



Final decision

**Framework and approach paper**  
**Advanced metering infrastructure review 2009-11**

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# Contents

<b>Shortened forms</b> .....	<b>1</b>
<b>Summary</b> .....	<b>2</b>
<b>1 Introduction</b> .....	<b>5</b>
1.1 Timeframe for the rollout .....	6
1.2 Legislative and regulatory framework .....	7
1.2.1 Regulatory responsibility .....	9
1.3 Structure of this paper .....	10
<b>2 Analytical framework</b> .....	<b>11</b>
2.1 Introduction .....	11
2.2 Requirements of the revised Order .....	11
2.2.1 Initial AMI period budget application and determination .....	11
2.2.2 Exclusions from the Initial AMI period budget .....	13
2.2.3 Charges for 2011 .....	14
2.2.4 Budgets and charges for the subsequent AMI budget period – 2012 to 2015 .....	15
2.3 Proposed positions .....	15
2.4 Summary of submissions .....	20
2.4.1 Analytical framework .....	20
2.4.2 Is expenditure within scope? .....	21
2.4.3 Is expenditure a contract cost? .....	22
2.4.4 A competitive tender process .....	22
2.4.5 More likely than not that expenditure will be incurred .....	23
2.4.6 A substantial departure from the commercial standard a reasonable business would exercise .....	24
2.4.7 Existing contractual arrangements with related parties .....	24
2.5 Issues, AER considerations and AER approach .....	24
2.5.1 Analytical framework .....	24
2.5.2 Is expenditure within scope? .....	27
2.5.3 Is expenditure a ‘contract cost’? .....	30
2.5.4 A competitive tender process .....	33
2.5.5 More likely than not that expenditure will not be incurred .....	39
2.5.6 A substantial departure from the commercial standard a reasonable business would exercise .....	40
2.5.7 Existing contractual arrangements with related parties .....	42
<b>3 Technical issues</b> .....	<b>44</b>
3.1 Introduction .....	44
3.2 Requirements of the revised Order .....	44
3.3 Proposed positions .....	45
3.4 Summary of submissions .....	48
3.4.1 Net costs (or revenue) associated with providing metering services from 1 January 2006 to 31 December 2008 .....	48
3.4.2 Weighted average cost of capital .....	48
3.4.3 Efficiency carryover mechanism .....	48
3.4.4 Taxation .....	49
3.4.5 Value of the metering asset base .....	49

3.4.6	Regulatory depreciation .....	49
3.5	Issues, AER considerations and AER approach .....	49
3.5.1	Net costs (or revenue) associated with providing metering services from 1 January 2006 to 31 December 2008.....	49
3.5.2	Weighted average cost of capital .....	50
3.5.3	Efficiency carry over mechanism .....	54
3.5.4	Taxation .....	58
3.5.5	Value of the metering asset base.....	60
3.5.6	Regulatory depreciation.....	61
<b>4</b>	<b>Charges.....</b>	<b>64</b>
4.1	Introduction.....	64
4.2	Requirements of the revised Order .....	64
4.3	Proposed positions .....	64
4.4	Summary of submissions .....	66
4.4.1	Price controls .....	66
4.4.2	Exit and restoration fees.....	66
4.5	Issues, AER considerations and AER approach .....	66
4.5.1	Charges for 2009.....	66
4.5.2	Price controls .....	67
4.5.3	Exit and restoration fees.....	69
4.5.4	Unmetered supplies.....	70
4.5.5	Customer requested service fee .....	71
<b>5</b>	<b>Information requirements .....</b>	<b>73</b>
5.1	Introduction.....	73
5.2	Requirements of the revised Order .....	73
5.3	Proposed positions .....	74
5.4	Summary of submissions .....	74
5.5	Issues, AER considerations and AER approach .....	75
5.5.1	General principles for information provision .....	75
5.5.2	Initial AMI budget period budget application .....	77
5.5.3	Timeframes for initial AMI budget period .....	78
<b>Appendix A:</b>	<b>Information templates .....</b>	<b>80</b>

## Shortened forms

AER	Australian Energy Regulator
AMI	Advanced metering infrastructure
CPI	Consumer price index
ECM	Efficiency carryover mechanism
ESCV	Essential Services Commission – Victoria
IMRO	Interval meter rollout
NER	National Electricity Rules
SORI	Statement of regulatory intent
WACC	Weighted average cost of capital

## Summary

In 2006, the Victorian Government decided there should be a rollout of advanced interval meters to all Victorian electricity customers with annual electricity consumption of 160 MWh or less. The Victorian Government subsequently decided that each Victorian electricity distributor would be responsible for the rollout to customers connected to its network.

