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Essential Services Commission
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ADVANCED METERING INFRASTRUCTURE REVIEW

Consultation Paper: Revised Framework and Approach December 2008

Origin Energy Retail Limited (Origin) welcomes this opportunity to respond to the Essential Services Commission's (the Commission's) Consultation Paper on the Revised Framework and approach for the review of the advanced metering Infrastructure (AMI).

Origin commends the Commission on recognising the importance of retaining consistency with previous decisions (where possible) while also (a) acknowledging the principles set out for the national smart meter framework by the Ministerial Council of Energy (MCE) and (b) working towards the handover of responsibility for the regulatory oversight of the AMI program to the Australian Energy Regulator (AER).

Origin understands that from 1 January 2009, the AER will be the party responsible for undertaking the Review. For this reason, and for the sake of clarity in our submission, we have referred separately to both the Commission and the AER.¹

Origin also recognises the complexity of the Commission's review process, particularly in the light of the revised Order in Council dated the 25 November 2008 (revised Order), which substantially amended the original Order in Council made in August 2007. In particular, the revised 2008 Order amends the timetable for the AMI program and provides for a fundamentally different approach to establishing prices for metering services over the period 2010-2015.

The revised Order provides for a cost pass through model in which (simplistically) distributors provide forecasts of expenditure and the onus of proof for rejecting the distributor expenditure claims rests with the AER. This is an important change from incentive based regulation and as such represents a significant shift in approach towards regulating a monopoly service for the provision of advanced metering infrastructure.

Separate to our submission on the Review itself, Origin expresses its concern that having imposed a monopoly² on what was previously a competitive market for the provision of

¹ Noting that the Review itself refers to both entities as the "Commission".

² On 21 November 2007 the Australian Energy Market Commission (AEMC) received a Rule Change proposal to implement the roll out of AMI which included the proposal to establish the local network service provider (the "distributor") as the exclusive responsible party for the rollout of AMI. In September 2008, the AEMC ruled in support of this subject to certain conditions. See: AEMC 2008, *Victorian Jurisdictional Derogation, Advanced Metering Infrastructure Roll Out*, Draft Rule Determination, 25 September 2008, Sydney.



advanced metering infrastructure services (at least until 31 December 2013), the decision has been made in Victoria to move away from an incentive based regulatory model to one where the onus of proof rests on the regulator.

Given this, and the other restrictions placed by the revised Order on the AER's ability to review actual and budget expenditures, it is not clear to Origin how effective the regulator can ultimately be in ensuring the most cost-effective delivery of AMI services to Victorian customers.

Origin's specific comments on the Review paper follow.

Exclusions from the initial AMI period budget

The Commission's review identifies that the revised Order provides that certain elements of the "building blocks" which relate to expenditure and events between 1 January 2006 and 31 December 2008 do not form part of the initial budget application under the Order. They are to be considered separately but included in the determination of the initial charges for 2010 and 2011.

Origin concurs with the Commission's interpretation of the Order (clause 5D.5) that many of the cost items claimed by the distributors for the period 2006 - 2008 will not be subject to review at any time, except to establish whether or not the claimed costs were attributable to providing AMI services and systems in the period. In other words, the expenditures claimed by the distributors in these cost categories are not subject to any prudential review by the Commission, or (and we seek verification of this) subject to any independent audit review process.

Given that small customers in Victoria have been paying increasing metering charges to distributors for these services under the 2006 Electricity Distribution Price Review 2006-2011 (EDPR)³, it is disappointing to note that the revised Order does not appear to allow for greater review of these claimed expenditures.

While Origin recognises that the AER will be obliged to set 2010 and 2011 prices within the framework of the revised Order, nevertheless we request the AER carefully analyse these expenditure claims bearing in mind also that the revenue benefits provided by consumers to distributors in this period should be captured and returned to consumers to the fullest extent possible - and including recognition of the NPV of this revenue stream to the distributors.

