Advanced Metering Infrastructure Roll-out Subsequent Budget Application from Jemena Electricity Networks (Vic) Limited

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Jemena Electricity Networks (Vic) Limited (**JEN**) is well progressed with its AMI deployment and is meeting its obligations to use its best endeavours to meet the roll out schedule set down by the Victorian government. Since the establishment of the AMI mandate in August 2007, JEN has met a number of key milestones, including:

- accreditation of JEN's AMI solution by the Australian Energy Market Operator (**AEMO**)
- go live of JEN's AMI systems
- meeting the mandatory roll out targets
- maintaining costs within the constraints set out in the AMI Cost Recovery Order.

Table 0-1 below presents JEN's actual (for 2009 and 2010) and forecast (for 2011, 2012 and 2013) installation profile for the mass roll out. The profile is presented in per centage terms and compares JEN's profile to the mandated profile in the AMI Cost Recovery Order.

Table 0-1: JEN's mass roll out installation profile compared to targets in AMI Cost Recovery Order

Mass roll out install profile	2009	2010	2011	2012	2013
Percentage installed / to be installed by JEN	4%	11%	38%	34%	14%
Cumulative percentage installed / to be installed	4%	15%	52%	86%	100%
AMI Cost Recovery Order cumulative percentage target	0%	10%	43%	76%	100%
Percentage ahead of mandated roll out	4%	5%	9%	10%	0%

This budget application sets out the proposed budget for JEN to deliver the mandate in the AMI Cost Recovery Order in the subsequent AMI budget period (**subsequent budget period**), being the calendar years 2012-2015. The budget application also provides a forecast of the number of metering installations that JEN proposes to install in each year of the subsequent budget period.

JEN's proposed Total Opex and Capex for each year of the subsequent budget period is set out in Table 0-2 below.

Table 0-2: Proposed Total Opex and Capex for subsequent budget period

Budget	2012	2013	2014	2015
Capital Expenditure	34,098,309	17,890,820	7,668,962	7,345,462
Operating and Maintenance	19,422,094	17,226,413	15,819,662	15,941,122
Total Opex and Capex	**53,520,403**	**35,117,233**	**23,488,625**	**23,286,584**

The forecast of the number of metering installations that JEN proposes to install in each year of the subsequent budget period is provided in Table 0-3 below.

Table 0-3: Metering installation forecast

Calendar Year	2012	2013	2014	2015
Meters to be installed	**113,464**	**51,559**	**7,348**	**7,348**

The proposed metering installation profile will ensure that JEN meets its roll-out targets, as set out in the AMI Cost Recovery Order.

JEN takes compliance with the law seriously. This budget application only seeks to receive expenditure for activities that are within scope and expenditure that is prudent, as required by the AMI Cost Recovery Order.

- The activities outlined in this budget application are reasonably required for the provision of Regulated Services or to comply with a metering obligation or requirement (i.e. they are within scope).
- The expenditure is prudent because in the vast majority of cases it will be incurred under contracts that have been let in accordance with a competitive tender process. For other costs, the expenditure is prudent because incurring it does not involve a substantial departure from the commercial standard that a reasonable business would exercise in the relevant circumstances, including the cost savings from not conducting a competitive tender process and the benefits of avoiding the need for other contractors to 'come up to speed'.

In those circumstances therefore, JEN submits that its proposed budget complies with the requirements of the AMI Cost Recovery Order.

1 Introduction

This document is JEN's subsequent budget period budget application (**application**) to the Australian Energy Regulator (**AER**) pursuant to clause 5A.1(c)(i) of the *Order in Council made on 28 August 2007* (being an order under Section 15A and Section 46D of the Electricity Industry Act 2000), as amended by the *Order in Council made on 12 November 2007,* the *Order in Council made on 25 November 2008,* the *Order in Council made on 31 March 2009* and the *Order in Council made on 19 October 2010* (the **AMI Cost Recovery Order**).

This application covers JEN's AMI costs for the period 1 January 2012 to 31 December 2015.

This section introduces the application and provides a brief overview of:

- the background to the deployment of AMI in Victoria
- JEN's AMI obligations
- the joint program that JEN is undertaking with United Energy Distribution (**UED**) to deliver AMI.

Finally, the introduction also indicates how JEN has identified confidential and commercially sensitive information in this application and sets out the structure of this budget application.

1.1 AMI mandate

On 28 August 2007, the Victorian Government established a legal requirement (also known as a **mandate**) for electricity distributors to roll out AMI. The mandate defined a range of requirements for the deployment of AMI, including minimum AMI functionality, performance and service levels and roll-out timelines.[1]

The mandate also defined a cost recovery framework for AMI. The nature of the cost recovery framework has changed significantly over time, with the approach moving from an incentive-based regime to a cost pass-through regime in November 2008, with the amendments to the original AMI Cost Recovery Order made by Order in Council on 25 November 2008.

[1] Minimum AMI Functionality Specification for Victoria (**Functionality Specification**) originally published by the Department on 18 October 2007 and revised in September 2008, as approved by the Hon Peter Batchelor, Minister for Energy and Resources; and Orders in Council under section 15A and section 46D of the Electricity Industry Act 2000 originally published in the Victorian Government Gazette on 28 August 2007 and 12 November 2007 (**AMI Specifications Order**). Both OICs were amended on 25 November 2008.

As a condition of JEN's distribution licence, the AMI Cost Recovery Order requires JEN:

- to use best endeavours to install AMI meters by 31 December 2013 for all customers with annual consumption of less than 160 MWh (for which JEN is the responsible person);
- to ensure its AMI meters meet the minimum functionality and service levels specified under the Functionality Specification and the AMI Specifications Order (see footnote 1 above);
- to use best endeavours to observe the following percentages of the total number of AMI meters to be installed:[2]
  - by 30 June 2010 – 5 per cent
  - by 31 December 2010 – 10 per cent
  - by 30 June 2011 – 25 per cent
  - by 30 June 2012 – 60 per cent
  - by 30 June 2013 – 95 per cent, and
  - by 31 December 2013 – 100 per cent.

Not only does the AMI Cost Recovery Order require JEN to deploy new complex and advanced meters to replace all existing residential meters, it also requires JEN to:

- implement a large-scale, high-performance, two-way communications network (with 324,000 end points)
- establish new business processes for planning and management of the roll-out, including new processes to manage customer enquiries, claims and complaints
- establish a process for the ongoing management of the new metering and communication environment
- from 1 January 2012, provide metering data for each day by 6:00am the following day
- implement processes and information systems to capture data at half-hourly intervals (48 reads per meter per day)
- implement new information systems to validate, process and store the metering data
- establish new processes and systems to manage the new meter, network and systems environment and achieve associated service obligations, and

[2] Each number includes the previous percentage.

- establish business processes to ensure that the current manual meter-reading environment can be efficiently and effectively operated over the four-year period in which it is being replaced by AMI.

JEN provides more detail on the relevant regulatory framework in section 2 of this application.

1.2 JEN's progress

JEN takes compliance with the law seriously. It is well progressed with its AMI deployment and is meeting its obligations to use its best endeavours to meet the roll out schedule in AMI Cost Recovery Order. Since the establishment of the AMI mandate in August 2007, JEN has met a number of key milestones. The key milestones achieved to date are summarised in Table 1-1 below.

