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United Energy 2015 AMI Charges Revision Application

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1. Executive summary

As of 30 June 2014, United Energy's internal management of the AMI installation program has produced material improvements in installation rates, resulting in more than 96% of meter exchanges completed and appropriately transmitting smart meter by 30 June 2014. This is a highly successful outcome for a leading-edge infrastructure and technology project.

In accordance with the Cost Recovery Order in Council (CROIC[1]), the AER approved an annual expenditure budget and the associated metering charges for each year of the 2012-15 regulatory period. The CROIC requires United Energy to lodge a charges revision application annually, which effectively updates the AER's approved metering charges to take account of United Energy's actual expenditure to date and the company's latest expenditure forecasts.

This submission is United Energy's charges revision application for 2015, which provides United Energy's actual expenditure for 2013 and updated forecasts for 2014 and 2015. The table below presents the resulting proposed metering charges for 2015. The table also shows the AER's approved budget for 2015 (which was set in October 2011), and United Energy's actual metering charges for 2014.

Table 1.1: AMI Charges and Budget 2014-2015 ($ nominal per meter)

Nominal $/Meter	2014 Actual Charges	2015 Approved Charges	2015 Proposed Charges
Single phase single element meter	$141.33	$165.02	$160.44
Single phase single element meter with a contactor[2]	$141.33	$168.43	$160.44
Three phase direct connected meter	$159.39	$186.11	$180.94
Three phase current transformer connected meter	$170.02	$198.52	$193.01

As a result of lower-than-forecast expenditure in previous years, United Energy's proposed metering charges for 2015 are lower than the AER's approved budget for that year. Despite this saving, however, United Energy's actual capital expenditure of $71.7 million for 2013 exceeded the AER's budget of $18.2 million for that year, primarily as a result of delays to completion of the rollout and consequent differences in the timing of expenditure versus the original plan. In contrast, United Energy's operating expenditure for 2013 was closely aligned with the forecast, exceeding it by only $0.29 million (1.1%).

Where United Energy's actual expenditure in any particular year exceeds the AER's budget, the CROIC requires United Energy to demonstrate that this cost overrun was prudently incurred. The CROIC lists a number of factors that the AER may consider in assessing the prudency of the expenditure, including:

- The information available to the distributor at the relevant time.

[1] Cost Recovery Order in Council (CROIC) originally gazetted on 28 August 2007 and amended on 12 November 2007, 25 November 2008, 2 April 2009, 21 October 2010 and 22 December 2011

[2] This charge is applicable for single phase, single element meters with a contactor and also single phase, two element with contactor once this metering configuration is available

- The nature of the provision, installation, maintenance and operation of advanced metering infrastructure and associated services and systems.
- The nature of the rollout obligation.
- The state of the technology and the risks inherent in a project of this type.

By way of background, it is worth recalling that the AMI rollout is a Government-mandated program that is subject to a set of cost recovery provisions in the CROIC. These provisions provide United Energy with strong incentives to minimise its expenditure while ensuring that it satisfies its best endeavours obligation to complete the program by 31 December 2013. The information provided in this submission demonstrates that United Energy responded appropriately to these incentives by taking prudent and efficient management decisions throughout the program in response to changing circumstances.

Ernst & Young has recently concluded its compliance audit on behalf of the Essential Services Commission (ESC). Ernst & Young's audit report identified the following factors as preventing United Energy from completing the rollout program by 31 December 2013[3]:

- An insufficient number of installers were available;
- Lower than expected installation rates being achieved by the incumbent installer;
- Difficulties for installers in gaining access to customer premises in order to install AMI meters;
- The TOU tariff moratorium and the introduction of optional TOU tariffs;
- The Government's review of the AMI program and subsequent negative media coverage, which led to "a high number of aggressive customer behaviours towards installers resulting in delayed installation, reduced productivity, high installer turnover and difficulties in attracting new installers to ramp up the rollout";[4] and
- The need to satisfy the prudency test in order to recover AMI project costs.

