Advanced Metering Infrastructure Cost Recovery Order in Council

Victorian Advanced Metering Infrastructure Review

2012-15 budget and charges applications

Advice

Introduction

This advice considers the correct approach to interpretation of, and the AER performing its functions and exercising its powers under, the Advanced Metering Infrastructure Cost Recovery Order in Council[1] ("**AMI Cost Recovery Order**").

This is in the context of the AER making its determination for the 2012-15 budget and charges applications of the Victorian electricity distributors, for which it has recently released its *Draft Determination: Victorian Advanced Metering Infrastructure Review 2012-15 budget and charges applications* dated 28 July 2011 ("**Draft Determination**").

The advice then considers whether in the Draft Determination the AER has adopted a correct approach to the AMI Cost Recovery Order.

Relevancy of efficiency considerations

As is well known the AMI Cost Recovery Order was made pursuant to Division 6A of Part 2 of the *Electricity Industry Act 2000 (Vic)* ("**the EIA**"). The Order mandates a cost pass through model for the costs of advanced metering infrastructure ("**AMI**") incurred by the distributors[2].

It is relevant to observe that Chapter 6 of the National Electricity Rules ("**NER**") – in particular rule 6.6 – allows cost pass throughs in the case of the imposition of a "regulatory obligation or requirement"[3]. Thus, even without the AMI Cost Recovery Order and if the Victorian Government had imposed on distributors during a regulatory control period an obligation to roll out AMI, the distributors would have been able to seek a cost pass through under the NER.

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[1] The AMI Cost Recovery Order was made 28 August 2007 (Gazette S200, 28/08/07) and amended on 12 November 2007 (Gazette S286, 12/11/07), 25 November 2008 (Gazette S314, 25/11/08), 31 March 2009 (Gazette G14, 2/04/09) and 19 October 2010 (Gazette G42, 21/10/10). In addition a further scope was published pursuant to clause 14B.1 of the Order, in Gazette G4, 22/1/09 page 143.

[2] "distributor" is defined in clause 2.1 of the AMI Cost Recovery Order as a "distribution company" which picks up the definition of that term in section 3 of the EIA which is a person who holds a licence (issued under that Act) to distribute electricity.

[3] This arises from the definitions in Chapter 10 of the NER of "positive change event" (used in rule 6.6.1) then, "pass through event", "regulatory change event" and lastly "regulatory obligation or requirement".

The AMI Cost Recovery Order is made pursuant to section 46D of Division 6A. Section 46E(2), also in the Division, allows the Order to confer "powers and functions on, and leave any matter to be decided by, the Commission". The reference to "the Commission" is a reference to the Essential Services Commission of Victoria ("**ESC**").

The AER is in the shoes of the ESC for the purposes of the AMI Cost Recovery Order. This occurs pursuant to the provisions of section 27A of the *National Electricity (Victoria) Act 2005* ("**NEVA**"): note particularly the words in section 27A(1) "the AER must take action under the AMI Order **as if it were the ESC**" (emphasis added).

The AER being in the shoes of the ESC is important as it means that in performing its functions and powers under the AMI Cost Recovery Order, the AER must perform them in accordance with sections 8 and 8A of the *Essential Services Commission Act 2001 (Vic)* ("**ESC Act**"). Those two sections provide as follows:

8 Objective of the Commission

(1) In performing its functions and exercising its powers, the objective of the Commission is to promote the long term interests of Victorian consumers.

(2) Without derogating from subsection (1), in performing its functions and exercising its powers in relation to essential services, the Commission must in seeking to achieve the objective specified in subsection (1) have regard to the price, quality and reliability of essential services.

8A Matters which the Commission must have regard to

(1) In seeking to achieve the objective specified in section 8, the Commission must have regard to the following matters to the extent that they are relevant in any particular case—

(a) efficiency in the industry and incentives for long term investment;

(b) the financial viability of the industry;

(c) the degree of, and scope for, competition within the industry, including countervailing market power and information asymmetries;

(d) the relevant health, safety, environmental and social legislation applying to the industry;

(e) the benefits and costs of regulation (including externalities and the gains from competition and efficiency) for—

(i) consumers and users of products or services (including low income and vulnerable consumers);

(ii) regulated entities;

(f) consistency in regulation between States and on a national basis;

(g) any matters specified in the empowering instrument.