Table 1-1: Key milestones achieved to date

Date	Milestones	Status
Dec 2008	Signing of contracts with AMI technology providers	Achieved
	Signing of contracts with IT and system integrators	Achieved
Sept 2009	Commence roll-out of AMI meters and communications equipment	Achieved
April 2010	AEMO accreditation for new AMI solution	Achieved
June 2010	Production go-live of full AMI solution	Achieved
June 2010	5% AMI meters installed and operating as remotely read interval meters in market	Achieved (22 July 2010)
Dec 2010	10% AMI meters installed and operating as remotely read interval meters in market	Achieved (7 Nov 2010)

By 7 November 2010, 8 weeks ahead of schedule, JEN achieved the milestone of 10 per cent AMI meters on its network. JEN also met the regulatory obligation of 5 per cent AMI meters operating as remotely read interval meters on 22 July 2010. At 17 January 2011, 47,149 AMI meters were installed on JEN's network, representing 15.5 per cent of JEN's meter base.

JEN (jointly with UED) was the first distribution business in Victoria operating AMI meters in the market as remotely read interval meters with daily delivery of the meter data to market. This shows the workability of JEN's chosen technology selection. As at 17 January 2011, 39 per cent of JEN's distribution network had AMI communications in operation.

By the end of the initial budget period, the most complex parts of the roll out will be behind JEN:

- Between 2008 and 2010 JEN developed and commissioned the technical, IT, business and commercial environment to support the roll-out of AMI meters to meet the regulatory obligations, timetable and functionality specifications.
- With JEN's AMI systems now live, JEN's AMI technology solution has proven to be workable and robust.
- By the middle of 2011, JEN will have communications coverage across 99 per cent of customer sites on its network.

The focus from 2012 onwards will be on installing AMI meters in place of the remaining non-AMI meters, and transitioning to AMI meters and systems as business-as-usual operations.

JEN continues to be committed to meeting its AMI obligations by ensuring a robust, effective and commercial AMI solution is implemented to meet the high expectations of the roll-out. However, JEN has concerns regarding a number of legal and regulatory AMI uncertainties. As a direct result of this, JEN has had to make a number of assumptions for the purpose of this application. JEN has clearly set out its assumptions in this application and, where appropriate, has provided additional information on the budget implications that would result, should those assumptions not hold.

1.3 Joint JEN/UED/JAM AMI program

JEN's initial budget period budget application had explained that Jemena Asset Management (6) Pty Ltd (**JAM**, formerly Alinta Asset Management Pty Ltd) has developed a joint program to manage the delivery of AMI for JEN and UED (referred to below as the **joint program**). Over 2011, the joint program will come to an end, with JEN and UED transitioning to business-as-usual operation of the AMI meters and systems, with JAM continuing to provide AMI mass rollout activities to both JEN and UED over the AMI deployment period.

JEN, being the smallest distributor in Victoria with stand alone IT infrastructure and systems, has benefited greatly from the joint program with JAM and UED. By joining forces with JAM and UED, JEN has been able to meet its obligations while reducing costs. Without this partnership, JEN would have struggled to fulfil the required AMI mandate and would have also incurred materially higher costs in setting up its own program.

The Victorian AMI roll-out has been a world leading capital works and market integration initiative that has involved many complexities, adaptations and lessons. Despite these challenges, the joint program is achieving each of its key milestones and is delivering an effective metering solution that complies with current obligations, as well as a sound platform for continued compliance over the subsequent budget period.

JAM performed efficient and effective technology investigations and trials, which informed the selection and procurement processes. Effective programs and project plans were developed and implemented to manage the design and delivery of the AMI solution and the capital works program, and to manage associated AMI delivery risks and issues for UED and JEN. A sound conceptual design guided the development and implementation of the AMI technology and supporting IT systems and infrastructure. This culminated in the selection of a solution that has proven to be workable and robust.

JAM followed prudent procurement practices, establishing an open expression of interest process followed by a tender, and a selection and procurement process to contract for the provision of:

- AMI communications technology and associated management systems
- AMI meter providers
- installation services
- IT system and infrastructure integrators
- IT hardware and high availability infrastructure required to meet AMI performance and service level obligations
- back office IT systems to support business processes required to meet AMI obligations, and
- production IT data centre and disaster recovery data centre.

Since the commencement of the program, JAM developed the detailed design of AMI IT Systems and Infrastructure and AMI technology solutions, business processes and mass roll-out plans and processes. JAM built, tested and implemented all IT systems (including applications, infrastructure, integration, conversion and testing), implementing AMI and transitional business processes, and commenced the mass roll-out of AMI meters.

This capital works and market integration initiative has involved many complexities, adaptations and lessons. Despite this challenging environment, costs and budgets for the joint program remain within the constraints and allowances in the AMI Cost Recovery Order.

By incurring additional expenditures to address unanticipated issues and manage risks, and expending some funds earlier than originally planned, JAM has enabled JEN's compliance with regulatory obligations, minimised risks and, in some instances, delivered operational efficiencies earlier than anticipated.

1.4 Confidential information

JEN has identified confidential information in this application that is commercially sensitive using bolded square brackets.

This information is not available in the public domain and is commercially sensitive for reasons that include:

- The information enables unit price forecasts to be established for meters, installation services and IT systems and infrastructure which may yet be tendered by JEN (or by others, on behalf of JEN). JEN does not want to prejudice any future competitive tender processes that JEN or other parties may conduct in relation to meter provision or metering services.
- The information relates to the terms and conditions under which JAM is providing asset management services for metering. JAM competes for asset management services in a number of markets. Disclosing this information would prejudice the competitive position of the Jemena asset management business in those markets.

We respectfully draw the AER's attention to Part 3, Division 6 of the National Electricity Law (**NEL**), which defines the specified set of circumstances under which the AER is authorised to disclose information given to it in confidence.

For the avoidance of doubt, JEN notes that it does not give the AER consent under section 28X of the NEL to disclose the confidential information in this application. JEN also notes that, should the AER intend to disclose this information on the grounds of public benefit under section 28ZB of the NEL, the AER must:

- issue JEN with a written notice of such intent and a written decision setting out the AER's reasons
- provide JEN with no less than 5 business days to respond
- consider every representation JEN makes in response
- if the AER maintains its intent to release the information, issue JEN with a further written notice and a written decision setting out the AER's reasons
- not release the information for a further 5 business days after the date of the further notice.

1.5 Nature of dollar figures

As required by the AER, the budget figures are in real 1 July 2011 dollars.

1.6 Application structure and overview

JEN's application comprises this document and associated appendices. In addition to this introduction, this document contains 5 sections:

- Section 2 explains JEN's interpretation of the AMI regulatory framework that now applies, as well as explaining in more detail the background to the current regulatory framework.
- Section 3 describes the arrangements that JEN has put in place to deliver metering services from 2012 forward.

- Section 4 provides the forecast of the number of metering installations that JEN proposes to install in each year of the subsequent budget period.
- Section 5 provides JEN's proposed budget for the subsequent budget period, including the budget figures, how they were arrived at and the assumptions made in preparing those figures.
- Section 6 substantiates the proposed budget in terms of the relevant tests set out in the AMI Cost Recovery Order.

The AMI Cost Recovery Order specifically requires the provision of certain information. The information is provided in JEN's application and the list below provides a guide to where the relevant information can be found:

- The process that is proposed (or in the case of contracts already entered into, has been used) for competitive tenders—Chapter 8 of Appendix A.
- A forecast of the number of metering installations—Section 4 of this document.
- Expenditure for Regulated Services for each year of the subsequent budget period (distinguishing between capital expenditure and operating and maintenance expenditure)—Section 5 of this document.
- Total Opex and Capex for each year of the subsequent budget period—Section 5 of this document.
- Information relating expenditure to scope—Chapter 4 of Appendix A.
- Filled out information templates—attached as Appendix F, a separate Microsoft Excel file.

2 AMI regulatory framework

The legal and regulatory instruments that create or affect the legal obligation for JEN to roll out AMI are:

- the AMI Specifications Order, the Functionality Specification[3] and the Service Level Specification[4]
- the AMI Cost Recovery Order
- the National Electricity Amendment (Victorian Jurisdictional Derogation (Advanced Metering Infrastructure Roll Out)) Rule 2009 that the Australian Energy Market Commission (**AEMC**) approved
- JEN electricity distribution licence[5].