As explained in appendix C, the first 5 factors were primary causes of the cost overrun in 2013. In relation to cost efficiency, Ernst & Young's made the following remarks[5]:

> "Our audit procedures identified several key success factors in relation to the AMI Program. There has been significant board and senior management focus on the AMI Program from the outset. This has been underpinned by robust and regular project management and a thoroughly implemented risk management strategy.
>
> Our audit procedures demonstrate UE's commitment to delivering the AMI Program to time, scope, and within budget, whilst providing a safe operating environment for staff, service providers and the general public."

The material provided in this submission also address United Energy's cost performance. In particular, appendices C, D and E show that United Energy's 2013 expenditure was prudently incurred, even though it exceeded the AER's budget. The single most significant cost impact of the project delay was the deferral of meter purchases and installations from 2012 to 2013, as illustrated in the tables below.

[3] Ernst & Young, Audit of AMI Regulatory Obligations for Distributors, United Energy Distribution Ltd, May 2014, page 14.

[4] Ibid, page 30.

[5] Ibid, page 6.

Table 1.2: Volume of meter purchases – actual and budgeted

	2012	2013
Budgeted volumes	315,461	31,768
Actual volumes	185,263	183,113
Variance	(130,197)	151,344

Table 1.3: Volume of meter installations – actual and budgeted

	2012	2013
Budgeted volumes	315,461	31,768
Actual volumes	119,910	170,898
Variance	(195,551)	139,130

As a result of the project delay, total meter purchase and installation volumes in 2013 exceeded the budget volumes. Given its best endeavours obligation, United Energy had no option but to ramp up its activity in 2013. The increased volume accounts for approximately $38 million or 70 per cent of the cost overrun for 2013. Therefore, while the cost overrun appears to be very significant when 2013 is examined in isolation, the majority of the increase is explained by inter-year timing differences, rather than an increase in the total costs of the program. A different ramp up rate would not have led to lower costs, but would have exposed United Energy to significant risks of non-compliance or project failure.

United Energy provides further detailed explanation of the cost overrun in Appendix C, including the company's decision in June 2013 to bring the installation program in-house. A comprehensive prudency review of United Energy's cost overrun is set out in two independent expert reports:

- **Evans & Peck, AMI Installation Program Review of Prudency, provided as Appendix D**. As industry specialists, Evans & Peck have provided a report setting out a detailed examination of United Energy's meter installation costs in 2013. The report provides a qualitative and quantitative examination of the causes of the cost overrun, including a reconciliation to the AER's approved budget for 2013.

  Evans & Peck concludes that United Energy's actual meter installation capital expenditure for 2013 is within scope and prudent as it 'reasonably reflects the efficient costs of a business providing the Regulated Services.'

- **KPMG, Advanced metering infrastructure expenditure 2013, provided as Appendix E**. The KPMG report provides a forensic reconciliation of the causes of increased capital expenditure against the AER's approved budget. For each category of expenditure, KPMG provides an independent expert opinion of the amount of expenditure that is regarded as prudent. Where KPMG has relied on the findings in the Evans & Peck report, this reliance has been made explicit.

  KPMG concludes that the capital expenditure overrun in 2013 of $53.484 million is prudent.

Each independent expert report demonstrates to a very high standard that United Energy's actual expenditure in 2013 was prudent and efficient. KPMG has also undertaken high-level benchmarking which confirms this conclusion.

In addition to the material provided in Appendices C, D and E, United Energy will also provide the AER with the source evidence relied on by Evans & Peck and KPMG in reaching their conclusions.

2. Regulatory requirements

Clause 5G.1 and 5G.2 of the CROIC, require UE to submit a revised charges application with respect to setting charges for 1 January 2015, no later than 31 August 2014.

The form and content of this charge revision application is determined by the CROIC. In particular, this application complies with the general application requirements in clauses 5G and 5H of the CROIC.

The revised charges submission, in accordance with 5H.1, shall:

- State the period to which it relates;
- Set out the actual total operating and capital costs and revenue for 2013; and
- Contain an updated forecast of total operating and capital costs and revenue for 2014 and 2015.

