



6 October 2011

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Dear Anthony

**AMI DRAFT DETERMINATION - SUBMISSION OF MINISTER FOR  
ENERGY AND RESOURCES**

I refer to the Minister for Energy and Resources, the Hon Michael O'Brien MP's submission to the AER (undated) (**Minister's Submission**) on the AER's *Draft Determination Victorian Advanced Metering Infrastructure Review 2012-15 budget and charges applications* dated 28 July 2011 (**AMI Draft Determination**).

In the Minister's Submission, the Minister contends (at 2) that '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 ... are incorrect in terms of both the legal position and the policy that underpins the Order'. The sole support provided by the Minister for this contention is an accompanying advice by Geoff McCormick of Counsel dated 24 August 2011, attached to the Minister's Submission as Attachment 2 (**McCormick Advice**).

The McCormick Advice concludes that the AER must have regard to efficiency considerations in exercising its functions and powers under the AMI Cost Recovery Order.<sup>1</sup> In particular, McCormick concludes in respect of the 'commercial standard test' established by clause 5C.3(b)(iv) of the Order that efficiency is relevant and must be taken into account.

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<sup>1</sup> The term '**AMI Cost Recovery Order**' is used in this letter to refer to the Order in Council made under ss15A and 46D of the *Electricity Industry Act 2000* (Vic) (**EIA**) titled 'Order Under Section 15A and Section 46D' and published in the Victorian Government Gazette No. S200 on 28 August 2007, as amended by the Orders in Council made under the same sections of the EIA and published on 12 November 2007 (Gazette No. S286), 25 November 2008 (Gazette No. S314), 2 April 2009 (Gazette No. G14) and 21 October 2010 (Gazette No. G42) respectively.

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CitiPower and Powercor Australia (**Businesses**) disagree with the Minister's contention that the AER must have regard to efficiency in exercising its functions and powers under the AMI Cost Recovery Order, in particular in applying the prudent expenditure test in accordance with clause 5C.3(b)(iv) of that Order. The purpose of this letter is to explain why the AER was correct at law in concluding, in the AMI Draft Determination, that it is impermissible for it to consider economic efficiency in making its budget determination under clause 5C of the Order and applying that test, and where McCormick errs in concluding to the contrary in the McCormick Advice.

***Reasoning and conclusions in McCormick Advice***

As foreshadowed by the Minister in the Minister's Submission, McCormick relies on section 27A of the *National Electricity (Victoria) Act 2005 (NEVA)* and sections 8 and 8A of the *Essential Services Commission Act 2001 (ESC Act)* in support of his conclusion that the AER must have regard to economic efficiency under the AMI Cost Recovery Order.

McCormick's reasoning can be summarised as follows:

- 1 Sections 8 and 8A of the ESC Act applied to the performance of the ESC's functions and the exercise of its powers under the AMI Cost Recovery Order immediately prior to their transfer to the AER by the NEVA. This is because:
  - (a) the ESC's functions and powers to which those sections apply include functions and powers conferred on it by 'relevant legislation' under which a 'regulated industry' operates; and
  - (b) the EIA, pursuant to which the AMI Cost Recovery Order is made and permissibly confers functions and powers on the ESC, provides that it is 'relevant legislation' and the electricity industry is a 'regulated industry' (ESC Act, sections 10 and 11; EIA, sections 7A, 46D and 46E).
- 2 Sections 8 and 8A of the ESC Act apply to the performance of the AER's functions and the exercise of its powers under the AMI Cost Recovery Order, notwithstanding that those functions and powers are conferred by section 23 the NEVA and not the EIA or any other 'relevant legislation'. This is because section 27A of the NEVA provides that 'the AER must take action under the AMI Order as if it were the ESC, including the making of a determination under the AMI Order'.
- 3 Sections 8 and 8A of the ESC Act, in particular section 8A(1)(a) which provides that the ESC must have regard to 'efficiency in the industry and incentives for long term investment', make it clear that:
  - (a) efficiency is a relevant consideration under the AMI Cost Recovery Order, notwithstanding that the regulatory model under the Order is one of cost pass through; and
  - (b) more specifically, while the 'commercial standard test' established by section 5C.3(b)(iv) itself only 'imports whether the decision is judged economically sound and profitable', efficiency must be taken into account by the AER as a relevant consideration in applying that test.

The Businesses observe that, in reaching these conclusions, McCormick's reasoning contains an error of law that renders his conclusion that the AER may permissibly have regard to economic efficiency in making a determination under the AMI Cost Recovery Order incorrect.

