this spend is based upon the willingness of SA consumers to pay for services.

We do not propose to go through the proposed willingness to pay of South Australian consumers for each area. However, AGL would highlight that the framing of willingness to pay studies have been shown to have significant implications for the value estimated of avoidance of a particular action which could cause harm or pose a risk to safety.

It is unclear in the study presented by SAPN, and performed by NTF, how consumers were presented with the consequences or probabilities of the events they were asked if they were willing to pay to mitigate. Even with these probabilities disclosed, behavioural economists Sundstein and Zeckhauser (2010) found in their research that '*in the face of fearsome risk, people often exaggerate the benefits of preventative, risk-reducing or ameliorative measures'*.

The language used in the report discussing the survey and the framing of the three options identified by SAPN for consumers to consider for investment include:

- High Bushfire Risk areas and Bushfire Risk areas;
- Non-bushfire risk areas; and
- Traffic Black-spots.

The report goes on to state that High Bushfire Risk areas are…. *'an area where a fire could start and readily escape into an unrestricted area of flammable material causing major to catastrophic consequences'*. Both bushfires and potential for unsafe roads are clearly significant and important concerns for South Australians, rightly so. However the language used within this section of the report if replicated in the survey, without appropriate context, consequence and probability is likely to influence and potentially inflate values, a natural response to risk aversion.

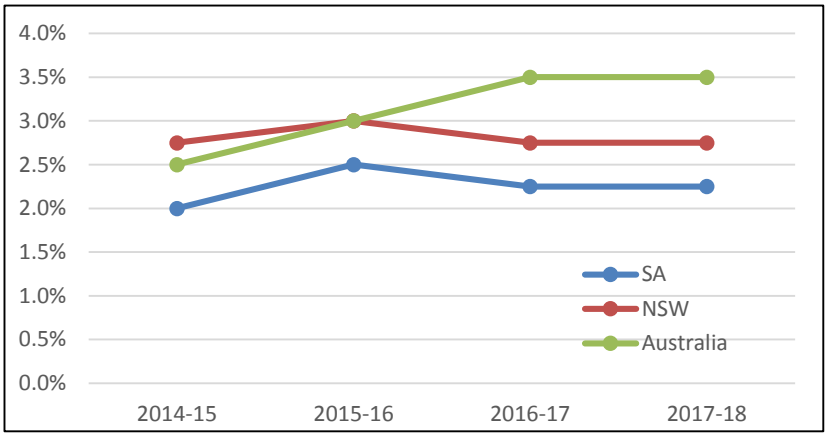
These factors raise questions around the robustness of the conclusions reached by the willingness to pay study used by SAPN in their submission.

Without reviewing the questionnaire used to perform the willingness to pay study, it is difficult to establish the potential for the over or under-valuation of willingness to pay for future investment. AGL recommends that the questionnaire be released publically as part of the consultation and that consideration be given by the AER as to robustness of the findings.

AGL would also highlight that a *willingness* to pay is not the same as an *ability* to pay, and that some temperance is required.

The economic forecasts of South Australia (see Figure 1) continue to illustrate that economic growth is below the national average, and even below non-commodity based state economies (for example NSW).

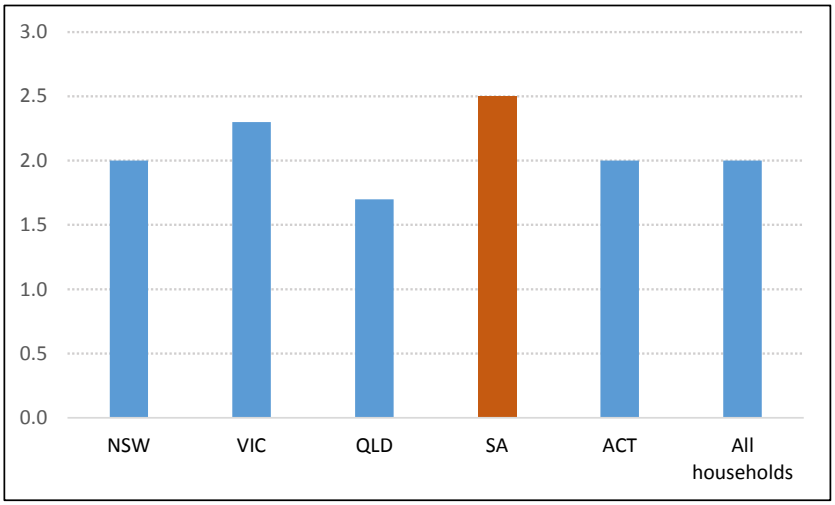
Figure 1: Real GDP Growth by state



Add to this the fact that South Australian consumers are already paying the highest proportion of income for energy in the mainland NEM (see Figure 2).

This is also supported by the AER (2014) Annual Report on the Performance of the Retail Energy Market that found in 2013-14, the average annual South Australian electricity bill reached over 6 per cent of a low-income household's disposable income. This compared adversely with 5 per cent in New South Wales, 4.5 per cent in Victoria and 4.8 per cent in Queensland (p40).

Figure 2: Energy Expenditure/ Gross Income by state



Furthermore, South Australia generally has a higher representation of indicators to suggest customers are experiencing payment difficulties.

The AER (2014) Annual Report also highlighted in 2013-14 that a higher proportion of residential electricity customers in South Australia carried energy debt with over 5 out of every 100 customers on average per quarter carrying energy debt - compared to around 3 in 100 for New South Wales (p18). This is further mirrored in the average number of customers on payment plans, with around 3 out of every 100 customers receiving payment plans in this state - the highest proportion of customers out of all states reported (p19).