The regulatory arrangements relating to the rollout are set out in an August 2007 Order in Council made by the Victorian Governor in Council under sections 15A and 46D of the *Electricity Industry Act 2000* and an amending Order made on 25 November 2008. For the purposes of this final decision the original Order, as amended, is referred to as the 'revised Order'.

The revised Order sets out the regulator's role and is the primary regulatory instrument which will guide the determination of prices for metering services.

While the services which are the subject of the revised Order are the same as for the original Order, the revised Order provides for a fundamentally different approach to establishing prices. In particular, the revised Order provides for a cost pass through model under which budgets for the rollout are established at the beginning of the period and then annual charges are determined based on actual expenditure. The focus of the regulatory framework is on the regulator ensuring that the expenditure is within scope and is otherwise prudent, in accordance with the tests established by the revised Order.

The revised Order refers to 'the Commission', meaning the Essential Services Commission, Victoria (ESCV). On 1 January 2009 the ESCV's powers and functions under the revised Order were transferred to the AER.

The revised Order envisages that the regulator may publish a framework and approach paper and requires distributors' applications to include the information specified in any framework and approach paper.

As well as specifying in detail the information required to be provided in distributors' applications, the framework and approach paper assists distributors in preparing their applications to the AER by stating the AER's likely approach (and its reasons for that likely approach) with respect to key aspects of the determinations it is required to make under the revised Order.

An AMI framework and approach consultation paper was released by the ESCV in December 2008 seeking the responses of the distributors and other stakeholders to the proposed framework and approach. Submissions were received by the ESCV.

Having considered the requirements of the revised Order and the submissions received to the ESCV's consultation paper, the AER has made its final decision on the framework and approach. This paper sets out that decision.

Key elements of the final decision include the following:

- In establishing whether expenditure is within scope the AER will seek to understand how the expenditure proposed relates to the activities being undertaken, and how these activities relate to the scope, based on the matters included at Schedule 2 of the revised Order.
- The AER does not intend to compare expenditure across businesses, or against benchmarks, at a detailed scope line item level, in determining whether expenditure is within scope.
- The requirement proposed in the consultation paper to submit, with each charges application, a breakdown of payments made under the contract to date and separated into fixed payments, variable payments, performance based penalties or rewards and other margins or contingencies is not included in this final decision. This level of breakdown is only required for the budget application.
- In establishing whether a competitive tender process has taken place, as part of the prudency test, the AER will have regard to, amongst other things, the actual tender process documented, the process carried out by the distributors and the tender outcomes. 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.
- In respect of contracts with existing related parties, the AER will also examine the circumstances in which the contract was entered into.
- Tender arrangements might provide that final contractual details are subject to negotiation between the distributor and the successful contractor. The AER will also consider whether these negotiations have been carried out on a competitive basis and that the outcomes are appropriate.
- As part of the budget application, and if requested by the AER to support a charges revision application, the distributor is to provide a probity auditor's report prepared by a suitably qualified independent probity expert, who was not involved in designing, validating or operating the distributor's tender or probity processes.
- Distributors will be required to explain their choice, where relevant, for entering into and relying on an external contractual arrangement over its own internal provision of services. Where the AER considers that it needs to examine the choice more fully the distributor may be required to provide a business case.
- An explanation will be required from distributors of why they consider each joint tender to be appropriate for each distribution business. Where the AER considers that it needs to examine the choice more fully the distributor may be required to provide details of the synergies obtained.
- If expenditure items proposed represent the aggregated costs of undertaking a number of activities, the AER may seek to understand, for each activity, whether it is more likely than not that the expenditure related to it will be incurred.