Other significant legal and regulatory influences include:

- the national electricity market (NEM) metrology procedures
- the Victorian AMI program
- the National Smart Metering Program[6].

This section briefly reviews these elements as they currently stand. JEN notes some ongoing uncertainty regarding many of these instruments and it has made assumptions in section 5.2 as to how to manage this uncertainty.

2.1 Specifications Order, Functionality Specification and Service Levels Specification

The Victorian Government gazetted the AMI Specifications Order on 12 November 2007 and amended it on 25 November 2008. It defines the minimum meter functionality and meter service levels to be provided by JEN by reference to the Functionality Specification and the Service Levels Specification.

[3] Department of Primary Industries, "Minimum AMI Functionality Specification (Victoria) – Release 1.1", September 2008 – previously published as release 1.0 in October 2007

[4] Department of Primary Industries, "Minimum AMI Service Levels Specification (Victoria) – Release 1.1", September 2008 – previously published as release 1.0 in October 2007.

[5] Essential Services Commission of Victoria, "Electricity Distribution Licence – Jemena Electricity Networks (Vic) Ltd, ABN 82 064 651 083, as varied on 24 September 2008", September 2008, http://www.esc.vic.gov.au/NR/rdonlyres/5B3E5903-E0AE-4369-B0E7-E34542E99E1F/0/Jemena240808.pdf.

[6] http://share.nemmco.com.au/smartmetering/default.aspx.

2.2 AMI Cost Recovery Order

The Victorian Government originally gazetted the AMI Cost Recovery Order on 28 August 2007 and prescribed an incentive-based framework under which distributors were to recover the cost of providing metering services to customers. However, on 25 November 2008, the AMI Cost Recovery Order was amended, changing the cost recovery framework and defining the scope of AMI. The new framework is based on a cost pass-through, rather than an incentive-based approach. Subsequent minor amendments also followed on 31 March 2009 and 19 October 2010.

The AMI Cost Recovery Order (clause 5A.1(c)(i)) requires JEN to make this budget application no later than 28 February 2011. The AMI Cost Recovery Order (clause 5B.3) also allows JEN to revise this application by 31 August 2011 where there is:

- a change in expenditure due to a contract being entered into between 28 February and 31 August, or
- a material change in a metering regulatory obligation or requirement.

The AMI Cost Recovery Order (clause 5F) also allows JEN to notify the AER of an actual or anticipated variance from its approved budget at any time after the AER makes its determination on JEN's application.

Clause 5C sets out the criteria the AER must apply in a budget determination and the process the AER must follow in assessing a budget application. A separate process is defined for setting charges, once a budget is approved (this is a separate process and, therefore, this application does not deal with the issue of charges[7]).

Under clause 5C.2, the AER must approve the Submitted Budget unless the AER establishes that the expenditure (or part thereof) that makes up the Total Opex and Capex for each year:

- is for activities outside scope at the time of commitment to that expenditure and at the time of the determination, as defined in Schedule 2, ("scope test"), or
- is not prudent ("prudence test").

Clause 5C.3, in turn, provides that expenditure is prudent and must be approved by the AER, unless the AER establishes that:

- for expenditure that is a contract cost—that the contract was not let in accordance with a competitive tender process ("competitive tender prudence test"), or

[7] Pursuant to clause 5A.1(c)(ii) of the CROIC JEN has submitted with this application a separate charges application.

- for expenditure that is not a contract cost (or is a contract cost, but the AER has established that the contract was not let in accordance with a competitive tender process)—
    - o it is more likely than not that the expenditure will not be incurred, or
    - o incurring the expenditure involves a substantial departure from the commercial standard that a reasonable business would exercise in the circumstances ("commercial reasonableness prudence test").

It is important to note that the prudence test does not state that contract costs are only prudent if there has been a competitive tender process. Even absent a competitive tender process, they must be approved unless the AER establishes that incurring the expenditure does not satisfy the commercial reasonableness prudence test.

When applying the commercial reasonableness prudence test the AER is required to take into account and give fundamental weight to the matters referred to in clause 5I.8, including:

- the circumstances of the distributor, or
- if not the distributor, the circumstances of the person that directly incurred or managed the expenditure,

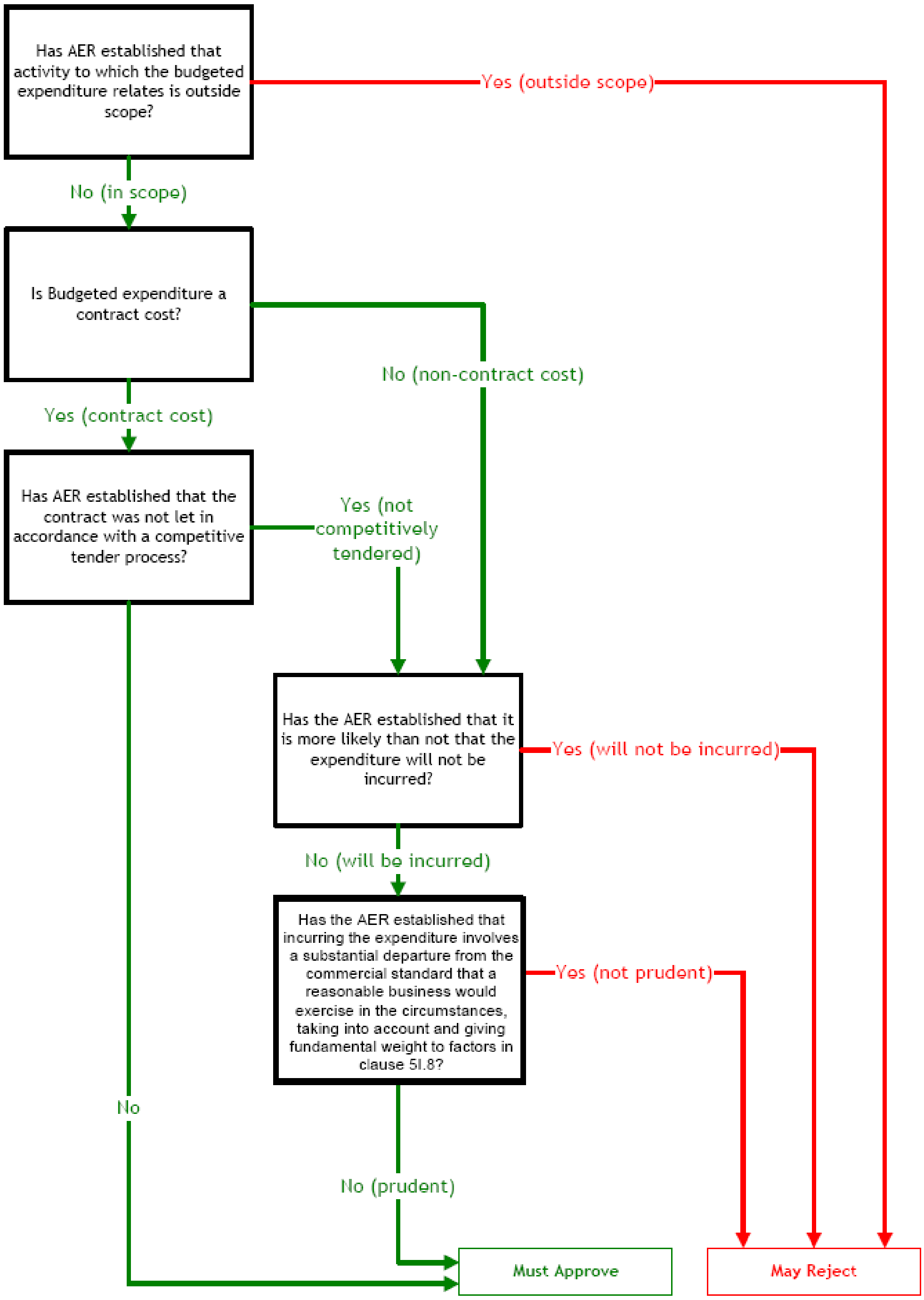
at the time the commitment was made to incur or manage the expenditure. In this regard relevant circumstances include:

- the information available at the relevant time;
- the nature of the provision, installation, maintenance and operation of AMI and associated services and systems (the **AMI project**);
- the nature of the AMI rollout obligation;[8]
- the state of the technology relevant to the AMI project;
- the risks inherent in a project of this type;
- the market conditions relevant to the AMI project; and
- any metering regulatory obligation or requirement.