The AER's determination is to be made in accordance with the regulatory principles in clause 4.1 of the CROIC, the general application requirements in clause 5, particularly 5G, and the process set out in clauses 5G and 5I. Any cost overrun is assessed in accordance with 5I.5 to 5I.9.

The CROIC provides for a subsequent AMI WACC period commencing on 1 January 2014 and currently ending on 31 December 2015. The AER has determined the WACC of 5.62% (real).

Clause 5.3 requires UE to identify the documents that the company is relying on in making this revised charges application.

In addition to the above, Clause 5.5(b) also requires a forecast of the metering installations that the distributor proposes to install for each year of the period covered by the application.

Clauses 5H.2 and 5I.3 require that actual costs for 2013 are audited to ensure that they have been incurred and are within scope.

3. Period over which charges apply

Clause 5H.1(a) requires the revised charges application to state the period to which it relates. This application is for the pricing period 1 January 2015 through to 31 December 2015.

4. Actual Operating and Capital Expenditure, and Revenue

In accordance with clause 5H.1 (b), UE has provided the actual 2013 operating expenditure, capital expenditure and revenue in Table 4.1.

The numbers below reflect the actual costs and revenue arrangements, including the arrangements under CROIC clause 4.1 (o) and 4.1 (p).

Table 4.1 Actual Operating and Capital Expenditure and Revenue for 2013

Description	2013 actual $m-nominal
Gross Capital Expenditure	$71.7
Operating Expenditure	$25.9
Revenue	$82.7

UE is seeking to have the excess expenditure included in the building blocks in accordance with 5I.5. Appendix C describes UE excess expenditure with a supporting expert report on the excess capital expenditure in Appendix D and a specific report on meter installations costs in Appendix E.

This submission has been provided to the AER earlier than the last date of 31 August to allow sufficient time for the AER to consider all of the material provided in assessing the 2013 excess expenditure. This approach has meant that the policy amendments expected in the CROIC around mid to late July 2014 have not been included. Additional costs may arise from these changes and a new manual meter read fee may require some adjustment of the 2015 costs between metering charges and the manual meter fee. Once the amendments have been made legally, UE will make the necessary adjustments in the 2015 proposed costs.

5. Forecast Operating and Capital Expenditure, and Revenue

In accordance with clause 5H.1 (c), UE has reviewed its forecast operating and capital expenditure and revenue for the remaining years in the subsequent budget period, these are provided in the AER template.

The numbers provided in the AER template are the best available numbers reflecting the forecast to reach practical completion and the continued roll out obligation for the tail of customers who have been allocated in one of the following categories: refused, no access, made no contact with UE or the site has a defect or technical issue which has prevented a meter exchange. The revised forecast has sought to balance the best endeavours obligation for continued roll out and the need for efficiency and prudency in accordance with the amendments made to the CROIC in December 2013. The revised forecasts do not seek to cater for any policy decisions and implementation requirements from the rebate and manual meter read policy. The implications of a national smart metering framework and metering churn are also not included in the forecasts.

6. Information relied on

Clause 5.3 of the CROIC requires UE to identify the documents which the company relies on in making this charges application. They include:

- This application;
- Appendix A – AER template;
- Appendix B – Ernst & Young review of 2013 actual Operational and Capital Expenditure;
- Appendix C - Excess Expenditure Submission including all documents listed in that submission;

- Appendix D – Evans and Peck, AMI Installation Program, Review of Prudency (Historical Expenditure) including all documents listed in that report;
- Appendix E – KPMG Independent Expert Report 2013 Capital Expenditure including all documents listed in that report: and
- All other information provided to the AER by UE with its previous budget and charges applications.

7. Audit requirements

Under the CROIC, actual revenue and costs relating to 2013 must be audited. The actual revenue and expenditure is to be derived from UE's Regulatory Accounting Statements and must be allowed except for any part the AER can establish is not attributable to the provision, installation, maintenance and operation of advanced metering infrastructure and associated services and systems.