³ The 2006 EPDR set out a schedule for annual metering service charges, which increased each year of the EPDR, based on the assumption that a Type 5 meter roll out would commence early in the determination period. Although this did not occur, customers have continued to pay increasing annual amounts, which has provided significant additional revenue to distributors over and above the charges for the provision of standard network and metering services.



Defining the Scope of Expenditure

Stakeholders are invited to comment on matters relating to establishing whether expenditure is within scope.

We note that the revised Order binds the AER to accept an audit report that certifies expenditure in respect of the “charges revision application” for 2011 charges. Again, we are concerned that the AER’s discretion to assess the expenditure applications is limited by the revised Order.

Origin therefore strongly supports the Commission’s proposal that the AER will “pay close regard” to that audit certification in other years when determining if an expenditure is within scope or not. In supporting this proposal, Origin highlights that the determination of whether an item is “in scope” or “out of scope” is one of the very limited set of expenditure assessment tools that the AER will have available to it.

More particularly, we strongly support the Commission’s proposal (and notwithstanding the Order is not explicit on the matter) that distributors will be required to provide expenditure against each of the items identified as “in scope” for both initial charges applications and charges revisions applications budget expenditure.

Similarly, Origin agrees with Commission that allocation of business overheads for the AMI project is an important question when defining if expenditure items are in scope or not. We are pleased to see recognition of the risks that distributors may obtain “double recovery” of these overhead costs and support the proposal by the Commission to seek detailed information to demonstrate that double recovery is not occurring.

Nevertheless, the monopoly nature of the AMI service provision during the roll-out period inevitably complicates the identification of in and out of scope costs, as there is no competitive stand alone service provider to compare costs with. Origin is not convinced that “comparing expenditure on a category-by-category” basis across distributors will be sufficient to provide a useful guideline to decision making in this area. We encourage the AER to consider alternative benchmarks in this process.

Origin has concerns also with the feasibility of the AER making determinations regarding the timing of the relevant expenditure (as discussed in section 2.3.1 of the Review).⁴ The revised Order requires the AER to put themselves in the minds of the distribution entity when expenditure commitments were made, and to accept as reported the timing of those commitments. It would also appear that the AER will not have the opportunity to consider whether such expenditure commitment was prudent or whether it was actually spent or not (Origin seeks further confirmation on this).

⁴ As stated in section 2.3.1, the revised Order implies that if expenditure was within the scope at the time it was committed to, but outside the scope at the time it was spent, the Commission must include it in the revised charges (page 14).



Audit Certification

Stakeholders are invited to comment on the form and nature of the proposed audit certification.

The revised Order requires that actual expenditure information provided in a charges revision application shall be accompanied by an audit report prepared and signed by an external auditor. The audit report must certify that the expenditure is within scope and has been actually incurred.

Given the revised Order places the “onus of proof” on the regulator, Origin believes the independent auditor has a key role in ensuring that Victorian consumers are charged on a fair basis for the AMI services. This is particularly true given the monopoly position of the distributors as stated previously.

Origin therefore strongly supports the proposal by the Commission that the audit appointment process for charges revision applications in all years comply with the requirements set explicitly for the 2011 audit⁵, namely:

- The auditor must be approved by the Commission, or in default, nominated or engaged by the Commission; and
- The auditor must hold certain qualifications (as set out in the revised Order).

The Commission also suggests that it “would not be inappropriate” for the auditor of the AMI audit to be the same auditor as appointed to audit the distributor’s regulatory accounts. Origin believes this approach may have benefits in terms of costs and efficiency, providing the auditor in question meets the other criteria.

However, there is also benefit in having an independent review. In particular, use of the same auditor may risk compromising the requirement in the revised Order for the auditor to have a “formal duty” to both the Commission and to the distributor. Origin therefore requests the AER give further consideration to this matter, particularly given the importance of the audit process to ensuring only relevant costs are passed through to customers.

Contract Costs

Stakeholders are invited to comment on matters relating to establishing whether expenditure is a ‘contract cost’.