- If the AER establishes that it is more likely than not that expenditure related to a particular activity will not be incurred, then the aggregated expenditure proposed will be reduced by this amount.
- In establishing whether expenditure involves a substantial departure from the commercial standard that a reasonable business would exercise in the circumstances, which forms another aspect of the prudence test, the AER will assess each instance on a case by case basis.
- The initial AMI weighted average cost of capital (WACC) period is from 1 January 2009 to 31 December 2013 and is coincident with the period of the AMI rollout. The AER considers that an appropriate term for the WACC calculation is one that matches this period. The term will therefore be 1 January 2009 to 31 December 2013.
- The gamma to be applied in relation to 2006 to 2008 taxation benchmark allowances will be 0.5, consistent with the current price determination. The gamma for 2009 and later years will be that established by the AER in its most recent Statement of Regulatory Intent.
- Distributors are required to consider the pricing principles of 'cost of service provision', 'cost allocation' and 'simplicity' when setting charges, and charges may be reviewed for compliance with these principles.
- Rebalancing constraints will not be applied to charges in the initial AMI budget period.
- Individual initial AMI budget period budget application data templates for each distributor, based on that distributor's scope and financial system capabilities, will be used.
- Items relating to the initial charges application are not included in these data templates. Following further consultation, the AER will release separate templates for the submission of information in initial charges applications and charges revision applications.



# 1 Introduction

In October 2005, the Essential Services Commission Victoria (ESCV) determined in its *Electricity Distribution Price Review 2006–10 Determination* (the 2005 Determination), the price control applying to distribution businesses' distribution use of system charges (DUOS). In this 2005 Determination, the ESCV also established a separate price control for prescribed metering services. This followed the ESCV's decision to mandate the rollout of manually read interval meters and to provide distributors with exclusive responsibility for metering services to customers who do not have a remotely read interval meter and consume less than 160 MWh of electricity per annum.

In 2006, the Victorian Government decided there should be a rollout of advanced interval meters to all Victorian electricity customers. This superseded the ESCV's earlier decision on manually read interval meters. Throughout 2006 and the first half of 2007, the Victorian Government worked with distributors, retailers and consumer groups to establish the requirements of the advanced metering infrastructure (AMI) rollout. The regulatory arrangements relating to the rollout were initially set out in an August 2007 Order in Council made by the Governor in Council under sections 15A and 46D of the *Electricity Industry Act 2000* (referred to hereafter as 'the original Order').

Under the original Order the ESCV was required to redetermine the distributors' metering services revenue requirement and establish a new price control to take effect from 1 January 2009. To facilitate this process the ESCV released a consultation paper in August 2007 which set out the approach that the ESCV intended to use to make a determination on the prices distributors can charge for the metering services specified in the original Order. Following the receipt of comments from the distributors and other stakeholders, the ESCV released a final framework and approach paper in December 2007.

In 2008, however, following discussions between the Victorian Government, distributors and other stakeholders, arrangements relating to the rollout of advanced interval meters were amended. Changes were made in a number of areas, and as discussed below, the original Order was revised accordingly on 25 November 2008. These changes included:

- the timing for the rollout. The original schedule required the distributors to complete the rollout by 31 December 2012. The new schedule provides for the rollout to be complete by 31 December 2013.
- regulatory arrangements for the rollout. Under the original Order the regulatory arrangements provided for charges to be set based on forecasts of expenditure and for the distributors to have incentives to outperform the expenditure forecasts. Under the new arrangements prices are based on a cost pass through model with the intention that both distributors and customers will benefit from prices being set with greater knowledge of the costs of the rollout
- regulatory responsibility for the rollout. Responsibility for regulatory oversight of the rollout transferred from the ESCV to the Australian Energy Regulator (AER) on 1 January 2009.

As a consequence of these new arrangements, the ESCV released a consultation paper in December 2008 in which it revisited the framework and approach to setting prices.

In preparing the consultation paper the ESCV had regard to the revised OIC as well as positions established in its December 2007 framework and approach paper and the consultation that preceded that paper, to the extent relevant. The consultation paper was also informed by developments since December 2007, including the distributors' initial submissions to the ESCV.

Stakeholders were asked to comment on the consultation paper and submissions were due on 29 December 2008. Given the transfer of functions from the ESCV to the AER on 1 January 2009, the AER is now responsible for finalising the framework and approach paper for the AMI review.