[8] As to which attention is drawn to clause 14 of Schedule 1.

The process described above is summarised in Figure 2-1 below.

Figure 2-1: Budget determination flow chart



2.3 Exclusivity Derogation

The Victorian Government's stated position is that the Victorian distributors should have primary responsibility for the mass installation of AMI meters for the initial roll-out period, plus one further year (i.e. 2009 to 2014 based on the current time-frame). On 3 November 2007, the Victorian Government wrote to the Australian Energy Market Commission (AEMC), setting out its position and proposing a Rule change seeking a jurisdictional derogation from the National Electricity Rules (NER).[9] The proposed derogation would establish the local network service provider as the exclusive responsible party for small customer metrology and, in particular, for the roll-out of AMI.

On 29 January 2009, the Australian Energy Market Commission approved the derogation proposal and gave notice under sections 102 and 103 of the National Electricity Law (NEL) making the National Electricity Amendment (Victorian Jurisdictional Derogation (Advanced Metering Infrastructure Roll Out)) Rule 2009 (Exclusivity Derogation) and related Rule determination.

2.4 The Victorian AMI Program

The Victorian AMI program is a collaborative program involving the Victorian Government, Victorian distributors, retailers, inter-state energy businesses and consumer groups. This program led by the Victorian AMI Industry Steering Committee (ISC) creates a forum for distribution retail businesses and customer groups to identify risks and resolve issues common to all stakeholders. Among its achievements is the development of an operating model for how businesses interact with customers and one another to implement AMI.

The AMI Cost Recovery Order provides for the ISC to advise the Minister for Energy and Resources of any impacts to the rollout timeframes and targets.

In July 2008, the ISC provided such advice to the Minister which was taken into account when the Victorian Government amended the AMI Cost Recovery Order in November 2008.

2.5 National Smart Metering Program

At the national level, the Ministerial Council on Energy (**MCE**) Standing Committee of Officials reviewed the costs and benefits of a national roll-out of interval meters with two way communications. This project—under the auspices of the MCE—has been coincident with the development of the Victorian AMI program.

[9] Department of Primary Industries: Victorian Government Rule Change Proposal (Jurisdictional Derogation) – Advanced Metering Infrastructure Rollout, August 2007.

On 13 June 2008, the Ministers of the MCE issued a communiqué, stating that:

> Ministers committed to development of a consistent national framework for smart meters in the National Electricity Market, supporting distributors to be responsible for the roll-out of smart meters.
>
> …To maximise the benefits of the roll-out, MCE will develop a consistent national framework for smart meters in the National Electricity Market (which excludes WA) with the obligation for deployment placed on distributors and appropriate cost recovery…[10]

This national smart metering initiative has significant implications for the Victorian AMI program.

JEN considers it is most desirable for the Victorian AMI framework (including the AMI Cost Recovery Order and the Specifications Order) and the national smart metering framework to be aligned.

The National Smart Metering program has developed a national AMI meter functionality specification and package of rule changes to support possible AMI mandates in other jurisdictions. The Australian Energy Market Operator (**AEMO**) has assumed responsibility form the National Stakeholder Steering Committee (**NSSC**) for the development of the complementary market processes and procedures, which will apply in Victoria when AEMO implements them.

The constituent voting organisations of the NSSC—Energy Networks Association, Energy Retailers Association of Australia and the National Consumer Roundtable—intend to establish a strategic forum in which they will discuss and seek to resolve AMI policy issues that remain. These issues include the nature of gateway reviews designed to examine the technical and economic feasibility of AMI contestability after a mandate or, in the case of Victoria, after cessation of its exclusivity derogation. Such a review would take account of the benefits of AMI technology in place as a result of the mandate, the extent to which that technology can enhance customers' choice of load management products and provide greater access to price and product information, along with the costs and benefits of possible additional investment in new AMI technologies or its alternatives that may be necessary to enable greater competition benefits.

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[10] Ministerial Council on Energy, Communique, June 2008, Canberra, pages 1 and 4.

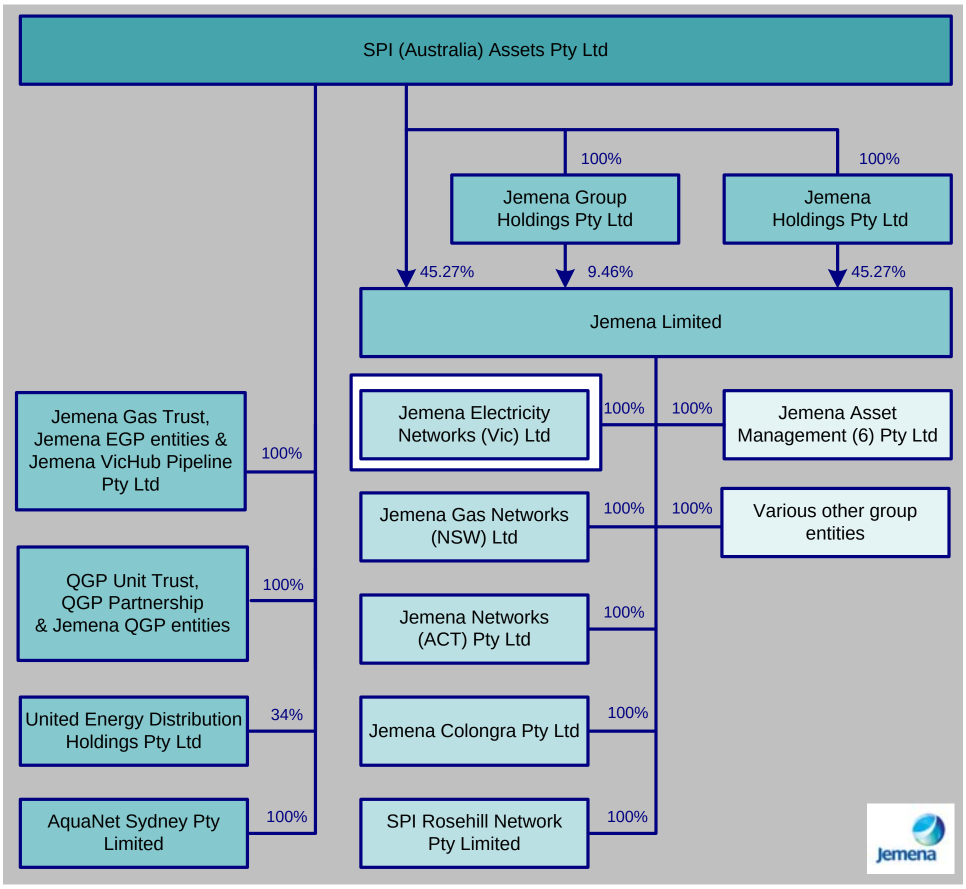
3 Metering Delivery Arrangements

This section explains the arrangements JEN has put in place to deliver metering services over 2012-2015.