UE engaged Ernst & Young to audit the 2013 Regulatory Accounts including the costs and revenues attributable to AMI services. Ernst & Young concluded that:

- The actual expenditure incurred is for activities within scope;
- The actual expenditure incurred has been incurred in the amount claimed; and
- The actual revenue has been incurred in the amount stated.

A copy of the audit letter for the purposes of this revised charges application for 2013 expenditure and revenue is included in Appendix B.

In addition to the statement made above in relation to expenditure, Ernst & Young has concluded that the revenue attributed to AMI services is a correct account of revenue attributed for AMI services for the 2013 calendar year. This sign off was included as part of the 2013 regulatory accounting audit.

In accordance with clause 5I.2, UE can confirm that actual expenditure for 2013 satisfies the necessary conditions. Details are provided in Appendix A and B of this application.

8. Charges for Regulated Services

This section sets out UE's proposed charges for 2015 and describes how those charges comply with the AER's pricing principles.

8.1. Proposed charges

The table below compares the approved 2015 charge with proposed charges.

Table 8.1 Proposed 2015 Charges

Nominal $/Meter	2015 approved charges	Proposed 2015 charges
Single phase single element meter	$165.02	$160.44
Single phase single element meter with a contactor[6]	$168.43	$160.44
Three phase direct connected meter	$186.11	$180.94
Three phase current transformer connected meter	$198.52	$193.01

8.2. Approach to setting charges

In determining the charges, UE has taken the building block revenue requirements over the initial and subsequent AMI budget period. UE has:

- Allocated costs to service category (e.g. by meter type);
- Adjusted the WACC in the subsequent AMI WACC period; and
- Divided the allocated costs by service category by forecast customer numbers in each service category.

Consistent with CROIC clause 4.1(p), UE has opted to set its charges based on its revenue requirement over the initial and subsequent AMI budget periods. UE has previously noted that this approach will result in it under-recovering its annual revenue requirements for 2009, 2010, 2011 and 2012, with an expectation that UE will recover the shortfall in the remaining years of the subsequent AMI budget period. In view of this approach, UE is seeking to provide a smooth price path for the remaining years. 2013 is the first year where UE started to recover the shortfall amount.

UE believes that the proposed price path for its AMI charges is simple and achieves an outcome that balances customers' interests of minimal price volatility with UE's own interests in achieving cash flow certainty to match the significant ramp up in required investment to meet the Regulated Services obligations.

There is no change to the current pricing structure and therefore the pricing structure meets the pricing principles established in the CROIC and those established by the AER. The AER approved a revised budget for UE in October 2011. This revised budget included the capability to provide two element interval meters where dedicated load circuits were active and being separately metered. UE has previously had a charge for single phase, single element with contactor metering. These charges will apply for any single phase metering with a contactor whether there is one or two elements in the metering configuration. This approach continues to provide a balanced outcome for customers.

[6] This charge is applicable for single phase, single element meters with a contactor and also single phase, two element with contactor once this metering configuration is available

9. Forecast meter numbers

In accordance with CROIC clause 4.1(l), Table 9.1 below provides UE's revised forecast meter numbers.

Table 9.1: Forecast total meter numbers at end 2015

Meter Type	Total Meter Numbers
Single phase single element	503,910
Single Phase Off Peak	72,232
Three phase direct connected meter	93,810
Three phase current transformer connected meter	2,822
Total	**672,774**

In accordance with CROIC 5.5 (b) the forecast of the number of metering installations that the distributor proposes to install for each year of the period is shown in Table 9.2. .The 2014 and 2015 forecasts include new connections.

Table 9.2: Number of AMI Meter Installs

Installation Profile	2011	2012	2013	2014	2015
Annual Installations	128,184	145,094	160,205	91,711	14,259

10. Contact details

If you have any queries please contact:

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11. APPENDICES

APPENDIX A: AER Template

See attached model

APPENDIX B: Auditors Report

Appendix C - UE Excess Expenditure Submission

Appendix D - Evans and Peck, AMI Installation Program, Review of Prudency (Historical Expenditure)

Appendix E - KPMG Independent Expert Report 2013 Capital Expenditure

Appendix F – EY Audit of AMI Regulatory Obligations