The purpose of this paper is to set out the framework and approach to be applied in making a determination on the prices distributors can charge for the metering services specified in the revised Order. This paper focuses on the process that will be followed to determine prices for regulated services for the first budget period and in particular 2010 and 2011. It also sets out for stakeholders the proposed consultation process that will be followed by the AER in formulating its draft decision on the prices. In finalising this paper, the AER has had regard to all the submissions received to the ESCV's position paper.

This paper also sets out the information that will be required from distributors in their 27 February 2009 initial budget applications.

## 1.1 Timeframe for the rollout

Under the revised timeframes for the rollout the distributors are required to commence installing advanced interval meters by the middle of 2010, with the rollout to be completed by the end of 2013. The full schedule is shown in Table 1.1.

Table 1.1 **AMI rollout schedule**

<i>Timeline</i>	<i>Rollout percentage</i>
30 June 2010	5%
31 December 2010	10%
30 June 2011	25%
30 June 2012	60%
30 June 2013	95%
31 December 2013	100%

The Victorian AMI rollout is the first of a potentially more widespread planned rollout of similar meters across other States. The New South Wales Government has indicated that advanced interval meters (referred to as 'smart meters' in NSW) will be rolled out prior to 2017. Other jurisdictions are proceeding with pilot programs and

business cases in order to determine whether to proceed with rollouts. The Ministerial Council on Energy (MCE) has committed to establishing a consistent national framework for AMI meters.

## 1.2 Legislative and regulatory framework

The primary regulatory instrument which will guide the determination of prices for metering services remains the Order in Council made by the Governor in Council in August 2007. However, this Order was revised by an amending Order made by the Governor in Council on 25 November 2008 and published in the Government Gazette No. S314. The amendments made to the original Order are substantial and the majority of the original Order has been revised. For the purposes of this final decision the original Order, as amended, is referred to as the ‘revised Order’.

The revised Order provides the framework for setting prices for the following services:

- regulated services comprising:
  - metering services supplied to first tier customers or second tier customers with annual electricity consumption of 160 MWh or less where the electricity consumption of that customer is (or is to be) measured using a revenue meter that is either an accumulation meter or a manually read interval meter
  - metering services supplied to first tier customers or second tier customers with annual electricity consumption of 160 MWh or less where the electricity consumption of that customer is (or is to be) measured using a revenue meter that is a remotely read interval meter
- other fees and charges:
  - exit fees where the retailer becomes the responsible person for a relevant customer’s metering services
  - restoration fees where a retailer ceases to be the responsible person for a relevant customer’s metering services and the distributor becomes the responsible person
  - prices for unmetered supplies
  - customer requested services—which are services provided to a retailer in respect of a customer that requests a service to a standard in excess of that normally provided.<sup>1</sup>

While the services which are the subject of the revised Order are the same as for the original Order, the revised Order provides for a fundamentally different approach to

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<sup>1</sup> It is also possible for a retailer to seek enhanced functionality or enhanced service levels from a distributor. The process for determining the price for such enhanced services is covered by the complementary Order in council made by the Governor in Council under sections 15A and 46D of the *Electricity Industry Act 2000* in November 2007 (referred to in the revised Order as the ‘AMI Specifications Order’).

establishing prices. In particular, the revised Order provides for a cost pass through model under which budgets for the rollout are established at the beginning of the period and then annual charges are determined based on actual expenditure. The focus of the regulatory framework is on the regulator ensuring that the expenditure is within scope and is otherwise prudent, in accordance with the tests established by the revised Order.

The revised Order divides the regulatory process into two separate periods. The first is the first budget period, which applies from 1 January 2009 to 31 December 2011. The second budget period applies from 1 January 2012 to 31 December 2015. From 2016 onwards the determination of prices for metering services and other fees and charges will be undertaken by the AER in accordance with the process provided in chapter 6 of the National Electricity Rules (NER) to establish prices for standard control services and alternative control services. Final 'true-ups' in relation to total AMI expenditure and revenue from 2009 to 2015 will be reflected in prices in 2016 and 2017.

The broad framework applying in respect of the two budget periods is similar. It requires distributors to provide an initial budget to the regulator which the regulator must approve unless it can establish that the expenditure is for activities that are out of scope or is not prudent. Expenditure is taken to be prudent unless:

- in the case where expenditure is a contract cost, the regulator establishes the contract was not let in accordance with a competitive tender process
- in the case of other expenditure, where the regulator establishes it is more likely than not that the expenditure will not be incurred or that incurring the expenditure involves a substantial departure from the commercial standard that a reasonable business would exercise in the circumstances.