The Commission notes that where a distributor commits to any expenditure⁶ pursuant to a major contract, then under the terms of the revised Order, it will be able to recover that expenditure. In other words, apart from assessing whether the expenditure is

⁵ As noted by the Commission in Section 2.3.2, the revised Order is only explicit with respect to requirements of the auditor for the 2011 charges revision application.

⁶ The revised Order is not concerned about when the expenditure actually occurs, but only when the contract was entered into by the parties.



within scope (see above), the AER will be bound by the revised Order to accepting costs that meet the definition of a “contract cost”.

To determine if it is a contract cost, the AER will be required (at a minimum) to determine if the claimed expenditure is (a) related to an identifiable contract and (b) if related to a contract, whether it is consistent with the terms of that contract.

Origin considers that to fulfil this requirement, the AER will need to have detailed understanding of the relevant contracts and supports the Commission’s proposed information requirements on the relevant contracts for each budget and charges revision application.

The AER’s assessment of (a) and (b) above, will be further complicated to the extent that the distributors have contracts with related parties. Origin considers this is a major issue facing the regulator given the degree to which the Victorian distribution companies have already established related party metering service provider companies and the difficulties related party transactions have created in general for regulatory determinations.⁷ We welcome the fact that the Commission identifies this potential issue in establishing relevant costs and addresses the matter specifically in later sections of the Review.

Competitive Tender Process

Stakeholders are invited to comment on matters relating to establishing whether a competitive tender process has taken place.

Under the revised Order the AER will be required to assess whether a contract was let in accordance with a “competitive tender” process. This assessment relates to both reviewing the distributors’ initial budget applications and making a determination on any revised charges.

The existence of a competitive tender is another important decision point for the AER in approving charges for the AMI program. If proposed expenditure is in scope, and has been the outcome of a competitive tender process then the AER must include the relevant costs in the approved charges.

Assessing this requires the AER to investigate the tender process and ensure it complies with competitive outcomes. Given the difficulty of the task placed on the AER (particularly given related party issues) and the importance of the conclusions the AER draws, Origin supports the Commission’s proposals, namely:

- that where a tender does not result in competitive outcomes it may be inferred that the tender process that was followed was not a competitive one;
- a requirement for the distributors to provide a probity auditor’s report prepared by a suitably qualified and independent probity expert;
- that the tender process meets the stated process requirements (as set out in section 2.5.2); and

⁷ The related party issue for instance, is an important driver in the AER’s current examination of Total Factor Productivity measures as an alternative approach to determining distribution revenues.



- placing additional scrutiny on the process and outcomes when related parties are involved in the transaction (section 2.5.2 and 2.5.3).

In supporting all of the Commission's proposals, Origin is cognisant of the fact that we would not generally support such intrusive examination of contractual processes. Our views, however, are clearly influenced by the other limitations place on the AER by the revised Order together with the monopoly nature of the AMI services provision.

Determining if Expenditure would have been incurred

Stakeholders are invited to comment on matters relating to establishing whether it is more likely than not that expenditure will not be incurred.

When considering a budget application for within-scope expenditure that is not a contract cost or does not meet the contract cost threshold test, the AER is required under the revised Order to consider whether "it is more likely than not that expenditure will not be incurred".

Origin believes this "balance of probabilities" type assessment is inevitably subjective and leaves the AER open to challenge by the distributors on its determinations. We are concerned therefore that the AER might take an overly cautious view on this matter and thereby expose consumers to charges greater than they would be under a more rigorous model of regulated price determination.

Nevertheless, given the AER is bound by the revised Order, Origin supports the Commission's view that it is important to pay particular attention to items that may be considered "peripheral" to the provision of the AMI infrastructure. We note, and agree, that the Commission includes in this expenditure items such as contingency amounts, reward and penalty payments, overheads and managements costs.