(2) Without derogating from section 8 or subsection (1), the Commission must also when performing its functions and exercising its powers in relation to a regulated

industry do so in a manner that the Commission considers best achieves any objectives specified in the empowering instrument.

Sections 8 and 8A apply because of section 7A of the EIA which provides that, for the purposes of the ESC Act, the EIA is "relevant legislation" and the electricity industry is "a regulated industry"[4]. Section 10(a) of the ESC Act picks these two terms up when it provides that the functions of the ESC are "to perform such functions as are conferred by this Act and the relevant legislation under which a regulated industry operates"[5].

Although section 10 of the EIA Act sets out the objectives of the ESC under the EIA, that section was introduced into the EIA by the ESC Act and is not an exclusive objective. The scheme of the ESC Act was to replace the multiple and various objectives of the ESC contained in Acts such as the EIA with an overarching objective contained in the ESC Act. The EIA (and other Acts under which the ESC performs functions or exercises powers) was then left to specify any additional objectives that are unique to that Act. This is apparent from section 8A(2) of the ESC Act that requires the ESC to "also" perform its functions and powers in a manner that the ESC considers best achieves "any objectives specified in an empowering instrument". The definition of "empowering instrument" in section 3 of the ESC Act, by its specification of "the relevant legislation", includes the EIA.

Thus sections 8 and 8A of the ESC Act apply in addition to section 10 of the EIA Act.

Sections 8 and 8A also apply in addition to the Regulatory Principles set out in clause 4 of the Order. In that regard it is important to note that nothing in Division 6A permits the AMI Cost Recovery Order to disapply sections 8 and 8A[6]. And indeed there is nothing in the Order that purports to disapply the two sections[7]. Moreover, even if the AMI Cost Recovery Order had purported to disapply sections 8 and 8A, that would have failed on the basis that the Order was beyond power, further or alternatively as subordinate legislation in conflict with an Act[8].

Likewise, sections 8 and 8A apply in addition to the matters set out in clause 5I.8 which, pursuant to clause 5C.4, the AER is directed to "take into account and give fundamental weight to"[9] when applying the test of clause 5C.3(b)(iv). Again clause 5I.8 does not

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[4] See section 71 of the ESC Act. Note that the Victorian legislation website (www.legislation.vic.gov.au) omits this section in its publication of the Act in the "Victorian law today" part, however it can be found in the Act as published in the "Victorian statute book" part.

[5] Note also the definitions of the two terms in section 3 of the ESC Act.

[6] There is no "Henry VIII" provision that would allow the Order to override the provisions of the EIA or ESC Act.

[7] Clause 3.1 of the Order, which provides that the Order applies notwithstanding anything to the contrary in the Tariff Order, certain Price Determinations of the ESC and the Excluded Services Guideline of the ESC, does not provide for override of any Act.

[8] Ie, repugnant to the Act. See the discussion of repugnancy in *Delegated Legislation in Australia 3rd ed, Pearce & Argument, paras 19.9 et seq.*

[9] It is to be doubted that the words "give fundamental weight to" add much. They clearly draw from what was said by the Full Court of the West Australian Supreme Court in *Re Dr Ken Michael AM; Ex parte Epic Energy Nominees (WA) P/L & anr [2002] WASCA 231 (2002) ATPR 41-886 @ para 55* about what was

purport to disapply sections 8 and 8A, nor could it do so for the reasons previously outlined.

That sections 8 and 8A apply to the AER performing its functions and exercising its powers under the AMI Cost Recovery Order is similar to the way that the National Electricity Objective ("**NEO**") applies when the AER acts under the National Electricity Law and NER.

The AER's approach to interpretation of the AMI Cost Recovery Order

In its *Framework and approach paper Advanced metering infrastructure review 2009-11* dated January 2009 ("**Framework and Approach Paper**") the AER at pages 24 – 42 set out its approach to the "analytical framework" contained in the AMI Cost Recovery Order.

Relevantly, it included Figure 2.1[10] setting out the decision flowchart that the Order establishes. No issue can be taken with that flowchart. Similarly in its Draft Determination the AER has included Figure 1.1[11] headed "AER approach to assessment as required by the revised Order"[12]. Again no issue can be taken with that flow chart which usefully identifies the two critical provisions of the Order namely clause 5C.2 (the scope test) and clause 5C.3 (the "prudent" test").