3.1 Ownership Structure and Management

Figure 3-1 below shows the current ownership structure. JEN is a wholly owned subsidiary of Jemena Limited that, in turn, is a wholly owned subsidiary of SPI (Australia) Assets Pty Ltd (SPIAA). Jemena Limited owns 100 per cent of the Jemena asset management business, which uses a number of contracting entities, including JAM and Jemena Asset Management Pty Ltd.

Figure 3-1: JEN ownership structure



3.2 Metering Services Delivery Arrangements

As discussed in JEN's initial budget application and in section 1.3, in order to meet its AMI roll out obligations, JEN entered into a cost-sharing arrangement with UED (the arrangement was discussed in Appendix A of JEN's initial budget application), under which JEN entered into a commercial outsourcing contract with Alinta Asset Management Pty Ltd, now JAM, which, together with Jemena Asset Management Pty Ltd, is part of the Jemena asset management business. This contract was the Service Requirements Agreement (SRA).[11] UED and JAM entered into a similar contract.

Over 2009, 2010 and 2011, to deliver on its obligations under the two SRAs with JEN and UED, JAM created a comprehensive and professional program (**joint JEN/UED/JAM program** or **joint program**) to plan, develop and implement a solution to meet JEN's and UED's AMI obligations established through the AMI Specifications Order, the Functionality Specification and the AMI Cost Recovery Order.

The joint program covered:

- the selection, procurement and installation of:
    - meters
    - communications systems
    - IT systems
- participation in industry activities related to AMI
- business process change design, planning and implementation.

Detailed information on the joint program during 2009, 2010 and 2011, including its activities and costs, was provided in Appendix A of JEN's initial budget application. JAM set up the joint program as a stand-alone project. The scope of the program focused on establishing AMI systems and rolling out AMI meters. The scope did not include the operation of AMI meters and systems once they have been rolled out. Over 2011, the joint program, having achieved its objectives, will disband.

Notwithstanding disbandment of the joint program office, JAM will continue to provide AMI mass rollout activities to both JEN and UED over the AMI deployment period.

[11] The SRA is attached with this budget application as Appendix B

JEN has contracted with JAM to deliver metering services (as well as other non-metering services, the cost of which is not included in this application) for the subsequent budget AMI period under a Customer and Market Services Agreement (**CMS agreement**), attached as Appendix D. Under the CMS agreement, JAM will operate both AMI and non-AMI metering on JEN's network. JEN understands that UED has entered a similar agreement with JAM. JEN's arrangements under the CMS agreement are explained in the next four sections.

As explained below, it is consistent with (and not a substantial departure from) the commercial standard that a reasonable business would exercise in the circumstances surrounding the AMI project for JEN to have entered into the CMS agreement with JAM. In particular, under the CMS agreement:

- through the governance process, JEN retains control of any expenditure made on JEN's behalf by JAM.
- the contract costs to JEN are made up of JAM's actual costs—with any cost reductions in JAM's actual costs being passed onto JEN—and a management fee, which is discussed separately below
- JEN has gained access to economies of scale with JAM's other clients
- JEN has been able to avoid the substantial costs of conducting a tender
- JEN has retained continuity in service provision and JAM's existing knowledge, while avoiding the costs and risks associated with a new service provider having to 'come up to speed' with JEN's systems and working arrangements
- the management fee paid by JEN to JAM compares favourably with industry benchmarks and the governance processes in the CMS agreement allow JEN to ensure that actual costs incurred by JAM in providing services to JEN are efficient
- risks are allocated fairly between JEN and JAM.

3.2.1 Why JEN chose JAM for the subsequent budget period

JEN has historically outsourced all services related to the maintenance and operation of its distribution network. At the time of the decision to enter the CMS agreement, JEN did not, nor does it now, have the internal capability or resources to deliver the Regulated Services.

With the joint program arrangement coming to an end by the end of 2011, JEN needed to ensure the ongoing delivery of Regulated Services. Given JEN's circumstances, JEN considered three options for achieving this:

1. bringing the services in-house, by hiring relevant staff to establish JEN's capability to deliver these services itself
2. outsourcing the services to JAM
3. outsourcing the services to a third party provider that would be appointed through a tender process, with JAM participating in the tender.

Option 1 would involve JEN establishing a capability it does not currently posses by establishing a new in-house unit. JEN estimated that the additional costs of option 1 over option 2 to JEN would be c-i-c in opex costs over the 2011-2013 period. While, under option 1, JEN would not be required to pay management fees to JAM estimated at approximately c-i-c on opex, JEN would incur additional opex costs of c-i-c to pay new staff. This estimate was conservative as it only accounted for the salary costs of new JEN internal staff under option 1 and did not include the transaction costs of finding and hiring the new staff. Further detail of this analysis is set out in the JEN Board Paper attached as Appendix C.

JEN considered that the costs of option 3 would outweigh the benefits, when compared to option 2, because:

- JEN's smart meter network infrastructure comprises of world leading metering and communication technologies and applications. The knowledge and expertise required to operate and maintain the different components of the system were developed and refined during the design, development and testing phases of the programme. JAM possesses a unique in-depth understanding of JEN's metering systems and assets—both legacy systems and new advanced metering systems. That understanding and expertise is unmatched in the market. While other providers could develop such expertise, this would take time and come at a significant cost and risk to JEN.
- Since the commencement of the AMI mandate, JAM has an excellent track record in delivering JEN's (and UED's) large-scale AMI program, including delivering metering services for JEN to a high standard and within budget.
- Conducting a tender for the volume and type of work covered under the CMS agreement would involve substantial costs for JEN in terms of developing adequate technical specifications and technical assessments.
- Due to the nature of the services and the very high service levels specified by the AMI Cost Recovery Order, one of the essential selection criteria in a tender process would have to be the demonstration of experience and capability in operating a similar type of infrastructure. This type of infrastructure being unique in Australia, in all likelihood would result in the appointment of JAM.

JEN notes that this reasoning appears to be supported by UED, which JEN understands has also chosen to continue with JAM as the service provider for metering services. UED recently conducted a competitive tender for the provision of distribution services on their network, but elected not to run a similar tender for the provision of metering services.

Given the above, JEN considered that the most commercially prudent and reasonable choice would be to continue with JAM as JEN's contractor for providing metering services. JEN's management therefore recommended that JEN pursue option 2[12], and JEN's Board approved that recommendation.

3.2.2 How JEN negotiated the CMS agreement

JEN negotiated the agreement directly with JAM. JEN's negotiating team was made up of General Manager Electricity Networks, Manager Network Risk and Facilities, and Legal Counsel. In negotiating the terms of the agreement, JEN applied the same rigour as it would in any commercial negotiation. JEN also took into account the terms of JEN's existing SRA with JAM.

When negotiating the value of the management fee that JEN would pay JAM for providing the relevant services, JEN considered:

- the findings of the Ferrier Hodgson Forensics report that was considered at the time JEN entered into the SRA[13]
- a benchmark study prepared by NERA for Envestra on contractor profit margins.[14]

Both of these reports lead JEN to believe that c-i-c was a reasonable quantum for the management fee. The negotiated management fee is within the 95 per cent confidence interval for the mean EBIT margins in the infrastructure contracting industry, as calculated by NERA. This is a particularly good outcome for JEN because

c-i-c

3.2.3 Standard of service under the CMS agreement

The CMS agreement ensures that metering services on JEN's network are delivered at least cost and to the appropriate standards by explicitly requiring JAM to deliver services:

- in accordance with good industry practice (exercising the degree of skill, diligence, prudence and foresight that reasonably would be expected from an experienced operator)
- in accordance with all regulations and acts relevant to the services performed
- in accordance with the relevant asset management, environmental management, quality assurance and occupational health and safety plans

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[12] The relevant board paper is provided with this application as Appendix C.