With respect to contingency amounts, Origin would further highlight that in the "first budget period" (up to December 2011) the revised Order gives the distributors the right to automatic approval of "actual expenditures" up to some 120% of the budget expenditures. In the context of this allowance, Origin considers that it would risk a degree of double dipping to (1) allow significant contingency amounts then (2) a revision for actual expenditures of up to 120% of budget. The ability to obtain cost recovery for actual costs in this ways means that contingency allowances should be kept to a minimum.

Departure from Commercial Standards

Stakeholders are invited to comment on matters relating to establishing whether expenditure involves a substantial departure from the commercial standard that a reasonable business would exercise in the circumstances.

Where an expenditure is not a contract cost or does not meet the contract threshold test as part of either a budget application or a charges revision application, the Commission is required under the revised Order to consider the expenditure relative to a commercial standard of reasonableness.



However, the test only applies (in the case of a charges revision application at least) if the expenditure does not arise as part of a competitive tender process.

Moreover, the test must meet the threshold of a “substantial departure”, and must take into account and “give fundamental weight” to the circumstances at the time the commitment to that expenditure was made (as per criteria set out in section 2.7).

As in the previous section, this test includes a significant component of subjective judgement and therefore exposes the AER to a greater threat of court challenge by the distributors. As noted previously, Origin is concerned that this might lead to an overly conservative approach by the AER and therefore we strongly recommend that the relevant concepts are defined more clearly prior to the initial budget period approval process.

More generally, Origin considers that the test is particularly generous to the service providers, even to the extent that it may encourage distributors to avoid competitive contracts if, in the alternate, they believe this test is easier to pass.

Market Observable Parameters

Stakeholders are invited to comment on the methodology the distributors should use to calculate the market observables for their February 2009 budget applications. Stakeholders are invited to comment on the methodology the distributors should use to determine equity raising costs.

Origin notes the Commission’s proposal to accept a WACC based on the AER’s draft decision on market observable parameters for transmission and distribution businesses (December 2008) in the initial budget applications for first AMI WACC period. The Commission proposes that the AER then revise and update these parameters (to be updated in line with the final AER statement of regulatory intent due in March 2009) when making their draft decision on the distributors’ budget applications.

Origin supports the Commission’s proposal as a practical approach to the determination of the WACC for the first period, and one which will ensure the most up-to-date information is included before the final budget approvals.

Origin also notes that the decision for the initial AMI WACC period (up to 31 December 2013) includes an allowance for debt and equity raising costs within the WACC calculation although this formula prescribed in the NER prevents these costs from being compensated for through the WACC.⁸

The revised Order mandates that a debt raising cost of 12.5 basis points is adopted for the initial AMI WACC period (as part of the debt raising premium in the WACC calculation). Origin requests that the AER ensure debt raising costs are not also captured elsewhere in the distributor budget submissions.

⁸ As noted in the Review, these costs may however, be compensated for in other cost components such as capital and operating expenditure allowances provided they meet “the requirements in the NER for these allowances” (see page 28)



Origin also supports the Commission's proposal to consider only those equity raising costs that are related to actual costs incurred if and when equity is raised to fund the AMI program, and not to any theoretical benchmark costs for equity. We suggest that the AER require the relevant independent auditor to specifically comment on this requirement, given that the AER itself will have limited transparency on this matter.

As a final comment, Origin notes that for the period 2006 to 2008, distributors may have over-recovered on metering costs given that the proposed MRIM roll-out did not occur. In this case, as the distributors would have had the benefit of consumers' funds, Origin requests careful consideration be given to the calculation of the time value of money from the consumers' perspective.

Efficiency Carryover Mechanism (ECM)

Stakeholders are invited to comment on how the benchmark costs should be adjusted for the purposes of the ECM, particularly in relation to metering data service IT costs.

Stakeholders are invited to comment on matters relating to ensuring that reported costs represent the true value of costs incurred.

Stakeholders are invited to comment on whether there should be the potential for a net negative carryover from the 2006 to 2008 period.