In its Framework and Approach Paper[13] the AER addressed a submission that it was focusing on matters that would be relevant if the task was to determine that contract costs were efficient. In response to that the AER said (at page 34) the following:

> The AER is not seeking to introduce efficiency tests nor to increase regulatory risk, but is seeking to apply the tests set out in the revised Order in a manner it considers appropriate given its powers and functions as the regulator under the revised Order. The powers and functions of the regulator include the power to develop a framework and approach paper and discretion to apply the tests as it considers appropriate, as long as its application is consistent with the revised Order.

The AER also addressed in the Paper the "substantial departure from the commercial standard a reasonable business would exercise" test contained in clause 5C.3(b)(iv) of the Order. This was against a submission seeking guidance as to how the AER would apply the test. The AER (at pages 41 and 42) said the following:

> While some stakeholders may consider that it would be useful if the concepts were defined more clearly, the AER does not consider that there is value in attempting at this

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meant by the words "take into account" as used in section 2.24 of the National Third Party Access Code for Natural Gas Pipeline Systems, namely that those words meant that a Regulator is required to take "the stipulated factors into account and give them weight as fundamental elements".

[10] Page 26 of the Paper.

[11] Page 15 of the Draft Determination.

[12] The AER calls the AMI Cost Recovery Order the "revised Order".

[13] See page 33.

time to add specific additional matters to the criteria provided by the Order. Each application of the test may be unique, including circumstances and issues that are absent from other cases. It is appropriate that the regulator is able to apply the test as fully as possible in each instance in which it is required.

With respect to Origin's concern that the AER will reach 'overly cautious conclusions', the AER will apply the tests, as set out by the Victorian Government in the revised Order, in accordance with its regulatory powers and responsibilities.

Therefore, having regard to the matters set out in the Order and any other relevant matters the AER will assess each instance of expenditure that is not a contract cost or does not meet the contract cost threshold test as part of a budget application or charges revision application case by case on its merits in establishing whether it involves a substantial departure from the commercial standard that a reasonable business would exercise in the circumstances.

Later, the AER said (at pages 42 – 43) the following:

The regulator therefore has some discretion to decide the matters it considers to be relevant. In the case of establishing whether, in the context of related party expenditure, the expenditure involves a substantial departure from the commercial standard a reasonable business would exercise in the circumstances, the AER considers that the following matters are relevant to the test and will be taking them into account:

- the structure of the contract, including whether:
    - the contract gives an incentive for the contractor to lower costs
    - these cost reductions are passed on to the distributor and
    - the contract gives the distributor control over expenditure
- the extent to which contract costs represent actual costs incurred in providing the services
- the extent to which contractual arrangements with the related party confer other benefits such as:
    - enabling economies of scope to be achieved
    - cost savings from not conducting a competitive tender process
    - other benefits such as retention of knowledge and avoiding the need for other contractors to 'come up to speed' with the distributor's working arrangements
- how the costs under the contract compare with benchmarks of efficient costs
- the extent and manner in which risks are allocated under the contract.

> In considering these matters the AER is not introducing economic efficiency tests. Through obtaining information on these matters the AER is seeking to understand the circumstances of the distributor and establish whether the expenditure involves a substantial departure from the commercial standard a reasonable business would exercise in the circumstances.
>
> Matters relating to the economic consequences for the distributor are considered to be appropriate matters for consideration given that such matters would typically be considered by businesses when deciding whether to enter into a contract.

In its Draft Determination, at pages 83-84 and in the context of related party margins, the AER repeats the above statements from the Framework and Approach paper.

In addition the AER (at page 84 of the Draft Determination) says the following:

> As clarification, the AER notes that its assessment of margins in this section is performed under the revised Order's commercial standard test and the test is different from that applied by the AER when assessing related party margins under the requirements of the NEL and NER. While some of what the AER takes into account in applying the commercial standard test under the Revised Order may reflect considerations that are also relevant to assessing efficiencies of margins, the AER is here performing a different task and the result of this commercial standard test does not necessarily have any bearing on the AER's approach to applying its efficiency requirements under the NEL and NER.