[13] Refer to confidential Appendix C of JEN's initial budget application.

[14] NERA, "Benchmark Study of Contractor Profit Margins", September 2010. This paper is provided with this application as Appendix E and can be found on the AER website at http://www.aer.gov.au/content/index.phtml/itemId/740632.

- in a timely manner
- in a commercial, prudent and reasonable manner, and
- using staff for each task with the requisite level of professional skill, customer service orientation, care and diligence which may be reasonably expected of a skilled, professional person suitably qualified and experienced in the performance of such tasks.

3.2.4 CMS agreement governance arrangements

The governance arrangements under the CMS agreement establish an Operations Steering Committee (to be chaired by a JEN staff member) and an Operations Working Group (to be chaired by JAM). Both of these bodies will have representatives from JEN and JAM.

The Operations Steering Committee will direct the relationship between the two parties, monitor service breaches and make decisions relating to their respective rights and obligations under the CMS agreement. The Operations Working Group will manage the day-to-day affairs, service level management and relationship between the parties.

Enforcing standard of service

JEN management, through its membership on the Operations Steering Committee and the Operations Working Group, and in the usual course of its duties, will oversee the standard of service provided under the CMS agreement. The key positions within JEN responsible for managing and enforcing the CMS agreement are General Manager Electricity Networks and Manager Network Risk and Facilities. These staff will:

- represent JEN on the Operations Steering Committee and/or the Operations Working Group
- negotiate and approve the service delivery plan
- negotiate and approve the meter asset management plan
- negotiate and approve the annual budget
- monitor and assess JAM's day-to-day performance against the plans and the budget
- review monthly reports and other information provided by JAM.

Plans and budgets

The CMS agreement contains detailed provisions covering the manner in which JEN establishes and approves the scope of the activities to be delivered under the CMS agreement, as well as the annual budget for the costs JEN is prepared to pay for the delivery of those services.

The Service Delivery Plan and the Meter Asset Management Plan identify the key activities that JEN expects JAM to deliver and the standard to which they must be delivered. The activities include asset maintenance, repair and any capital expenditure. JEN may approve changes to these plans from time to time.

JEN approves an annual budget that identifies all elements and categories of costs that JEN expects JAM to incur in providing the services and which JEN is prepared to pay for. Once JEN approves the annual budget, JAM must deliver the services within that budget. JEN may authorise JAM to incur additional costs, if JEN considers this reasonable. JEN will receive detailed monthly reports on JAM's progress and performance.

JEN pays JAM the estimated actual costs for each month as set out in the most recent approved annual budget plus the management fee applicable. In July and January of each contract year, the parties will undertake a "true up" process whereby a difference payment will be made by either JAM or JEN depending on whether JAM had under or over spent against the budget in the relevant 6 month period.

Statement of actual costs

As a part of the true up process described above, JAM must prepare (on an open book basis) a statement of actual costs and allow JEN, if it so wishes, to appoint a financial auditor to review and report on JAM's statement. The auditor is to be provided access to supporting information including all vouchers, timesheets, receipts and any other relevant information.

The purpose of the audit is to verify (amongst other things) whether the costs:

- are for activities indentified as within scope for Regulated Services under the AMI Cost Recovery Order or for activities related to electricity distribution services
- are for all services and are within budget
- have been incurred in the amount claimed, and
- are in accordance with the terms of the CMS agreement.

Subcontractors

Under the CMS agreement, JAM must submit to JEN all sub-contracts that JAM intends to use to perform the services for JEN. JEN must approve any amendments or variations that JAM may want to make to the terms of such contracts. JEN must also approve any new contracts that JAM may wish to enter into with suppliers. A condition of such approval, amongst other things, may be that the sub-contractor or supplier is selected through a competitive tender process or that JEN is a party to the sub-contract and is involved in the negotiations.

The CMS agreement, through the Service Delivery Plan, also requires JAM to adhere to the Jemena group procurement and recruitment policies.

JAM has an express obligation to be open and transparent in its performance of the services and in its participation in the governance bodies and in providing information in connection with the budget. JAM must itself, and ensure that its sub-contractors, keep complete, accurate and up to date records as well as comprehensive supporting information in respect of the derivation and calculation of the charges for the services and provide JEN with access to those records. Furthermore, the statement of actual costs to be provided by JAM as a part of the "true up" process must be prepared on an open book basis and be supported by sufficient information to verify the nature and extent of the costs claimed.

3.2.5 JEN's costs under the CMS agreement

Under the CMS agreement JEN has agreed to pay JAM:

- JAM's direct costs (that, is JAM's "base costs") of providing the contracted services on JEN's network c-i-c
- A management fee paid for the delivery of the services c-i-c

JEN also incurs its own direct costs in providing Regulated Services c-i-c . These costs are the regulatory audit costs, as required by the AMI Cost Recovery Order. Section 6.3 describes JEN's direct costs in more detail.

JAM base costs

JAM's base costs do not include indirect costs incurred by JAM, such as corporate overheads.

JEN understands that JAM has entered into a similar agreement with UED. As a result, the JAM base costs presented in this application represent JEN's share of the direct costs incurred by JAM in providing services for both JEN and UED.

For capital expenditure, the cost sharing arrangements are the same as those that were in place under the original SRAs between JAM and UED, and JAM and JEN. New cost sharing arrangements have been established for operating expenditure. The cost sharing arrangements ensure that JEN's costs are lower than they would be if JEN were to in-source the provision of metering services.

JAM management fee

c-i-c

4 Metering installations forecast

JEN's forecast of the number of metering installations that it will install in each year of the subsequent budget period is provided in Table 4-1 below. The table includes both new connections and replacement meters.

Table 4-1: Metering Installation Forecast

Calendar Year	2012	2013	2014	2015
	Number of Meters Installed			
AMI Meters				
Single Phase	71,200	32,803	5,376	5,376
Single Phase Off Peak	24,887	10,439	120	120
Three Phase Direct Connect	14,897	7,229	1,752	1,752
Three Phase CT Connect	2,038	905	100	100
AMI Meters Sub-total	**113,022**	**51,376**	**7,348**	**7,348**
Non-AMI Meters				
Accumulation Meters	252	105	0	0
Manually Read Interval Meters	190	78	0	0
Non-AMI Meters Sub-total	**442**	**183**	**0**	**0**
Total Meters	**113,464**	**51,559**	**7,348**	**7,348**

JEN's proposed metering installation profile for AMI meters will ensure that JEN meets its roll-out targets, as set out in the AMI Cost Recovery Order, and replaces faulty meters, as well as meters reaching the end of their useful life.

5 Proposed budget

This section sets out JEN's proposed budget for the subsequent budget period. All figures are provided in real 1 July 2011 dollars, unless stated otherwise. The substantiation for the proposed budget is provided in section 5.2.

JEN's proposed Total Opex and Capex for each year of the subsequent budget period is set out in Table 5-1 below.

Table 5-1: Proposed Total Opex and Capex for Subsequent Budget Period

Budget	2012	2013	2014	2015
Capital Expenditure	34,098,309	17,890,820	7,668,962	7,345,462
Maintenance and Operating Expenditure	19,422,094	17,226,413	15,819,662	15,941,122
Total Opex and Capex	**53,520,403**	**35,117,233**	**23,488,625**	**23,286,584**

JEN has arrived at its proposed budget by adding forecasts of:

- JEN's share of JAM's base costs—which are set out and substantiated in Appendix A
- the JAM management fee—which it calculated in accordance with the methodology set out in JEN's CMS agreement with JAM
- JEN's direct costs of delivering the Regulated Services, such as JEN regulatory audit costs.