Prices are set on the basis of the budgets approved by the regulator, and are adjusted on an annual basis based on actual expenditure incurred. The revised Order provides for actual expenditure to be reflected in prices where it is within scope, certified in an audit report, and no more than 120% (in relation to the first budget period) or 110% (in relation to the second budget period) of the budget. Where actual expenditure is outside these ranges the regulator may only not permit it to be recovered where the regulator establishes that it is not prudent. The revised Order applies a generally similar definition of 'prudent' to that used in the consideration of a budget application.

The revised Order also contains a number of clauses relating to specific elements of the framework, including the cost of capital, an efficiency carryover mechanism relating to the rollout of manually read interval meters prior to 1 January 2009, and the treatment of tax.

More detail regarding provisions of the revised Order, and the way in which the regulator will implement them, is set out in chapters 2, 3 and 4.

The AMI Specifications Order, which sets out the detailed specifications for the AMI rollout, has also been amended, however the changes to this Order are mostly consequential in nature.

The timetable for establishing prices for regulated services under the revised Order is set out in table 1.2.

**Table 1.2 Overview of AMI price setting timetable**

**First budget period**

Initial prices take effect (based on the current price determination)	1 January 2009
Distributors submit initial budget submission (in respect of 2009 to 2011)	27 February 2009
Distributors to provide proposed 2010 and 2011 charges	1 June 2009
Determination on initial 2010 and 2011 budget and charges application	31 October 2009
Initial budget period charges take effect	1 January 2010

**Second budget period**

Distributors submit initial budget submission and charges application (in respect of 2012 to 2015)	28 February 2011
Determination on initial 2012 to 2015 budget and charges application	29 October 2011
Subsequent budget period charges take effect	1 January 2012

**1.2.1 Regulatory responsibility**

Regulatory responsibility for the rollout transferred from the ESCV to the AER on 1 January 2009. Because the timeframes for the review set out in the revised Order require distributors to make a budget submission by 27 February 2009 it was not possible for the AER to consult on and establish a framework and approach for the review prior to this date. Therefore the ESCV and the AER agreed that the ESCV would be responsible for publishing the consultation paper for the framework and approach for the review prior to the transfer of functions. With the assumption of these responsibilities from 1 January 2009, the AER is in a position to finalise the revised framework and approach, including taking into account and addressing any submissions in response to the ESCV’s consultation paper. The AER is now responsible for implementing the framework. The statutory framework established to regulate the transition of responsibility for the AMI price review from the ESCV to the AER provides that work done by the ESCV (including the preparation and issue of a framework and approach paper) in relation to the AMI price review will be taken to be work done by the AER.

The revised Order and the ESCV’s consultation paper reference ‘the Commission’ in all places. All such references, unless explicitly stated or the context provides otherwise, are to be read as references to the AER. In this final decision references to the ESCV and the AER are references to those organisations. The term ‘regulator’ is

used to refer to the organisation carrying out the function or exercising the power being referred to.

### **1.3 Structure of this paper**

Chapter two sets out the broad approach to the review including the way in which the regulator will consider the distributors' budget applications, budget variations and charges applications. Chapter three discusses some of the specific regulatory issues including the efficiency carryover mechanism, the cost of capital and the treatment of taxation. Chapter four discusses the establishment of individual prices, including 2009 prices and charges for the provision of metering services to unmetered connection points. Finally, chapter five discusses the information that will need to be provided by the distributors as part of the review process. It also sets out the proposed timeframes in respect of the initial AMI budget period.

## **2 Analytical framework**

### **2.1 Introduction**

This chapter sets out the approach with respect to the analytical framework within which the AER will assess the charges that distributors may set for the provision of the regulated services under the revised Order. In doing so it also identifies some of the information that the AER will require from distributors in order to undertake its assessment. Information requirements are also discussed in chapter five.

This chapter focuses on the first AMI budget period from 1 January 2009 to 31 December 2011. However much of the discussion in this chapter is also relevant to the subsequent AMI budget period from 2012 to 2015.

