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General Manager
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Our Ref: SU600824

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Dear Mr Pattas,

AER'S 2012-2015 AMI DRAFT DETERMINATION

The Victorian Government provides the following submission on the Australian Energy Regulator's (AER) Draft Determination on the 2012-2015 metering services budgets and charges applications of the Victorian electricity distributors.

A key concern of the Victorian Government is to ensure that charges on customers' bills associated with the smart meter program reflect efficient costs and are not excessive. In this regard, I welcome the decision of the AER to reduce the metering services budgets on the basis that the substantial expenditure proposals have not been justified. I ask the AER to continue to apply a rigorous approach in assessing any revised submissions and further evidence provided by the distributors.

Government Review

As you are aware, the decision to mandate the Advanced Metering Infrastructure (AMI) or "smart meter" program was taken by the previous Labor government. Recognising and understanding the level of community concern over the AMI program, the Baillieu Government has commenced a comprehensive review to determine whether, and under what circumstances, the program can deliver value for money to consumers. This review will include a full and independent cost benefit analysis, as recommended by the Victorian Auditor-General.

I anticipate that the Government will make a decision on the future of the AMI program before the end of the year.

Through the Government's review, and the AER's budgets and charges application process, my overriding concern is to see that Victorian consumers do not pay more for the AMI program than is fair and reasonable.

The role and powers of the AER

I note that, in accordance with Section 27A of the *National Electricity Act 2005 (Victoria)*, the AER is required to perform its functions in this matter as if it were the Essential Services Commission of Victoria. That is, the AER must also give regard to Sections 8 and 8A of the *Essential Services Commission Act 2001* (Victoria), which promotes efficiency considerations in the long-term interest of Victorian consumers. Attached to this submission is an advice that explains this (refer Attachment 2).

Consequently I am concerned about statements in the Draft Determination suggesting that efficiency considerations have no bearing on the task that the AER performs under the Cost Recovery Order in Council (the Order). These statements are incorrect in terms of both the legal position and the policy that underpins the Order.

Under/over recovery in the 2009-10 period

The current framework (refer to Clause 4.1 of the Order) provides for metering services costs to be recovered under a pass-through mechanism, rather than through an incentive-based control mechanism (as used for the recovery of the costs associated with the provision of standard control services). Note 6 under Clause 4.1(p) of the Order states that:

The charges will be designed so that the net present value of building block costs incurred to date must equal the net present value of revenues incurred to date unless a distributor decides (and the Commission agrees) for a particular year that it will not recover its full building block costs in which case un-recovered expenditure will be carried over to a later year.

Note 4 under Clause 4.1(p) of the Order states that:

This process is repeated by the setting, in 2011, of charges to apply for the years 2012-15 based on actual expenditure and revenues known to 2010, revised forecasts for 2011 and an Approved Budget for 2012-2015.

Figures 1.1 – 1.5 in the Draft Determination indicate that some distributors have underspent relative to their budgets while others have overspent relative to their budgets, but there is no information on the actual revenue relative to forecast revenue. As such variances, and the reasons for their occurrence, may inform the AER's assessment of the forecasts contained in the distributors' current budget and charges applications, I am of the view that the AER needs to consider how and why there have been these variances. In that respect, I draw your attention to Clause 4.1(c) of the Order which requires, *amongst other things,* that building block costs be based on actual expenditure.

Further, if the AER has not already done so, it should critically examine the distributors' regulatory accounting statements and the costs actually incurred by related parties in assessing the actual expenditure to 2010 and the revised forecasts for 2011.

Allocation of costs

With the charges for distribution services (standard control services) regulated through an incentive based regulatory framework with an efficiency benefit sharing scheme (EBSS) and the charges for metering regulated through a cost pass-through arrangement, it is important to guard against the incentive for the distributors to allocate as much expenditure to metering services as possible. By doing so, the metering service expenditure will be passed through to customers, and the distributors will be rewarded under the EBSS and through lower than forecast capex for lower distribution services expenditure.

The inappropriate allocation of costs may not necessarily be identified as part of an audit as it does not impact on the overall financial position of the distributor. However, it may impact on the costs that may be recovered by the distributors. In particular, Rule 11.17.6 of the National Electricity Rules (the Rules) provides that "metering services" regulated under the Order are not subject to regulation under a distribution determination made under the Rules. This requires the AER to focus carefully on what exactly is regulated under the Order and what is regulated under its recent Victorian electricity distribution determination to ensure that there is no double recovery. In that regard, the AER should consider the definition of "metering services" in the Order and its restriction to metering services provided by means of metering installations that meet the Functionality Specification[1].

I urge the AER to explain how it has critically examined the distributors' regulatory accounting statements to satisfy itself that Victorian electricity customers are not effectively paying twice for costs through the inappropriate allocation of costs[2&3].

Joint management

Jemena and United Energy have both entered into AMI contracts together, through their contracts with Jemena Asset Management. CitiPower and Powercor also have a joint AMI project.