5.1 Detailed cost tables

Cost and contract categories

JEN has set out its budget tables in the same format as the tables in Appendix A, which splits out JAM's direct incremental costs by:

- cost category by the relevant activity under which the cost is incurred:
  - AMI mass roll-out
  - Business-as-usual (**BAU**) metering
  - AMI Technology
  - AMI Operations
  - IT systems and infrastructure
- cost category by relevant AMI Cost Recovery Order prudence test to be applied:

- committed tendered contract costs – the expenditure that meets the AMI Cost Recovery Order definition of contract costs at the date of this application and that has been competitively tendered
- future tendered contract costs – the expenditure associated with contracts that will be entered into after the date of this application, all of which have been or will be subject to competitive tender
- other costs:
  - committed non-tendered contract costs – the expenditure that meets the AMI Cost Recovery Order definition of contract costs at the date of this application, and which will be incurred in a manner that is consistent with the commercial standard that a reasonable business would exercise in the circumstances, but the relevant contract has not been tendered
  - future non-tendered contract costs – the expenditure that will be committed to under contracts that will be entered after the date of this application and which will be incurred in a manner that is consistent with the commercial standard that a reasonable business would exercise in the circumstances, but the relevant contract will not be tendered
  - non-contract costs – the expenditure that will not be covered by a contract, but which has been or will be incurred in a manner that is consistent with the commercial standard that a reasonable business would exercise in the circumstances.

Almost all of JEN's costs are contract costs in that they will all be incurred pursuant to the CMS agreement between JEN and JAM. For the purposes of the categorisation of costs in this application, JEN has applied the AMI Cost Recovery Order definitions of contract costs to contracts that JAM has entered into. The note to clause 5C.11 of the AMI Cost Recovery Order expressly provides that 'The competitive tender process need not be conducted by the distributor, nor need the contract be one that the distributor has entered into'.

The prudence tests under the AMI Cost Recovery Order include the "competitive tender prudence test" or the "commercial reasonableness prudence test". JEN describes these tests in more detail in section 2.2.

The budget figures in the tables below treat management fee costs as committed non-tendered contract costs. This is appropriate because:

- The CMS agreement was signed before 28 February 2011. The cost therefore meets the AMI Cost Recovery Order definition of a contract cost.
- JEN agreed the CMS agreement with JAM, rather than undertaking a tender process.

Possible budget revision

Clause 5B.3 of the AMI Cost Recovery Order allows JEN to submit a revised budget application by 31 August 2011 where there is a change in expenditure by reason of a contract entered into between this application and that date. JEN may choose to submit a revised budget application under clause 5B.3 of the AMI Cost Recovery Order to address contracts that have been entered into between the date of this application and 31 August 2011.

Proposed budget

The tables below set out JEN's detailed build up of the proposed budget.

c-i-c

15

c-i-c

c-i-c

c-i-c

c-i-c

c-i-c

c-i-c

c-i-c

c-i-c

c-i-c

c-i-c

c-i-c

5.2 Assumptions

This section sets out the assumptions JEN has made in forecasting the proposed budget set out in the tables above.

Under the cost recovery framework, the cost of contingencies is not included in the budget. However, where changes in a metering regulatory obligation or requirement impact the scope and cost of AMI to the distributor, the AMI Cost Recovery Order provides for a revised budget application to be submitted under clause 5B.3 by 31 August 2011.

If a change in circumstances occurs after that date, the AMI Cost Recovery Order allows the distributor to notify the AER under clause 5F.1 of an actual or anticipated variance from its approved budget.

Where JEN's assumptions outlined below do not hold, JEN may need to submit a revised budget application or notify the AER of a variance from its approved budget. If the assumptions below do hold, there may still be unforseen changes in circumstances that may cause JEN to submit a revised budget application or notify the AER of a variance from its approved budget.

5.2.1 AMI Specifications Order, Functionality Specification and Service Levels Specification

For the purposes of this application, JEN assumes that the final versions of the specifications to which its must comply to roll out AMI will be:

- release 1.1 of the Functionality Specification
- release 1.1 of the Service Levels Specification.

5.2.2 Exclusivity derogation

JEN assumes that the Victorian Government's exclusivity derogation will stay in place unchanged.

While this assumption is sound and represents the most likely outcome, there are a number of scenarios under which the derogation or other related instruments (such as Chapter 7 of the National Electricity Rules) could be amended during the subsequent budget period and the derogation could lose its legal effect of providing distributors with an exclusive right to roll-out AMI meters to small customers.

JEN assumes that it will not be required to make any further investments in its AMI systems during the subsequent budget period to enable competition in the provision of AMI metering or services.

5.2.3 National Smart Metering Program

This application assumes that, following the submittal of this application, the NEM processes and procedures for AMI that AEMO is developing under the National Smart Metering Program will come into effect during the subsequent budget period, but that JEN compliance with them will not require JEN to incur any material cost.

While this assumption is sound and represents the most likely outcome, there is a possibility that the new processes and procedures will require JEN to incur material cost. Until the processes and procedures are developed, JEN cannot assess the extent of the cost.

5.2.4 The Victorian AMI program

This application is made on the assumption that any regulatory changes instigated the Victorian AMI program—for example, changes recommended by the ISC—will not create any significant changes in the scope or cost of JEN's AMI program.

While this assumption is sound and represents the most likely outcome, there is a possibility that the Victorian Program may instigate changes in JEN's metering regulatory obligations.

5.2.5 Cost sharing arrangements with UED

The costs presented in this application assume that JAM continues to provide services to both JEN and UED, thus allowing ongoing cost sharing to remain in place for the duration of the subsequent budget period.

5.2.6 Assumptions underpinning the JAM substantiation of base costs

JEN has accepted that JAM has made a number of assumptions in forecasting its base costs. A report from JAM, setting out and substantiating JAM's base costs is provided as Appendix A. The assumptions JAM made are set out in section 6.2 of Appendix A. JEN assumes that the assumptions set out in that section will hold.

5.2.7 AMI public education campaign

AMI presents a major opportunity for customers to better understand their energy usage patterns and respond to time of use pricing signals. At the same time, the physical roll-out of AMI meters has caused a level of disruption and other customer impacts.

JEN intends to continue to do what it reasonably can to minimise adverse impacts arising from its roll-out activity.

At this stage, JEN does not intend to conduct a widespread customer education campaign to promote AMI customer benefits. The costs of such a campaign have not been included in this application.

6 Substantiation of proposed budget

This section explains why JEN considers that the Total Opex and Capex in JEN's proposed budget meets the scope and prudence tests set out in clauses 5C.2 and 5C.3 of the AMI Cost Recovery Order and, therefore, must be approved by the AER.

As explained in sections 3.2.5 and 5, JEN has arrived at its proposed Total Opex and Capex budget by adding forecasts of:

- JAM's base costs
- the JAM management fee
- JEN's own direct costs.

The substantiation of these costs is explained in turn below.

6.1 JAM's base costs

To support this application, JEN requested and received from JAM a report that sets out the following information:

"...a document including the following information to support their respective 2011 Budget Applications as required under the Cost Recovery Order in Council:

1) Budget estimates of JAM's direct costs to be incurred under the joint Advanced Interval Metering Roll Out (AIMRO) Program in undertaking activities required to delivery Regulated Services in relation to AMI

2) Explanation of how the activities relate to the scope of regulated services (as defined in the CROIC: and to the extent relevant, as previously approved by the AER as within CROIC scope) including:

   a) that the activity is reasonably required for the provision of Regulated Services

   b) that the activity is reasonably required to fulfil metering regulatory obligations or requirements (including detailed tables of the relevant regulatory requirements).