AGL has seen a similar increase in customers from South Australia entering the hardship program Staying Connected. As of January 2015, South Australia has the highest proportion of customers participating in Staying Connected, compared to the total customer base in any state. Around 1.25 per cent of the total South Australian customer base were participating in AGL's hardship program, this compares with 1.08 per cent in Victoria, 0.74 per cent in New South Wales and 0.68 per cent in Queensland.

Given these circumstances, AGL would advocate a prudent level of expenditure rather than increasing to the levels suggested in the SAPN proposal which appear to be based on providing "optimal" levels of network service.

3. Energy and Demand Forecasts

Energy and demand forecasts are important in framing the SAPN's capital and operating expenditure proposals over the next 5 years.

The change in regulatory framework from a price cap to a revenue cap would suggest that the DNSPs' energy forecasts are less important given that aggregate revenue recovery over the period will be unchanged irrespective of forecast accuracy. This is correct from a network revenue recovery perspective but ignores the impact that an inaccurate forecast will have on future price changes and therefore on customers. This was clearly demonstrated over the current period in Queensland when under the revenue cap framework, actual energy consumption fell well below the approved forecast. This resulted in unexpected annual network price increases that were significantly above those indicated in the determination. The network price instability, lack of transparency and lack of certainty in these network price changes has had a negative impact on customers' confidence in the industry, their investment decisions and retailers' product development (e.g. fixed price products). It has also encouraged further reductions in energy demand with subsequent price impacts.

As such, the AER needs to ensure that conservative energy consumption forecasts are used by SAPN to ensure the Determination's indicative price paths are unlikely to be exceeded, noting that SAPN's cost recovery will be unaffected under the revenue cap framework.

SAPN's overall energy and demand forecasts are based on the Australian Energy Market Operator's (AEMO) *National Electricity Forecasting Report 2014* (NEFR 2014). As the official market forecast, the NEFR provides an appropriate benchmark and AGL considers SAPN's forecasts to be reasonable.

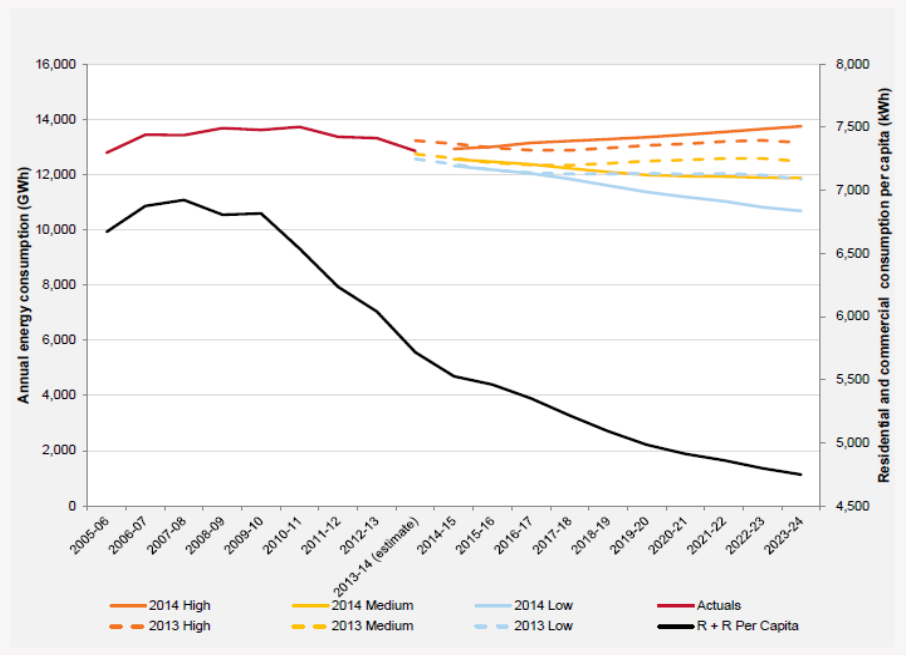
3.1 Forecast Energy Consumption

In the National Electricity Forecasting Report for South Australia, AEMO has outlined the key drivers for its forecasts:

- A decline in large industrial forecasts due to SA Water's desalination plant reducing its consumption following completion of operational tests; and
- A decline in residential and commercial forecasts due to highest existing levels of installed rooftop PV per capita across the NEM, and increased energy efficiency offsets.

Over the next ten years, energy consumption in South Australia is expected to be flat under the Low and Medium scenarios as shown in Figure 3.

Figure 3: Annual energy forecasts for South Australia



Source: AEMO, NEFR 2014, p 5-3

SAPN's energy forecasts have been adjusted for distribution losses and exports of PV back into the grid. These forecasts including major business sales volumes are consistent with the AEMO's forecast of flat sales.

Table 1: SAPN sales forecast 2015-20

GWh pa	2014–15	2015–16	2016–17	2017–18	2018–19	2019–20
Customer Sales	9,303	9,412	9,445	9,432	9,412	9,395
Major Business	1,115	1,098	1,085	1,035	1,035	1,035
Total Sales	10,418	10,510	10,530	10,467	10,447	10,430
% Growth pa						
Customer Sales		1.2%	0.4%	-0.1%	-0.2%	-0.2%
Major Business		-1.5%	-1.2%	-4.6%	0.0%	0.0%
Total Sales		**0.9%**	**0.2%**	**-0.6%**	**-0.2%**	**-0.2%**