### **2.2 Requirements of the revised Order**

In order to discuss the analytical framework it is necessary to understand in detail the requirements of the revised Order.

As noted in chapter one, the revised Order provides for a cost pass through model under which budgets for regulated services are established at the beginning of the period and then annual charges are determined based on actual expenditure. This process is set out below.

Note that the process set out below only applies to regulated services. This means that revenue and expenditure on other AMI services and related fees and charges (notably exit and restoration fees, unmetered supplies and customer requested services) are excluded.<sup>2</sup>

#### **2.2.1 Initial AMI period budget application and determination**

Distributors are required to provide an initial AMI period budget application to the regulator by 27 February 2009. The application must contain a budget for expenditure on regulated services for the initial AMI budget period. It must clearly distinguish between capital expenditure and maintenance and operating expenditure and must set out, amongst other things:

- a forecast for capital and operating expenditure on regulated services in 2009, 2010 and 2011
- information required in the regulator's framework and approach paper
- information required in templates issued by the regulator
- the process that has been used or is proposed to be used for competitive tenders for contracts for regulated services

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<sup>2</sup> The revised Order separately provides for the setting of these charges. Distributors may make fees applications to the regulator for exit and restoration fees and customer requested service fees, while charges in relation to unmetered supplies are set with reference to CPI.

- a forecast of the number of metering installations that are proposed to be installed each year
- the information upon which the distributor relies.

The distributors must, by 1 June 2009, make an application to the regulator which sets out their proposed initial charges for 2010 and 2011.

The regulator is required to review the budget application and initial charges application and make a determination on charges for 2010 and 2011 by 31 October 2009. Prior to making this determination:

- the regulator must release a draft determination
- the distributors may provide a revised budget application to the regulator by 31 August 2009 if there is a change in forecast expenditure by reason of a contract entered into by the distributor or a material change in a metering regulatory obligation or requirement.

Importantly, the regulator must approve the budget in the initial application unless the regulator can establish that the expenditure is:

- for activities that are outside scope at the time of commitment to that expenditure and the time of the budget determination or
- not prudent.

The revised Order provides that:

Activities within scope are those activities reasonably required:

- (a) for the provision of Regulated Services; and
- (b) to comply with a metering regulatory obligation or requirement.

It also provides the distributors with a list of activities or matters considered to be within scope. These lists are not exhaustive.

Under the revised Order budgeted expenditure is taken to be prudent:

- where that expenditure is a contract cost, unless the regulator establishes that the contract was not let in accordance with a competitive tender process, or
- where that expenditure
  - is not a contract cost or
  - is a contract cost and the regulator establishes that the contract was not let in accordance with a competitive tender process

unless the regulator determines that:



- it is more likely than not that the expenditure will not be incurred or
- the expenditure will be incurred but doing so involves a substantial departure from the commercial standard that a reasonable business would exercise in the circumstances.

A contract cost is expenditure incurred pursuant to a contract entered into before the relevant application is made, but excludes expenditure incurred pursuant to any variation to the contract made after that date.

In considering whether expenditure involves a substantial departure from the commercial standard that a reasonable business would exercise in the circumstances the regulator is required to take into account:

- the circumstances at the time of the distributor or other person incurring or managing the expenditure, including the state of technology, risks, market conditions; and
- the available information relevant to the provision, installation, maintenance and operation of AMI.

The revised Order also allows for a distributor to seek the regulator's approval for a budget variation at any time after the budget has been determined. The same criteria as set out above apply in relation to a determination by the regulator to approve or reject a variance in the budget.

Discussion in this paper in relation to budget applications is to be taken to include budget variance applications, except where otherwise indicated.

### **2.2.2 Exclusions from the Initial AMI period budget**

Clause 5B.2 of the revised Order provides that certain 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, but will be considered separately under clause 5D.4. These are the following items:

- a. net costs (or revenue) associated with providing prescribed metering services from 1 January 2006 to 31 December 2008
- b. the amount by which DUoS taxation liability was reduced as a result of the ESCV's consolidation of DUoS taxation and metering services in the current price determination
- c. the value of any efficiency carryover arising from the current price determination
- d. expenditure from 1 January 2006 to 31 December 2008 on trials conducted in accordance with the ISC or as directed or agreed by the Department of Primary Industries
- e. expenditure from 1 January 2006 to 31 December 2008 on installing, commissioning and maintaining telecommunications and IT systems required to support the AMI infrastructure

- f. other relevant expenditure incurred from 1 January 2006 to 31 December 2008 on project management and other preparation
- g. expenditure from 1 January 2006 to 31 December 2008 attributable to interest rate hedging costs and exchange rate hedging costs.