***Sections 8 and 8A of ESC Act do not operate to require AER to consider economic efficiency***

Even if it be accepted that sections 8 and 8A of the ESC Act apply to the performance of the AER's functions and the exercise of its powers under the AMI Cost Recovery Order notwithstanding that those functions and powers are not conferred by 'relevant legislation' and that McCormick's construction of clause 5C.3(b)(iv) of the Order is correct, it does not follow that the AER may have regard to economic efficiency in performing its functions and powers under the AMI Cost Recovery Order.

There is nothing in the terms of the AER's obligation in relation to the objective of promoting the long term interests of Victorian consumers to necessitate that, in making a determination under the AMI Cost Recovery Order, the AER must consider economic efficiency. Unlike the national electricity objective set out in section 7 of the National Electricity Law, the objective set out in section 8 of the ESC Act makes no reference to, and is not one of, efficiency.

Likewise, the further explanation of the AER's objective in section 8(2) of the ESC Act, namely having 'regard to the price, quality and reliability of essential services', does not mandate the consideration of economic efficiency under the AMI Cost Recovery Order.

It is presumably for this reason that the McCormick Advice places primary reliance on the AER's obligation under section 8A to have regard to the matters specified therein, more specifically its obligation under section 8A(1)(a) to have regard to 'efficiency in the industry and incentives for long term investment'. So, for example, the McCormick Advice concludes (at 7) in relation to the relevance of efficiency under the AMI Cost Recovery Order generally:

*Thus, to the extent that the AER has disclaimed in both its Framework and Approach Paper and the Draft Determination the introduction of "economic efficiency tests", that is not the correct approach. The AER is required under section 8A(1)(a) to have regard to "efficiency in the industry".*

But section 8A(1)(a) of the ESC Act does not operate to require the AER to have regard to economic efficiency in making its determination under the AMI Cost Recovery Order. This is because section 8A(1) of the ESC Act expressly provides that the AER must have regard to the matters set out therein only 'to the extent that they are relevant in any particular case'. That is, it is only where efficiency is a permissible relevant consideration under the AMI Cost Recovery Order itself that section 8A(1)(a) of the ESC Act operates to mandatorily require the AER to have regard to efficiency in discharging its functions and powers under the Order.

The concept of economic efficiency is not a relevant consideration under the AMI Cost Recovery Order itself. There is nothing in the prescription by clause 4.1(a) of the regulatory model under the AMI Cost Recovery Order as one of 'pass through of the costs of a distributor for Regulated Services', or the scope or prudent expenditure tests for the pass through of those costs established by clauses 5C.2 and 5C.3 (amongst others) of the Order, that renders economic efficiency a relevant consideration in the making of a determination under the Order. It follows that

section 8A(1)(a) does not operate to require the AER to have regard to efficiency in making its budget determination under clause 5C of the Order and that, to do so, would be taking into account an irrelevant consideration and an error of law.

***Error of law in McCormick Advice***

In relying on section 8A(1)(a) of the ESC Act to contend that the AER is required to consider economic efficiency in making a determination under the AMI Cost Recovery Order, the McCormick Advice makes no reference to the qualifying words in section 8A(1) 'to the extent that they are relevant in any particular case'. Those words are disregarded.

McCormick does not contend, in that Advice, that efficiency is relevant under the AMI Cost Recovery Order itself. Indeed, he implicitly acknowledges (at 8) that, absent sections 8 and 8A of the ESC Act, what is relevant under the prudent expenditure test established by clauses 5C.2 and 5C.3(b)(iv) of the Order is only 'whether the decision [to incur expenditure] is judged economically sound and profitable'.

McCormick only contends that economic efficiency is a relevant consideration under the AMI Cost Recovery Order by reason of the requirement under section 8A(1)(a) for the AER to have regard to 'efficiency in the industry'. In so contending, the McCormick Advice contains an error of law that renders his conclusion that the AER must have regard to efficiency in making a determination under the AMI Cost Recovery Order, including in particular in applying the prudent expenditure test in accordance with clauses 5C.2 and 5C.3(b)(iv), incorrect.

It follows that the Minister's submission that efficiency is a relevant consideration in making a determination under the AMI Cost Recovery Order should not be accepted.

The Businesses trust that drawing this legal error in the McCormick Advice and the Minister's Submission to the AER's attention prior to the making by the AER of its final determination will be of assistance. If, however, the Businesses can provide any further assistance to the AER in relation to this matter, please do not hesitate to contact me.

Yours sincerely,



**Brent Cleeve**  
**MANAGER REGULATION**