Source: SAPN regulatory proposal, Table 12.1

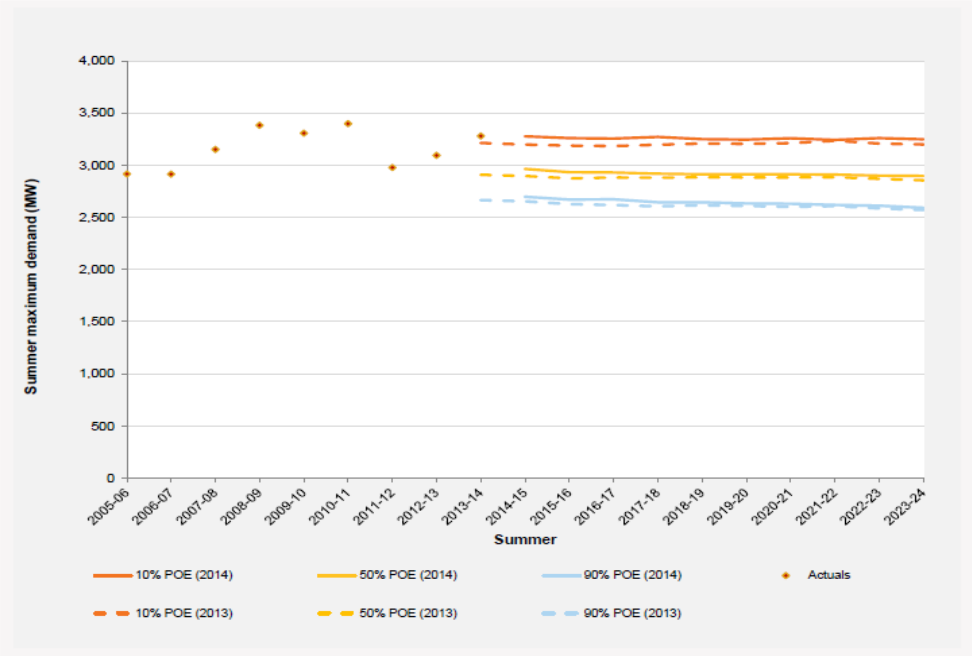
3.2 Forecast Maximum Demand

The NEFR 2014 expects maximum demand in South Australia to be flat at best over the next 10 years compared with 2013-14 demand. Under the 90%, 50% and 10% POE scenarios, the maximum demand of 3,281 MW in 2013-14 in South Australia will not be exceeded over the period to 2023-24.

The SAPN demand forecast is in line with the NEFR 2014 and expects peak demand to decline in each year of the 2015–20 period by less than 0.5 per cent.

SAPN submitted that this peak demand forecast is in part driven by the uptake of small scale distributed solar PV across its network.

Figure 4: Summer maximum demand forecasts for South Australia



Source: AEMO, NEFR 2014, p 5-5

4. Capex and Regulated Asset Base

Given no growth in energy consumption or in peak demand, the forecast capital expenditure and resultant increases in the Regulated Asset Base (RAB) over the period appear excessive.

In other jurisdictions, large capital spends on network assets over recent periods has combined with falling energy consumption to severely reduce asset utilisation and increase network prices, so much so that asset impairment has been raised as an solution.

This is not an issue for SAPN given its prudent spend over previous periods and enviable position regarding the value of its RAB and network utilisation. However, its regulatory proposal is a concern. SAPN has proposed to increase its capital expenditure by over 50 per cent compared to its spending in the 2010–15 period resulting in a 47 per cent increase in its RAB.

Networks expect consumers to pay regulated returns on these new assets for 40+ years but given the forecast for demand and energy consumption, it is highly unlikely that any firm would undertake these investments without the certainty of the regulated returns.

AGL believes SAPN should maintain its current position as an efficient distribution network and focus on utilising the current RAB by:

- limiting augmentation capital investment to new connections;
- delaying any major capital works until the risks posed by decreasing network utilisation or technological replacement are clearer; and
- avoid accelerating its capital replacement program at this time.

It is therefore important that the AER consider the prudency as well as the efficiency of SAPN's proposed capital expenditure.

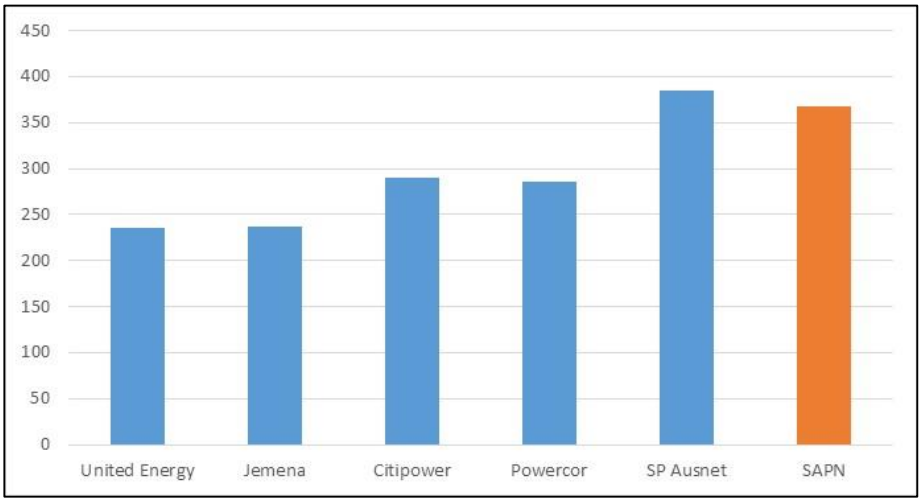
4.1 Regulated Asset Base

The issue of falling utilisation of distribution assets is a problem for all Australian electricity distribution networks as can be seen the regulatory proposals in New South Wales, Queensland and to some degree in South Australia. Figure 5 compares the RABs of SAPN and the Victorian DNSPs on a per MWh delivered basis.

The regulated rate of return is based on the value of the RAB so customers will pay for any increases to the RAB year on year.