As clause 5D.1 of the revised Order makes clear, these building blocks must be included when determining the 2010 and 2011 initial charges. The AER therefore requires distributors to provide this information, to the extent that it has not already been provided, by 1 June 2009 to enable it to be taken into account in that determination.

### **2.2.3 Charges for 2011**

Once a budget and charges for 2010 have been determined by the regulator then these charges will apply in that year. In August 2010 distributors are then required to make a charges revision application in respect of charges to apply in 2011. The revised Order provides that the charges revision application must:

- set out actual expenditure and revenue in 2009
- contain an updated forecast of expenditure and revenue for 2010 and 2011
- be accompanied by an audit report that certifies that expenditure incurred is within scope and has been incurred in the amount claimed.

In determining the charges to apply in 2011 the regulator must include in the building blocks, amongst other things, expenditure in 2009 on items which are certified in the audit report and are within scope at the time of commitment to or incurring that expenditure, and which are within 120% of approved budget total operating expenditure and capital expenditure.<sup>3</sup> For the purposes of the 2011 charges determination, actual expenditure must be considered to be within scope if it is so certified by the auditor.

Where expenditure that is within scope exceeds the 120% threshold the regulator is required to include this above-threshold expenditure in the building blocks if either:

- the excess expenditure was incurred prior to the regulator's approval of the submitted budget (or alternatively, determination of the approved budget) in 2009
- the excess expenditure is prudent.

In establishing whether the excess expenditure is prudent, the revised Order requires the regulator to adopt the same definition of prudent as when considering a budget application.

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<sup>3</sup> Note that this requires the aggregate of operating and capital expenditure to be within 120% in aggregate, of the budget. It does not require operating expenditure to be within 120% of the operating expenditure budget and capital expenditure to be within 120% of the capital expenditure budget. Thus, for example, if the operating expenditure budget was \$100 and the capital expenditure budget was \$100, the regulator would be required to ensure charges reflected an aggregate amount of less than 120% x \$200 = \$240.

In determining charges for 2011 (and indeed for any year from 2010 to 2015) the regulator must be satisfied that for the period from 1 January 2009 up to and including the year for which charges are being determined, the net present value of costs incurred is equal to the net present value of total revenue earned.

#### **2.2.4 Budgets and charges for the subsequent AMI budget period – 2012 to 2015**

The process and criteria for approving budgets and determining charges for 2012 to 2015 is similar to the process for 2010 and 2011. In February 2011 the distributors must provide a budget and proposed charges for 2012 to 2015 to the regulator for determination. In each of August 2012, 2013 and 2014 the distributors must provide charges revisions applications for 2013, 2014 and 2015 respectively. The key difference in this subsequent period compared to the initial period is that the actual expenditure approval threshold is 110% of total expenditure, rather than 120%.

There is a ‘true-up’ of revenue and actual expenditure in 2015 with the anticipated difference in revenue and actual expenditure from 2009 to 2015 to be calculated and carried through to prices in 2016. A final adjustment, based on actual 2015 revenues and expenditure, will be made to prices in 2017.

### **2.3 Proposed positions**

In its consultation paper, the ESCV described the proposed positions in relation to the analytical framework as follows:

- Schedule 2 of the revised Order (the scope document) consists of a list of activities that the distributor must undertake in order to give effect to the AMI rollout.
- To review whether expenditure is within scope the regulator will need to receive information which relates the expenditure to the scope—i.e. a list of expenditure against each item of scope.
- The regulator may conduct an initial review of whether expenditure is within scope by comparing expenditure on a category-by-category basis across the distributors. Where expenditure in one area for a particular distributor is significantly different from the other distributors, the regulator will seek information from that distributor in order that it can further investigate whether expenditure is within scope.
- The regulator will need to be provided with information that demonstrates that double recovery of costs through DUoS and AMI charges has not occurred and will closely review overheads and management costs.
- For a budget application and a charges revision application for 2011 charges, the auditor must be approved by the regulator or in default of approval, nominated or engaged by the regulator. The ESCV’s view was that it is also desirable that the audit appointment process for charges revision applications in other years comply with the same requirements.