Origin understands that the revised Order requires that the charges in 2010 and 2011 reflect an efficiency carryover amount in respect of metering operating expenditure between 2006 and 2008.

The Commission also considers that the EDPR contained sufficient detail to allow (for the most part) the separation of interval and accumulation meter costs and therefore to back-cast the relevant benchmark operating expenditure given that the MRIM roll-out did not occur.

The Commission's approach appears to be reasonable given the constraints of the data. However, Origin would request the AER give consideration to whether distributors continued to roll-out a limited number of MRIM meters after the original roll-out MRIM was effectively cancelled. It is a moot point if these additional MRIM meters should be included in the calculation of the ECM, and perhaps instead they should be assessed on the basis of accumulation meter costs to the extent that the relevant MRIM meters:

- were installed by the distributors for commercial reasons unrelated to any roll-out requirements;
- may have been funded by customers or retailers;
- may not meet the functionality requirements of the current roll-out.

On the question of negative carryover, Origin supports the conclusion of the Commission to apply negative carryovers where they occur.



Cost of Tax

Stakeholders are invited to comment on matters relating to establishing the benchmark cost of tax in respect of the AMI rollout

Origin considers the Commission's proposals with respect to the taxation adjustment for 2006 to 2010 and the calculation of tax in the building blocks are reasonable and in accord with the revised Order. Origin supports consistency with the AER Statement of Regulatory Intent in the calculation of imputation or franking credits.

Treatment of Depreciation

Stakeholders are invited to comment on the proposal to use straight line depreciation to determine the amount of regulatory depreciation.

Origin notes the Commission's comments regarding the difficulty of consistently distinguishing between "meters and measurement transformers" on the one hand and "telecommunications assets" on the other. Given that the two categories are subject to significantly different asset life assumptions this is, nevertheless, an important distinction.

In response to this issue the Commission states that when there are difficulties in distinguishing where a particular asset sits, the distributors should "clearly outline the reason for the chosen classification".

Origin considers that this is a minimum requirement from distributors. However, we also consider that the Commission may be limiting its own discretion unnecessarily, particularly as it is not clear from this statement how the Commission will assess the distributors' classification or even if the Commission can do so. We therefore suggest that the AER consider establishing clearer guidelines for the distributors, perhaps based on the advice of independent technical experts.

The requirement under the revised Order to accelerate the depreciation of both accumulation meters and manually read interval meters over the period 2010 to 2013 such that depreciation period ends no later than 2013 imposes additional costs on consumers particularly given that all new and replacement meters that have been installed since 2006 will be part of this. We note here that it is not clear whether this accelerated depreciation will include any MRIM meters installed by distributors subsequent to the Government's decision to move to the AMI plan or any such meters installed in the period 2009-2010.

Generally, however, Origin supports the Commission's proposal to require distributor's to set out clearly the number and regulatory asset value of these meters. We request that the AER review these figures carefully in the light of other external data sources and require the relevant independent auditors to specifically certify the figures provided by the distributors.

Origin also agrees with the Commission's conclusion that notwithstanding the accelerated depreciation schedule, a simple and transparent straight-line depreciation form should be



used. Alternative depreciation forms would add further complexity to an already difficult regulatory task.

Pricing Principles

Stakeholders are invited to comment on the additional pricing principles, if any, to which regard should be given when considering distributors' charging proposals.

The Commission notes that the revised Order effectively decouples the pricing methodology for metering services from the price regulation methodology applied to determining the regulated services charges. Origin understands that the Commission is now charged with meeting two main requirements namely:

- for any year between 2010 and 2015, the Commission must satisfy itself that the net present value of total costs up to that year (starting in 2009) is equal to the net present value of total revenue earned in that period; and
- the charges may not differ depending upon whether the meter is an accumulation meter, a manually read interval meter or remotely read meter (although may determine different charges with respect to other meter characteristics as per section 4.2 page 39-40).

The Commission further notes that revised Order does not provide any guidance in relation to the principles of calculating individual charges or the need for rebalancing constraints.