Based on the metric in Figure 5, South Australian customers are paying higher network charges than Victorian customers for ostensibly the same service. AGL would highlight that the RAB per MWh for SAPN and the Victorian networks are significantly lower than those of the distribution networks in Queensland and New South Wales.

Figure 5: RAB/MWh – SA and Victorian DNSPs ($/MWh)

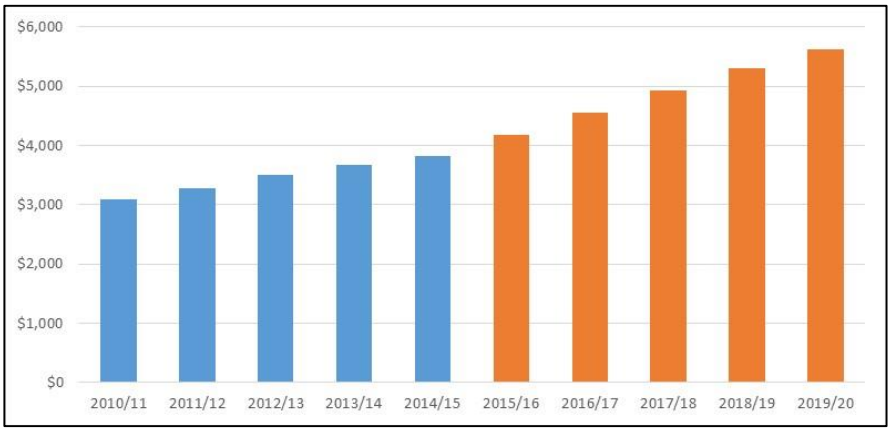


Source: Derived from AER Victorian Determination, Regulatory Proposals.

The SAPN proposal will result in nominal increases in the RAB for standard control services of 6 to 9 per cent per annum over the 2015-20 period (see Figure 6). These significant real increases in RAB are inconsistent with an environment where energy demand is flat or declining.

AGL supports the AER's stated intention to closely consider the rationale for this. Only essential capital investment should be included during this regulatory period so that the real value of the RAB can be constrained to its current levels to maintain network utilisation and minimise network price increases.

Figure 6: SAPN's Regulated Asset Base ($m nominal)



Source: SAPN regulatory proposal

4.2 Capital Expenditure

AGL is not in a position to review the detailed underlying capital expenditure forecasts nor the extensive supporting information provided by SAPN. However, we can comment on the proposed changes in relation to growth trends and the aggregate levels of the capital investment.

SAPN has significantly underspent actual capital expenditure during the current 2010-15 regulatory period by $184 million with actual total capital expenditure of $1,527 million compared with the total allowed capital expenditure of $1,711 million. While the under-spend may be prudent, AGL would highlight that networks continue to recover revenue based on the capital expenditure forecasts set in the previous regulation determination.

Under a backdrop of capital underspend and declining or flat energy consumption and peak demand, the total capital expenditure for 2015-20 is proposed to significantly expand. Specifically, over the next regulatory period SAPN has proposed capital expenditure totalling $2,485 million in real terms which is $958 million or 63 per cent higher compared with total 2010-15 capital expenditure.

This substantial increase over 2015-20 includes:

- a doubling of replacement capital expenditure compared to the current period;
- increases in safety expenditure ($300 million); and
- an increase in information technology spend ($200 million).

These and other items warrant further investigation, in particular.

In addition to the absence of growth in peak demand, AGL believes that the AER should also take into account SAPN's claims that its reliability performance has been better than the NEM average for many years and that it is the most efficient DNSP in the NEM.

It is reasonable to query if significant capital expenditure is required if a DNSP is already highly efficient and reliable.

Furthermore, the AER should take account SAPN's history of underspending their allowance for capital expenditure.

5. Operating Expenditure

SAPN's operating expenditure is proposed to increase from $247 million in 2014-15 to $329 million in 2019-20 in real terms.

To put this proposal into context, SAPN has proposed real operating and maintenance costs that are:

- 15.5 per cent higher in the first year; and
- 33 per cent higher in 2019-20 compared with its 2014-15 costs.

These cost increases have been proposed in an environment where there is:

- no growth in overall energy consumption and peak demand (despite new connections);
- significant capital expenditure proposed which should technically defray maintenance costs; and
- decreasing escalation rates compared to the previous regulatory period for cost drivers such as labour rates and material indices like oil, aluminum, copper and steel.

SAPN's forecast operating and maintenance expenditure has been developed using the "base-step-trend" approach using 2013-14 as the efficient base year. SAPN's proposal include a step increase of $217 million in real costs over 2015-20. AGL is concerned that using past expenditure as a base will entrench any existing inefficiency so that benchmarking is important to provide a test of reasonableness.

5.1 Key drivers of operating expenditure proposals

In its Issues Paper, the AER has outlined the main drivers of SAPN's operating and maintenance forecast which include:

- labour cost escalations;
- growth in the size of the distribution network, workforce size and customer numbers;
- maintenance and support of IT systems;
- asset inspections;
- vegetation management
- telecommunications, and
- workplace health and safety.

AGL does not have the resources or expertise to individually assess the validity these proposed expenditures.

While AGL understands that it is reasonable for additional costs to be incurred to manage new developments such as legislation and technology, AGL anticipates that the AER will only approve costs that are not only efficient and prudent but also pass a cost-benefit test.

Given the issue of information asymmetry, AGL supports the use of benchmarking as a guide to setting efficient and prudent costs. Benchmarking could also overcome the risk of entrenching existing inefficient operating costs under the "base-step-trend" approach.