3) Budget estimates relating to the activities in 2)

4) Material which demonstrates the prudency of the budget estimates (as per the prudency test in the CROIC) including splitting costs into categories by the relevant CROIC prudence test to be applied (either the "competitive tender prudence test" or the "commercial reasonableness prudence test") and for each cost category:

   a) explains the competitive tender processes or the reasonable commercial processes followed or to be followed when incurring the relevant cost

b) concludes whether or not the relevant prudence test is met.

5) Material which demonstrates the capability and performance of the joint AIMRO program over the current budget period, including the demonstrated prudency of the technology selection."

JAM's report is attached as Appendix A. Appendix A:

- For each of the activities with respect to which JAM base costs are incurred explains:
    - o that the activity is reasonably required for the provision of Regulated Services
    - o that the activity is reasonably required to fulfil metering regulatory obligations or requirements.
- Splits JAM base costs into categories by the relevant AMI Cost Recovery Order prudence test to be applied (either the "competitive tender prudence test" or the "commercial reasonableness prudence test") and for each cost category:
    - o explains the competitive tender processes or the reasonable commercial processes followed or to be followed when incurring the relevant cost
    - o concludes that the relevant prudence test is met.

Therefore, given the evidence presented in Appendix A, JAM base costs included in JEN's proposed Total Capex and Opex meet the scope and prudence tests in the AMI Cost Recovery Order and must be approved.

6.2 JAM management fee

JEN's arrangements with JAM:

- require JAM to deliver Regulated Services on JEN's electricity distribution network in a commercially prudent manner
- in return for JAM's services, require JEN to pay:
    - o JAM's direct costs, which exclude corporate overhead costs, of delivering Regulated Services on JEN's network (JAM base costs, discussed in section 6.1 above)
    - o a management fee c-i-c

6.2.1 Management fee costs are for activities within scope

The management fee relates directly to operating and capital expenditure that makes up the JAM base costs and the relevant activities as a result of which these costs arise. Appendix A explains, in detail, why each of the relevant activities is within the scope of cost recovery defined in the AMI Cost Recovery Order.

The management fee is expenditure for the relevant activities. Therefore, the management fee costs are within the scope of cost recovery. The fact that the management fee is within scope of cost recovery was also established by the Australian Competition Tribunal on 23 December 2009 as an outcome of the appeals by JEN and UED against the AER's original decision that the management fee was outside scope.

6.2.2 JEN's circumstances at the relevant time

JEN's the circumstances at the time JEN decided to enter into the CMS agreement with JAM are set out in detail in section 3. In summary, at the time JEN made its decision:

- JEN was under obligation to deliver a complex set of Regulated Services for the mandated AMI roll-out to a specific schedule
- the AMI technology relevant to the provision of Regulated Services was new and JAM had an expert understanding of that technology through the work JAM undertook for JEN under the existing SRA
- given the state of AMI technology and JAM's track record in successfully delivering a workable solution, JEN's risks would increase if JEN were to transition to an alternative provider
- JEN did not have the internal capability to deliver Regulated Services—those services were successfully delivered by JAM as part of a joint JEN/UED/JAM program
- bringing the provision of Regulated Services in-house would be risky and expensive
- the Jemena asset management business was a recognised commercial provider of infrastructure services to a number of customers, including both related and unrelated parties
- JAM was able to deliver reduced costs to JEN through JAM's economies of scale and scope, including enabling cost sharing with UED
- given the complexity of delivering Regulated Services, JAM's specialised AMI expertise, economies of scale and scope, and JAM's knowledge of JEN's business, another provider was unlikely to be able to deliver the level of service JEN requires.

6.2.3 Management fee costs are prudent

As explained in section 5.1, in this application, management fee costs are treated as committed non-tendered contract costs. The appropriate prudence test that applies is the "commercial reasonableness prudence test"—in considering the cost recovery of the management fee, it is relevant to consider whether:

- it is more likely than not that the expenditure will not be incurred, and

- incurring the expenditure involves a substantial departure from the commercial standard that a reasonable business would exercise in the circumstances.

The CMS agreement is a signed contract, which obliges JEN to pay the management fee and JAM's direct costs. It is therefore beyond doubt that management fee costs will be incurred. The rest of this section therefore focuses on why the decision to incur the management fee was not a substantial departure from the commercial standard that a reasonable business would exercise in the circumstances.

JEN's obligation to pay the management fee arose upon the execution of the CMS agreement with JAM. Therefore, the relevant decision to which the prudence test must be applied is the decision to enter into the CMS agreement. In the following subsections, we explain why JEN considers its decision to enter the CMS agreement fulfils the prudence requirements of the AMI Cost Recovery Order and is not a substantial departure from the commercial standard that a reasonable business would exercise in the circumstances. JEN's circumstances at the relevant time are set out in sections 6.2.2 and section 3. JEN's commercial reasoning for entering into the agreement is set out in section 3.2.

The AER also supports the commercial reasonableness of outsourcing arrangements. JEN observes and respectfully supports, the AER's acknowledgment that outsourcing arrangements can be commercially reasonable:

> …The AER recognises the significant economies of scale and scope or other efficiencies that a DNSP may gain access to through outsourcing…[16]
>
> …Outsourcing to specialist providers of a particular service is a common means by which businesses in the economy are able to gain access to economies of scale and scope and other efficiencies…[17]
>
> …The actions of each of the Victorian DNSPs (especially CitiPower, Powercor, JEN and SP AusNet) to outsource significant activities to centralised, specialist operators within their corporate structures appears consistent with good business practice. This is primarily because of the significant economies of scale and scope that each of these operators can achieve through operating multiple networks. The fact that significant economies of scale and scope have been achieved is not in dispute…[18]

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[16] AER, *Final decision: Victorian electricity distribution network service providers—Distribution Determination 2011-2015, October 2010*, p. 149.

[17] AER, *Final decision: Victorian electricity distribution network service providers—Distribution Determination 2011-2015, October 2010*, p. 150.

[18] AER, *Final decision: Victorian electricity distribution network service providers—Distribution Determination 2011-2015, October 2010*, pp. 195-6.

JEN's CMS agreement with JAM ensures that JEN pays substantially less than JAM's (or JEN's) stand-alone costs. JEN has considered a range of options available to it and has chosen the best one given JEN's circumstances. JEN therefore considers the costs incurred under the CMS agreement, including the management fee, to be prudent.

6.3 JEN's own direct costs

This application contains the costs JEN will incur in undertaking the audits of actual expenditure for Regulated Services, as required by clause 5H.2 of the AMI Cost Recovery Order. These costs are within scope as JEN is obliged by the AMI Cost Recovery Order to undertake the activity of regulatory audits. These regulatory activities are within scope (S2.1(b)(2)(xi)(G) of the AMI Cost Recovery Order).

The quantum of these costs is based on the actual costs JEN incurred in 2010 for the audit of actual expenditure in 2009[19], with adjustments made for inflation in each year. JEN's auditor, KPMG, has been approved by the AER as the auditor for JEN's regulatory accounts and for the purposes of audits under clause 5H.2. The fees charged by KPMG are market rates, commensurate with the rates charged by other audit firms, which Jemena Group engages from time to time. JEN therefore considers the level of the audit costs put forward to be reasonable and prudent.

[19] Refer KPMG invoice provided as Appendix G

APPENDIX A: Substantiation of base costs to provide regulated services

Attached as a separate file (confidential)

APPENDIX B: Service Requirements Agreement

Attached as a separate file (confidential)

APPENDIX C: JEN board paper seeking approval of Customer and Market Services agreement

Attached as a separate file (confidential)

APPENDIX D: Customer and Market Services agreement

Attached as a separate file (confidential).

APPENDIX E: NERA Benchmark Study of Contractor Profit Margins

Attached as a separate file.

APPENDIX F: JEN Budget templates

Attached as a separate file (confidential).

APPENDIX G: KPMG invoice for audit of 2009 actual costs

Attached as a separate file (confidential).