However, the metering services charges are similar for Citipower and Powercor (despite there being a much larger number of customers in the Powercor area than in the CitiPower area) but markedly higher for customers in the Jemena area than in the United Energy area (where similar disparities in customer numbers exist to the Powercor and CitiPower areas).

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1 *See the definition in clause 2.1 of the Order in Council.*

2 *The forecast costs associated with meters for new connections that have been included in the distributors metering budgets have been reduced. However, there is no indication that a check has been performed to ensure that the actual costs associated with meters for new connections have not been inappropriately allocated to metering services during the 2009-10 period. The Draft Determination indicates that there is a difference between the regulatory accounts and actual operating expenditure for CitiPower and Powercor due to the allocation of shared corporate costs. However, there is no indication as to whether the shared corporate costs (or any other costs) have been assessed as being appropriately allocated during the 2009-10 period.*

3 *The Draft Determination indicates that there is a difference between the regulatory accounts and actual operating expenditure for CitiPower and Powercor due to the allocation of shared corporate costs. However, there is no indication as to whether the shared corporate costs (or any other costs) have been assessed as being appropriately allocated during the 2009-10 period.*

This apparent discrepancy requires that the allocation of joint project costs to Jemena and United Energy be further examined by the AER.

I note that the Draft Determination appears to have adopted a different approach to assessing reasonable costs associated with meter testing in the CitiPower/Powercor and Jemena/United Energy areas. In the CitiPower/Powercor areas, the number of meters to be tested is assessed by considering the aggregate number of meters across both areas and assuming a cost to test of either $250 or $412.50 per meter, depending on the meter type (refer Table D.66). The number of meters to be tested in the Jemena/United Energy areas has been considered in isolation, with a cost to test of $239 per meter in the Jemena area (refer Table D.38) whilst the cost to test is $51.22 or $79.67 per meter in the United Energy area (refer Table D.23).

Related party contracts

The Draft Determination (refer page 94) outlines the principles for a commercial standard for determining the margin on related party contracts. However, these principles include the sharing of efficiencies with the distributor. Since the cost recovery framework is based on a pass-through mechanism, Victorian electricity customers in effect bear the risk associated with the delivery of metering services. Consumers should therefore receive the benefits associated with any efficiencies.

Further, the Draft Determination (page 96) notes:

... the efficiency benefit sharing scheme (EBSS) rewards opex efficiencies gained on standard control services for a six year period. The AER considers that in similarly rewarding past efficiencies for the AMI roll-out, it is appropriate to apply an efficiency sharing mechanism based on historical Australian Bureau of Statistics (ABS) multi-factor productivity (MFP) of 1.0 per cent for the 1985-86 to 2008-09 period.

The AER, in recognition that the Victorian businesses are more efficient than [distributors] in other states, in the Victorian Distribution Determination allowed a margin based on a 1 per cent productivity rate per year. The AER considers that a [distributor] or its related party would receive similar efficiencies in the provision of services in the [energy, gas and water] sector. Therefore, using an approach adapted from the EBSS and its recognition of efficiency benefits arising from productivity, the AER calculated the margin on the basis of productivity gained over the three year AMI roll-out period 2009 to 2011. These rewards, when shared over the period [of] the 2012-15 budget period, would result in a margin of a 3.0 per cent.

Because the Order is based on a pass-through of costs rather than an incentive-based control mechanism, the Order does not provide for efficiency sharing and does not include an EBSS. The reference to an EBSS in the Draft Determination is therefore not relevant, and the 3 per cent margin should not be allowed.

I note that the Draft Determination identifies that a margin needs to be provided on related party contracts for corporate overheads. I understand that the AER has the power to request information from related parties to obtain information on the corporate overheads that are actually incurred. I urge the AER to exercise these powers to identify the appropriate level of corporate overheads, rather than estimating a percentage based on reports (refer page 98) that may not be relevant to the particular circumstances applying to this determination.

SP AusNet's WiMAX Communications Network

Impaq identified that the communications network that is being used by SP AusNet for AMI WiMAX can be used to provide non-AMI-related communications services. For example, the ability for WiMAX to be used for smart grid applications more broadly is identified in a 2009 media release which states that:

Utilities and communications companies are investigating how WiMAX can play a role in their smart grid networks, and several high profile utilities have announced WiMAX smart grid pilot projects recently. Texas-based CenterPoint was one of the first utilities to test out GE's WiMAX-based smart meters. National Grid will be testing out WiMAX gear provided by Alvarion, to connect smart meters and distribution automation devices to the utilities' back office. Last month San Diego Gas and Electric (SDG&E) said it had applied for stimulus funds to build a smart grid wireless network that would include about 30 per cent of its network built with WiMAX. And Southern California Edison (SCE) has also said it is looking at WiMAX for part of its smart grid network. The biggest reason for using WiMAX for the smart grid is high bandwidth. SDG&E told us that WiMAX could be used around major grid assets, like substations, to collect a lot of data from phasor units, which monitor the reliability of the grid and collect information like voltage, current and frequency in real time. WiMAX could also be used to deliver services like mapping information and video tools for mobile workers, or provide video services for facility monitoring[4] *.*

If SP AusNet has purchased a more expensive WiMAX network with the express intention to also use that network for smart grid applications, then some of the costs associated with the WiMAX network should be allocated to distribution (standard control) services.