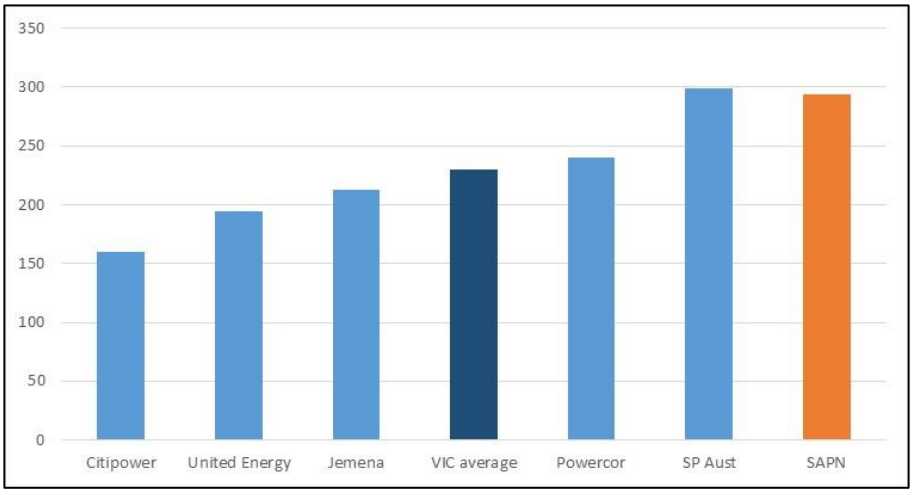
5.2 Comparison with Victorian DNSPs

To assess the reasonableness of SAPN's proposal for operating expenditure, AGL estimated the operating costs per customer for SAPN and compared with the Victorian networks. The figures for the Victorian distribution networks are for the 2014 calendar year and based on the AER's Final Determination 2010-15 adjusted following the Australian Competition Tribunal's decision. SAPN figures are for 2014-15 derived from SAPN's regulatory proposal and are before the proposed escalation in cost.

Figure 7 shows that SAPN's operating costs per customer is better than that of SP Ausnet, the most rural Victorian network, at about $293 per customer but remains significantly higher than the Victorian average of $230 per customer.

As current operating costs can be considered to be relatively high compared with the efficient Victorian networks, the proposed 2015-20 expenditure with significant real increases requires significant justification.

Figure 7: Current operating expenditure per customer, by DNSP



Source: AER Victorian Determination 2009, Regulatory Proposal

5.3 Efficiency Benefits Sharing Scheme

Efficiency Benefit Sharing Scheme (EBSS) are supposed to reward a network for any efficiency gains achieved during a regulatory control period while penalising them for efficiency losses.

The effectiveness of the EBSS in providing benefits to consumers is reliant on any efficiency gains exposed by the scheme being provided to consumers over the long-term. If this occurs correctly, the long-term benefits to consumers will eventually outweigh their short-term losses.

As it has previously submitted, AGL believes that the difficulties facing the AER in identifying actual operating efficiencies are widespread and cannot be easily resolved. As such, AGL supports the AER in removing efficiency benefit sharing schemes from the current regulatory framework.

6. Weighted Average Cost of Capital

SAPN has proposed a lower rate of return on its assets than in the 2010–15 period when they received 9.76 per cent. It has proposed 7.62 per cent.

In its recent draft decision for electricity and gas network service providers across NSW, ACT and Tasmania, the AER applied its rate of return guideline.

The AER rate of return guideline was extensively consulted upon and AGL considers the final decision a compromise. While we would argue on different input assumptions, the headline result attempted to provide an equitable balance between the interests of consumers and investors with the AER determining conservative estimates at the top end of the calculated range for most parameters.

We note that SAPN's rate of return proposal has departed from the guideline for some of the rate of return components including:

- proposing a higher equity beta of 0.82;
- proposing a substantially increased market risk premium of 7.72 per cent; and
- debt benchmarking using a credit rating of BBB rather than BBB+.

AGL believes that the AER should enforce its rate of return guideline as good regulatory principle and reject the amendments submitted by SAPN.

7. Alternate Services - Metering

AGL supports the direction of policy developments towards enhancing competition in metering, including the AEMC's Expanding Competition in Metering and Related Services Rule Change[1] (the Rule Change) consultation which proposes to:

> *"amend the National Electricity Rules and National Energy Retail Rules to establish a competitive regime that would enable widespread investment in advanced metering technology. The objectives of these arrangements are to:*
>
> - *support the uptake of efficient demand side participation (DSP) products and energy services that promote consumer participation and choice; and*
> - *allow for the benefits of demand side participation to be captured across the supply chain."*

AGL believe that meter provision and meter data services should be contestable in all circumstances, including new and replacement meters, and underpinned by a national framework based on national policy and rules. Competitive neutrality is a fundamental principle to ensuring smart metering and services are provided on an equal basis. Any meter provision needs to be based on providing value to the customer, and needs to provide an incentive for the customer to engage with and support the services and benefits that smart meters enable.

AGL does not support a monopoly roll out of meters which runs the risk of repeating the results in Victoria under their Government mandated smart meter rollout program.

Similarly, we do not support a 'smart ready' roll out of meters. Any roll out would be a violation of competitive neutrality; and could be seen as an attempt to use regulated funding to introduce a transient asset into a competitive market, and a breach of current distribution ring-fencing guidelines. A rollout of 'smart ready' meters would also be structurally inefficient, such that it could never provide full smart metering benefits to customers at an equivalent price point within a competitive environment.

AGL also believes that networks should be ring fenced, both structurally and financially, if they wish to compete under contestable metering conditions and/or compete as a Meter Coordinator once the Rule Change takes effect. This approach will ensure that networks are not able to use regulated revenue to compete for unregulated activities or allocate the costs of any competitive metering provision to Standard Control Services. Competitive neutrality also dictates that any asset which is to operate in a competitive market and installed by networks (such as 'smart ready' meters), should have the same risk profile as the assets with which it competes.