Further in the Draft Determination, the approach the AER has taken when applying the "commercial standard test" (ie that mandated by clause 5C.3(b)(iv) of the Order) is to where possible use benchmark levels of expenditure to assess the expenditure proposed by the distributors and where that has not been possible the AER has sought advice from its technical consultant Impaq as to the costs of the expenditure[14]. The AER notes that in many cases, where the distributor's further information did not "fully detail or explain a cost item"[15], Impaq "has usually conducted a 'bottom-up' assessment of the expenditure and come to a view on what the appropriate amount should be"[16].

Relevance of efficiency

The AER seems to be of the opinion that under the AMI Cost Recovery Order, efficiency is not relevant.

That is incorrect.

Sections 8 and 8A of the ESC Act, in particular section 8A(1)(a), make it clear that efficiency is a relevant consideration[17]. That is the case notwithstanding that the model

[14] See Draft Determination pages 8 and 9. The Impaq advice is published on the AER's website.
[15] Ibid, page 9.
[16] Ibid, page 9.
[17] The Victorian Department of Primary Industries sought to make this point in its submission dated 2 October 2009 to the AER by referring to the AER's "key statutory objective" being to "promote efficiency in electricity services". Later in that submission, and as noted by the Tribunal in *Application by United*

under the Order is one of cost pass through. The fact that clause 4.1(a) of the Order provides that there shall be no "incentive based control mechanism applied" does not detract from sections 8 and 8A. All that speaks to is that there shall not be a "CPI – x" mechanism applied. Efficiency is still relevant in terms of the costs that are sought to be passed through.

In this regard the Order is no different from rule 6.6 of the NER where, despite that rule mandating cost pass through in certain circumstances, the NEO (which likewise is an efficiency objective) still applies and is relevant to the determinations that the AER must make pursuant to that rule.

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

The Commercial Standard test

The test mandated by clause 5C.3(b)(iv) is "a substantial departure from the commercial standard that a reasonable business would exercise in the circumstances".

This is a fact specific inquiry as is obvious not only from the reference to "in the circumstances" but also from the importation of the matters referred to in clause 5I.8, which matters likewise commence with a reference to "the circumstances of the distributor".

Further, the test is an objective one as is apparent from the use of the words "a reasonable business". It requires the AER to consider what the hypothetical reasonable business would do in the particular circumstances of the distributor concerned. It is not a test that requires the AER to consider whether what that distributor did was subjectively (from the distributor's standpoint) reasonable.

There is no definition of what is meant by "substantial departure". However "substantial" is a common qualifier used in legislation[18] and regulatory instruments and is usually taken to mean real or of substance and not insubstantial or nominal[19]. When used in a relative sense (as is the case in clause 5C.3(b)(iv)), it requires one to know something of

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Energy Distribution P/L [2009] ACompT 10, (2009) ATPR 42-306 @ para 25, the Department took issue with the "AER's assertion" (as the Tribunal puts it) that the AMI Cost Recovery Order does not permit the AER to undertake an efficient cost review of related party margins. It may be that the significance of the reference to the "key statutory objective" has been overlooked by the AER.

[18] Especially legislation that provides for economic regulation.

[19] See *Tillmanns Butcheries P/L v Australasian Meat Industry Employees' Union (1979) 42 FLR 331 @ pages 338 (Bowen CJ) & 348 (Deane J).* The Full Federal Court was considering the use of the word "substantial" in the phrase "substantial loss or damage" as used in section 45D of the (then) *Trade Practices Act 1974 (Cth).*

the "commercial standard that that a reasonable business would exercise in the circumstances"[20].

In the context of clause 5C.3(b)(iv), the use of the word "substantial" directs the AER to only have regard to departures from the commercial standard that are more than nominal or trivial departures. It is, in effect, a de minimis test.

Similarly there is no definition of "commercial standard". However the use of the word "commercial" is clearly designed to focus attention on the standard that the hypothetical reasonable business would adopt for its decisions **as a commercial entity**. This imports whether the decision is judged economically sound and profitable[21]. However this is not to be taken to mean that efficiency considerations are irrelevant, they are because of sections 8 and 8A of the ESC Act.