Origin supports the Commission's preliminary view that the pricing principles set out in its December 2007 framework and approach paper should apply and that these principles would not be inconsistent with the revised Order. Moreover, the principles reinforce some of the criteria outlined in previous sections of the review (such as the allocation of overheads etc).

We note the Commission's reference to an alternative approach based on the pricing rules set out in the NER (Section 6.18). These alternative rules have some merit as they would provide tighter controls on pricing structures that have been set in a monopoly environment, and would also ensure more consistency with the national framework generally. Nevertheless from a practical perspective, it may be difficult to align them with the specific requirements of the revised Order given its unique characteristics with respect to regulatory cost recovery.

Origin also supports the recommendation by the Commission for distributors to use provisions in the revised Order that might enable a smoother price path.

Origin notes that the revised Order allows metering charges to be set based on yearly projected costs, and the regulator is not in a position therefore to set a smoothed price path (as is usually the case). It is therefore quite possible that the resulting year on year changes in the metering charges may be quite different each year, with potential for significant price shocks to consumers in any one year. Origin considers it would be in the interests of all industry participants if this was avoided, and therefore we commend the Commission for highlighting the options the distributors have to recover any "under-recoveries" in later years.



While recognising the inability of the AER under the revised Order to set a smooth price path (the option here being with the individual distributor as noted above), Origin would recommend that the AER:

- work closely with the distributors to establish a coherent and consistent approach to this issue; and
- provide expert advice to the industry generally on the expected year on year outcomes, in the event that distributors base their charges on each year's budget/actual outcomes.

Other Matters

Origin has three other matters that it would appreciate the Commission or the AER (as appropriate) considering. They are:

(1) Actual expenditure approval threshold

The revised Order allows for an actual expenditure threshold of 120% compared to the budget expenditure before approval must be sought from the AER to reflect these additional expenditures in the subsequent year charges.

It is not clear to Origin from the analysis provided in the Commission's Review of what actions arise when actual expenditure is less than budget in any year. Given that the charges for that year will be based on the approved budget, will consumers receive an offsetting benefit in the following budget year?

Origin considers that some form of symmetrical application is required, particularly where the reduced expenditure relates to factors other than demonstrable improvements in efficiency - for instance, if the reduced expenditure relates to a failure to meet the roll-out targets in any year.

(2) Exit and Restoration Fees

Origin notes the Commission's view that exit fees and restoration fees will not be payable during the initial AMI budget period (up to 2012) assuming that the AEMC confirms its draft rule determination which gives exclusive service AMI service provision up to 31 December 2013.

Origin agrees with this conclusion should the final rule determination adopt the same principles as the draft rule determination. However, we would highlight to the AER the need to develop clear principles around these fees prior to the end of the initial AMI budget period so that all participants in the industry can have some certainty about future costs and exposures.

(3) Post the Mandated Exclusivity Period

The application from the Victorian Government sought, and the AEMC's draft rule determination approved a derogation from the existing Rules granting exclusivity to distributors for the defined period of the AMI roll-out (in this case to 31 December 2013).

It is Origin's view that the MCE has similarly limited the exclusivity of the distributors to the relevant AMI roll-out period. The MCE has in fact as part of its policy intent spelt out the need for future flexibility such as to not preclude at this stage the further



expansion of competition of contestable metering services beyond any mandated AMI roll-out period.

It is not clear to Origin in either the revised Order or the Commission's Review how this aspect of the draft rule determination and the MCE policy intent is captured. We note here in particular that the second budget period extends out to the end of 2015, yet incorporates much of the same principles of cost recovery and regulatory oversight as the first budget period.

Origin requests that the AER give some consideration to this important matter.

Should you have any questions, or wish to discuss this response further, please contact David Calder (Regulatory Strategy Manager) on (03) 9652 5701 in the first instance.

Yours sincerely

A handwritten signature in cursive script that reads "Bev Hughson".

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