Under a contestable metering framework, the facilitation of a market led smart meter rollout will encourage competition and innovation in retail product design, and will result in enhanced customer service as meters record and report electricity more accurately.

This will in turn result in the elimination of estimated billing, simplify the process of moving house and reduce the need for onsite visits by field crews. Smart meters will also empower consumers through the regular provision of real-time information about household and business electricity usage, enabling customers to manage their consumption and therefore their costs. Further, it will also allow retailers to offer a

[1] AEMC 2014, Expanding competition in metering and related services in the National Electricity Market, Consultation Paper executive summary

broader range of products to consumers, meaning that consumers have greater choice in the way that they consume electricity.

With this in mind, AGL broadly supports the AER's approach and rationale contained within their draft decision on the NSW distribution regulatory proposals for the 2014-19 regulatory control period, particularly on exit fees. We request the AER take a consistent approach across all jurisdictions.

7.1 Metering service provision

AGL believes that smart meters[2] should be viewed as an enabler of a suite of services that will deliver substantial benefits to customers. As is the case with other markets and technologies, full realisation of these benefits can only be provided through open market access and competition.

In reviewing the regulatory proposal from South Australia Power Networks (SAPNs) for the regulatory control period 2015-20, AGL has several major concerns that are outlined below.

7.1.1 Policy and economic justification

AGL believes that SAPNs approach has not been developed in line with the direction of the CEC's agreed national policy on electricity market reform (which includes support from the South Australian (SA) Government) and the intent of the Rule Change.

We do not believe the SAPN proposal will efficiently or effectively achieve the SA Government's objective to increase penetration of smart meters. For example, metering charges are already unbundled in SA yet the existence of exit fees remains a barrier to entry for the SA metering market which will continue under SAPN's proposal.

The SAPN approach is set out in their Tariff and Metering Business Case (Business Case) and is underpinned by an aggressive meter replacement program and proposed rollout of 'smart ready' type 5 meters.

The Business Case, including SAPN's reflective network tariff policy, has been specifically developed off the back of the January 2014 "*South Australian Policy for New and Replacement Electricity Meters - Discussion Paper*" which has not been confirmed as State Government policy, and remains only a consultation paper to industry.

SAPN acknowledge in its Business Case that the SA Government's new and replacement meter discussion paper and the Rule Change "*are proposed reforms which are the subject of an ongoing consultation process that are expected to run until at least 2015, with final rule changes not expected to come into effect prior to 2016….therefore there is some considerable uncertainty around the final scope of the rule changes*", but that nevertheless, their Business Case has been developed to "*align with likely outcomes of State Government policy direction*".

SAPNs have also requested additional funding (through an increase in regulated revenues) for operating expenses such as IT system upgrades, interval data processing and management of third party providers, to support the implementation of their new and replacement 'smart ready' meter program, although it has not been confirmed as policy by the SA Government.

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[2] The Rule Change (page 6) defines a smart meter as: *"…an advanced metering technology that comprise the meter and a communications module. The communications software enables data to be retrieved from the meter remotely and enables other smart services……."*

We note that a key characteristic of a market led approach is that where smart meters are installed on customer premises on an 'opt out' basis, no additional financial cost is imposed on the customer unless they request additional products and services. However, the increased rate at which SAPNs intend to implement their meter replacement program and new cost-reflective tariff suggests that customers will be forced to accept a replacement prior to meter end-of-life.

AGL believe the installation of 'smart ready' meters in a contestable market would be inconsistent with current network ring fencing guidelines, anti-competitive and inefficient. AGL suggest that the AER closely review SAPN's replacement program to ensure that meters are only replaced where they no longer meet metrology standards or have reached end of life.

7.1.2 Roll-out of 'smart ready' meters

SAPNs regulatory proposal is predicated on their ability to rollout 'smart ready' meters to customers under a continuing regulated metering environment. We note that these meters are not communication-enabled at installation, but could be retrofitted at a later date to incorporate this capability.

In our view 'smart ready' meters should not be deployed by SAPN using regulated funding because they are:

(a) inconsistent with existing ring-fencing guidelines and will have an anti-competitive impact on the market for metering services; and

Current SA electricity guidelines[3] seek to:

> *"avoid the anti-competitive effects of cross-subsidies or other discriminatory interactions between contestable and non-contestable activities…ensure that unfair advantage is not secured by using information acquired by a monopoly activity, for the benefit of contestable activity; and avoid a perception of an uneven playing field that may deter potential market participants."*

SAPN's proposed 'smart ready' meter will, by its nature, operate in the competitive market for metering (following introduction of the Rule Change). It will compete with fully integrated smart meters (i.e. meters which include both metering and communications functionality) deployed by other providers. Consequently, AER approval for 'smart ready' meters would create a significant barrier to the market led approach and to overall competition in the metering provision and services market.

(b) inherently inefficient.

A rollout of 'smart ready' meters will require:

- two site visits (one to install the meter and a second to retrofit communications) which are the most expensive capital line items;
- the network to develop or upgrade expensive IT systems in order to manage asset deployment and ongoing functionality. SAPN have requested regulated revenue to cover this cost, however competitive meter and meter data providers developing these systems must cover these costs themselves.

For these reasons, SAPN's approach will not be sufficient to achieve the benefits of smart meters without imposing substantial additional costs on customers.

[3] Operational Ring Fencing Requirements for the SA Electricity Supply Industry: Electricity Industry Guideline No. 9 (June 2003); page 1

AGL strongly believes that no customer should have to pay extra charges for smart metering above their existing annual charge, unless and only if, they 'opt in' to such services. These events, generally associated with meter replacement, could include:

- a requirement to charge fees to recover additional metering charges;
- a change in the customer's current retail tariff; or
- provision of new products or services available enabled by the new meter.