The test should also be seen as both a qualitative and quantitative one. Although the test does not in its terms expressly mandate "bottom-up" cost modeling, to determine what the hypothetical reasonable business would do in the particular circumstances of the distributor concerned, it is relevant to conduct such modeling. To that extent, the test can be seen as quantitative. Likewise with benchmarking between distributors.

But also required is a standing back and a qualitative assessment, having regard to the quantitative outcomes, of whether viewed as a whole there has been "a substantial departure from the commercial standard that a reasonable business would exercise in the circumstances". And this must be done with the dictates of sections 8 and 8A of the ESC Act in mind.

To the extent that the AER in its Draft Determination has not yet carried out that qualitative assessment, then that needs to be carried out. Reliance on the quantitative assessment alone is only part of the task required under the clause.

The Draft Determination

The Draft Determination does not refer to or take into account sections 8 and 8A of the ESC Act. To the extent that it does not do that, it is in error. In that regard the statement that the AER makes (in the context of related party margins) at page 84 of the Draft Determination that applying the commercial standard test is different from assessing the efficiencies of margins overstates the case. Efficiency issues are still relevant even under the commercial standard test.

Likewise with the apparent focus on the "bottom-up" cost analysis. That analysis must take into account the efficiency test in section 8A of the ESC Act. Further such analysis

[20] Cf what Deane J says in *Tillmanns Butcheries P/L v Australasian Meat Industry Employees' Union (supra) @ page 348.*

[21] See eg Lord Cooke of Thorndon in *Manukau City Council v Ports of Auckland Ltd et al [1999] UKPC 38 @ para 11.* See also the discussion (in the context of the phrase "reasonable commercial endeavours") of the meaning of "commercial" in *Cypjayne P/L v Babcock & Brown International P/L [2011] NSWCA 173 @ paras 65 – 70* from which it is apparent that the NSW Court of Appeal saw the word "commercial" as introducing notions of commercial viability.

is not the only analysis that is required: there must be both quantitative and qualitative analysis.

That said, there are elements of the Draft Determination which can be supported in terms of the AMI Cost Recovery Order. In particular:

1. The AER has distinguished the Australian Competition Tribunal's decision in *Application by United Energy Distribution P/L*[22] on the basis that decision was about whether management fees were within scope in terms of the Order. The decision did not address whether the fees met the commercial standard test[23]. Distinguishing the Tribunal's decision on this basis appears correct.

2. To the extent that the AER has recognized that its examination as to what is prudent must be conducted on a case by case basis in accordance with the AMI Cost Recovery Order[24], that is correct. However where the AER also refers to the examination having to be in accordance with the Framework and Approach Paper[25] that is incorrect insofar as that paper suggests that efficiency considerations are not relevant.

3. To the extent that the AER has reflected considerations that are also relevant to efficiencies[26], then even though the AER may not have thought efficiency to be relevant, the AER has at one level acted consistently with sections 8 and 8A of the ESC Act. Having said that, the AER should go back and review its Draft Determination with the two provisions in mind as it may be that different outcomes will then arise.

4. The AER's conclusion that the risk born by the distributors is "negligible", for the reasons that it sets out at pages 94 and 95 of the Draft Determination (which include the pass though regime itself, the 110% uplift of costs and the wide ranging scope, inter alia), is to be supported noting that risk is a matter that clause 5I.8(h) requires the AER to "take into account and give fundamental weight to".

5. Similarly the AER's conclusion (as set out at page 97 of the Draft Determination) as to what is the appropriate commercial standard applicable to related party margins is to be supported, noting that in that context the AER sees the "historical efficiency of the contractor" as relevant. The latter can be supported by sections 8 and 8A of the ESC Act.

6. Lastly, to the extent the AER has taken issue with the high levels of Opex forecasts of the distributors as not being consistent with the completion of the

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[22] *[2009] ACompT 10, (2009) ATPR 42-306.*
[23] See Draft Determination page 84. Note that the Tribunal itself recognized the possibility that the management fee was "not prudent" but went on to say "that is a separate matter". See *Application by United Energy Distribution P/L @ para 55.*
[24] See Draft Determination page 85.
[25] See ibid.
[26] See Draft Determination page 84 (quoted in main text above).

AMI roll-out and entry into a "business-as usual" phase[27], that too is to be supported.

G.R.McCormick

415 Owen Dixon Chambers West

205 William St

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[27] See Draft Determination page 7.