I note that the Draft Determination indicates that the AER has not established that SP AusNet is using its WiMAX network for non-AMI proposes and therefore concluded that the expenditure is within scope. However, no detail is provided as to how it has been established WiMAX is not being used for other purposes. Moreover this conclusion raises the question as to what extent the cost of WiMAX would be reduced if it did not have the functionality that enables its future use for smart grid applications. In that regard, the marked disparity between SP AusNet's communications capex and that of the other "rural" distributor, Powercor, is relevant. Although the AER has determined that SP AusNet's contract for the manufacture of its communications technology was let in accordance with a competitive tendering process, the question still remains as to whether the WiMAX technology is only for AMI communications, or is for more than that and thus considerably more expensive than necessary.

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4 *http://gigaom.com/cleantech/the-wimax-smart-grid-is-here-brought-to-you-by-grid-net/*

Out of scope activities – meter volumes in excess of customer numbers

The Draft Determination notes that costs associated with installing meters for new customers are recovered through alternative control services.

It appears that the number of customers in 2011 has been taken as the reference point. It is unclear why this reference point has been chosen when it would seem more appropriate to use the number of customers in 2009 when the AMI roll out began.

If the distributors have operated prudently, any meters installed for new customers from the commencement of the roll out (if not earlier) will be AMI meters. Costs associated with the installation of these meters will be recovered through alternative control services. The only costs that should subsequently be included as part of the AMI roll out will be the costs associated with checking that the remote communications is working when the roll out occurs in that area. The proportion of meters installed for new customers prior to the roll out occurring in their area will be declining over time as the roll out matures.

Out of scope activities – two element meters

I note that the Draft Determination establishes that the installation of two element meters by Powercor, CitiPower, SP AusNet and United Energy is out of scope as the moratorium on time-of-use tariffs is due to end after 31 December 2011.

However I am advised that, should the moratorium continue in some form, it should be possible to provide a specialised two-part tariff for a customer with a controlled hot water or space heating service, with only a single element smart meter that avoids or minimises price changes for the customer. In this circumstance two element meters would not be required to be rolled out.

Further considerations

- To avoid misunderstanding, it might be useful for the Overview to more clearly indicate that the metering budget and charges include the costs associated with existing non-AMI metering.
- It is unclear why SP AusNet has an opex budget of $471,000 in 2014 and 2015 for meter reading (refer Table D.16) when United Energy has none (refer Table D.21) (which appears consistent with the prescribed roll out of remotely read meters being completed by the end of 2013).
- A 20 per cent threshold has been applied to the consideration of United Energy's IT opex when the 20 per cent threshold only applies in respect to the determination of revised charges[5] (which this is not).
- CitiPower has project management costs in excess of $1 million per annum that continue after completion of the AMI roll out. Similarly, Powercor has project management costs of around $3 million per annum that continue after completion

[5] *Cost Recovery Order in Council, Clause 5I.2(a)*

of the AMI roll out. There is no obvious reason for those costs to continue after the completion of the roll out and, as a consequence, they should be disallowed.

- It is also unclear why the cost to test a meter varies so much across the distributors (United Energy appear to test meters at a much lower cost than Jemena, CitiPower or Powercor). There being no obvious reason for this disparity, and with efficiency considerations being relevant, the lower costs of United Energy are to be preferred.
- It is unclear how the contract for SP AusNet's AMI systems integration services, which was conducted under a closed tender process with two companies invited to participate, was in accordance with a competitive tendering process. Indeed, ostensibly it appears not to be a competitive tender process as more conventionally understood.

Attachments

For further reference, I have included advice provided to the Department of Primary Industries (DPI) in relation to the Draft Determination, specifically:

- Attachment 1 – Assessment of AMI Costs following AER Draft Determination - A Report to the Victorian Department of Primary Industries (DPI), EMCa, August 2011.
- Attachment 2 – AMI Cost Recovery Order in Council: 2012-2015 budget and charges applications, Geoff McCormick, August 2011.

I also include a summary of the submissions received through the public consultation process completed by the DTF, prepared by ACIL Tasman.

- Attachment 3 – Summary of submissions – AMI Review by DTF, ACIL Tasman, July 2011.

Contact for further information

Should you have any queries in relation to this submission, please do not hesitate to contact Mr Mark Feather, Acting Executive Director, Energy Sector Development, Department of Primary Industries, by telephone (03) 9658 4793 or by email mark.feather@dpi.vic.gov.au.

Yours faithfully,

HON. MICHAEL O'BRIEN MP
Minister for Energy and Resources