However, it is clear that where 'smart ready' meters are installed under SAPNs proposal, additional charges will be borne by customers. This will include costs to recover distribution driven services such as monthly on-site meter reads and the back office functions necessary to accommodate an increase in the frequency of meter reads, validation and billing. These proposed services will add an extra $8-10 per year on top of their existing annual metering charge[4], in addition to the cost of the subsequent site visit to fully integrate the 'smart ready' meter.

AGL also notes that meter capability does not necessarily always equal the same level of functionality. NSW and Queensland are very good examples of where an approach to roll out smart capable meters (i.e. type 5) has occurred but where only type 6 operations were utilised. These decisions have resulted in:

- poor technology choices by networks;
- multiple site visits to install the meter and then refit at a later date with communications equipment; and
- additional metering costs incurred by customers as a result.

We encourage the AER to send the right market signal by rejecting the SAPN proposal.

7.2 Cost recovery for stranded assets

The measures outlined above will ensure that retailers face a fair, competitively neutral, and efficient choice in deciding whether to use a 'smart-ready' meter. The natural corollary of this is that a network should not receive additional cost recovery if the retailer decides to appoint a competitive provider who replaces the meter with its.

To allow cost recovery in this situation would be extremely inefficient, because it would:

- result in consumers paying concurrently for two sets of capital cost – one for the new (competitive) meter, and one for the old meter, even though the latter was replaced; and
- encourage networks to make inefficient asset investment decisions because cost recovery would be protected.

AGL recommends that for current metering assets that are replaced with smart meters, cost recovery should be based on depreciated asset value calculated by type of meter and directly recovered through the Standard Control Services.

7.2.1 Exit fees for churning customers

In 2013, the CEC proposed a set of criteria to determine the appropriate amount of cost recovery based on the average depreciated value of the stock of the existing accumulation and manually read interval meters, including any such administration fees.

[4] SA Power Networks: Tariff and Metering Business Case (September 2014); page 31

AGL notes that under these principles, SAPN have proposed significant cost recovery fees (i.e. exit fees) of up to $550 in 2015-16[5] for customers churning to other meter providers. We note the administration fee is a significant part of this calculation, is excessive and is a barrier to a more efficient market – since networks will gain some benefit from smart meters regardless of who installs the meter. Lastly, the fee itself does not differentiate between meter asset types or age i.e. accumulation meters which are older or the manually read interval meters that were installed in the last five years.

As a retailer interested in the contestable metering market, AGL does not support any upfront exit fees as it will impede a market led approach to installing smart meters and is a significant barrier to entry. AGL agrees with the approach taken by the AER in their NSW draft decision and their *Issues Paper: SA Electricity Distribution Regulatory Proposal 2015-20*:

> *"….exit or transfer fees proposed by SA Power Networks are likely to inhibit development of effective competition in the provision of metering services. This is because they will be a disincentive for consumers to switch to smart meters. In turn, the potential benefits of using smart meters will be less likely to emerge."*[6]

Furthermore, in the interests of promoting competition neutrality, any other costs associated with metering services such as fixed operating costs, IT assets, incremental costs etc. must be recovered through the Alternative Control Service or annual metering charge. These are costs of operating a metering business and should not be defrayed by making all customers pay through the Standard Control Service. AGL encourage the AER to explore this option.

7.3 New connections and meter replacement

The CEC has proposed changes to the NER, under the Rule Change, that allow state jurisdictions to determine their own new and replacement policies[7]. AGL does not support a fragmented and jurisdictional approach to new and replacement metering across the NEM.

To do so will:

- create barriers to any future market-led roll out of smart meters under competitive arrangements;
- limit the ability of energy retailers to offer products supported by smart meters across all jurisdictions; and
- create greater economic inefficiencies with increased likelihood of additional meter asset replacement at new and replacement sites.

AGL also recommend the AER consider new connections and replacement of aged meter assets as distinct activities.

7.3.1 New connections

New connections are new homes and properties of which the metering cost and installation is recovered directly from the customer/ developer/ builder (with the exception of South Australia). These costs currently vary by network and state.

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[5] SAPN: Regulatory Proposal 2015-20; Chapter 29: Revenue and Pricing; table 29.9

[6] http://www.aer.gov.au/sites/default/files/AER%20-%20Issues%20paper%20SA%20Power%20Networks%20regulatory%20proposal%20-%20December%202014.pdf

[7] COAG Energy Council (2013), Introducing a new framework in the National Electricity Rules that provides for increased competition in metering and related services, page 33 (section 5 of Attachment A)

AGL believes that meter charges (asset and installation) for new connections should be minimised in the metering regulated asset base under Alternative Control Services. A review of the SAPNs Business Case indicates that 348,177 new 'smart ready' interval meters are forecast to be installed over the 2015-20 regulatory period and customers would be moved to SAPNs new cost-reflective tariff rates, of which 116,620 would be rolled out over the initial two years[8].

AGL consider that these numbers seem high for a new and replacement program given the transition to competitive metering (and assuming all meters are replaced based on age or safety requirements as per the relevant metrological code) and when compared to SAPNs historical replacement rates outlined in its Business Case – Appendix B[9].

AGL believe that all these meters, particularly those in the initial two year period, could be connected more cost efficiently as smart meters in a contestable market rather than the proposed 'smart ready' type 5 manually read interval meter in a regulated market, which would include the additional cost of communications unit refit at a later date.

7.3.2 Aged asset replacement programs

AGL believes that the costs for metering and metering services must be unbundled from the regulated asset base funding arrangements that currently exist. Furthermore, meter provision and meter data service provision should be provided by separate entities that are ring fenced financially and operationally from other regulated activities carried out by them. This not only ensures that networks competing in meter/meter data provision markets do not use regulated revenue to compete in unregulated activities, but it is also a step towards achieving interoperability of metering standards and protocols.

This is consistent with the existing NER under chapter 7 where a network must, where requested, put in an offer to the Financially Responsible Market Participant (FRMP) who can either accept the offer or seek alternative metering arrangements.

In the case where the FRMP accepts the offer from the network, the network is then required to provide a meter at the lowest cost. AGL proposes that where a network is providing a meter in the scenario of new and replacement in a competitive market (following the Rule Change), the following approach should apply:

- the distribution network, as the party who has exclusive visibility of asset age on their network:
    - identify sites that need replacement every 12 months;
    - notify the FRMP which NMIs require replacement; and
    - where requested, put in an offer to the FRMP for metering replacement.
- the FRMP either accept the offer or choose a competitive metering provider of choice - under the Rule Change, this is the responsibility of the Metering Coordinator (MC);
- Where its offer has been accepted, the network (acting as MC) will apply regulated funds available under its AER determination to:
    - provide the cheapest basic type 6 accumulation meter until the customer seeks smart meter services; or
    - engage a competitive provider through commercial arrangements to install a smart meter.

[8] SA Power Networks: Tariff and Metering Business Case (September 2014); page 25
[9] SA Power Networks: Tariff and Metering Business Case (September 2014); page 80

7.4 Summary of Position

AGL broadly supports the AER's approach taken in its recent draft determination for the NSW distribution networks and encourages the AER to apply a similar approach in other jurisdictions.

As a general principle, AGL does not support the monopoly roll outs of meters, or the roll out of 'smart ready' meters. Instead, any meter provision needs to be based on providing value to the customer, and needs to provide an incentive for the customer to engage with and support the services and benefits that smart meters enable.

AGL believes that if the SAPN metering proposal is accepted it would stifle competition in smart metering, create significant barriers to energy and deliver negative impacts to consumers.

We call on the AER to reject the SAPNs proposal and their:

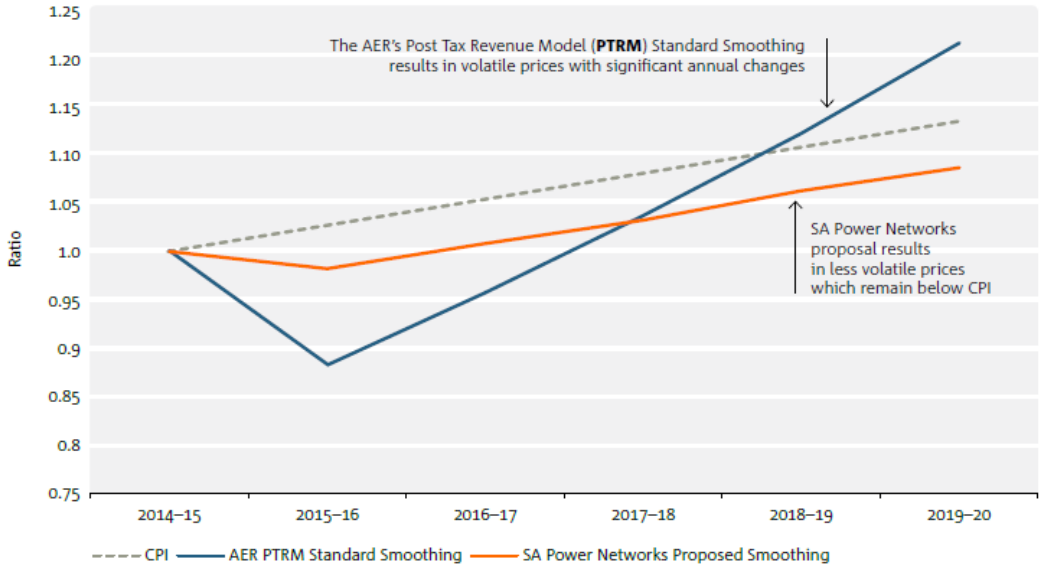
- policy and economic approach to a 'smart' ready meter rollout;
- request for increased regulated costs to develop and install new IT and back office functionality;
- request for asset cost recovery for 'smart ready' assets which are subsequently replaced as a result of competition; and
- application of exit fees.

AGL also encourages the AER to review the SAPN replacement program to ensure that meters are only replaced where they no longer meet metrology standards or have reached end of life.

8. Network Pricing

In its regulatory proposal, SAPN has proposed a price path of CPI - 4.3 per cent in 2015-16 and CPI thereafter. AER's standard smoothing approach would result in CPI - 3.4 per cent in 2015-16 then annual increase of CPI + 5.2 per cent per year as shown in Figure 8.

Figure 8: Price path smoothing outcomes



Source: SAPN regulatory proposal, p 353

It is expected that the final revenue and price outcomes will vary considerably in the AER's Draft and eventually Final Decision.

However, AGL supports the SAPN approach in principle. As a retailer, AGL would encourage price smoothing outcomes that provide the correct price signal in 2015-16 (i.e. a price decease to reflect the impact of the falling rate of return) but is less volatile and avoids any significant price increases in the remainder of the period (i.e. from 2016-17 onwards).

A price path which is less volatile is less likely to create customer concern about changes in energy prices. In addition, AGL's experience with revenue caps in Queensland suggests that it would be prudent to avoid embedding higher future price increases within the determination as these may be greatly magnified if energy consumption falls more than expected.

AGL would also support SAPN's movement to demand pricing for residential customers in order to prevent further network price instability.