- The ESCV's view was that it would not be inappropriate for the auditors appointed to audit the distributors' regulatory accounts to undertake this AMI audit.
- Prior to the audit process commencing, the regulator will brief the auditors on the matters they should consider and how they should ultimately form a view as to whether expenditure is within scope.
- For the regulator to establish whether expenditure has been incurred pursuant to a contract it will need to be provided with the following as part of each budget and charges application:
  - an overview of each contract entered into, including the third party contractor and the nature of the services provided
  - the total estimated value of the contract
  - payment schedules
  - details of the financial terms of the contract including:
    - fixed payments
    - variable payments
    - performance based penalties or rewards
    - other margins or contingencies
  - payments made under the contract to date, separated into the four sub-points above.
- As part of the budget application, and if requested by the regulator to support a charges revision application, the distributor is to provide a probity auditor's report prepared by a suitably qualified independent probity expert, who was not involved in designing, validating or operating the distributor's tender or probity processes.
- In determining whether a competitive tender process has taken place (or will occur), considerations the regulator will take into account include whether the distributor has demonstrated:
  - that the initial request for tender documentation is made widely available to all parties that might be interested in tendering
  - that, if adopted, any multi-stage tendering process is appropriate given the nature of the services sought and the number and prospects of potential bidders
  - that the issued tender documentation:
    - provides adequate information about the background to the AMI program and the distributor

- details the tender process
  - provides a detailed specification of the services sought
  - adequately addresses matters such as risk sharing and contractual terms and conditions
  - where appropriate, sets out the tender evaluation criteria
- that adequate time has been allowed for bid preparation and between tender stages, taking into account the scope and complexity of information sought from tenderers
  - that the request for tender does not unreasonably impose conditions that prevent or discourage the submission of any tender
  - that detailed and appropriate tender evaluation criteria have been developed and applied. The design of the tender and the evaluation criteria need to ensure that, as far as possible, competing bids are easily comparable.
  - that any ‘bundling’ of different services into a single contract is appropriate and that the advantages of doing so outweigh the costs
  - that appropriate tender briefings have been conducted and tenderers have been provided with the opportunity to clarify aspects of the tender
  - that the distributor has taken appropriate steps to verify the information provided in tender responses, including referee interviews, field trials, and other checks
  - that any post-tender negotiations with the successful tenderer are consistent with the tender and do not call into question the original selection decision
  - that the outcome of major tenders have been considered and approved by the distributors’ boards of directors
  - that for large contracts, a probity audit of the tendering process has been conducted. The probity auditor’s report is to address the issues raised above, and also set out the scope of the probity audit and state whether, if a probity plan was in place, it has been complied with.
- The regulator may have regard to whether the tender has been carried out in accordance with the relevant Australian Standards.
  - The regulator will consider whether there is a clear business case demonstrating why contractual arrangements are likely to lead to better outcomes than internal provision of services.
  - The regulator will consider the following matters and seek information from the distributors that confirms:

- that the tender process is consistent with the distributors' overall procurement program and risk management strategy
  - that where a 'multi-vendor' approach to procurement has been selected, that this approach has clear benefits compared to a single-vendor approach
  - where distributors seek to demonstrate synergies from undertaking joint tenders then standalone costs relating to each distributor need to be demonstrated by market testing standalone, individual distributor, projects
  - where competing technologies are available for a certain application distributors have considered seeking bids for each of these competing technologies from multiple vendors
- In respect of contracts with existing related parties, the regulator will also examine the circumstances in which the contract was entered into.
  - The ESCV did not consider it appropriate to approve, before the fact, a specific tender process. The regulator will assess each tender process and tender outcome on a case by case basis and on its merits, taking into account any information provided on the process.
  - 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. In considering whether a competitive tender process has occurred the regulator will have regard to the outcomes of the tender, including:
    - the number of respondents to the tender
    - the identity of the successful contractor, and specifically whether the successful contractor is a related party
    - the final contractual agreement with the successful contractor.
  - One of the matters the regulator will examine is how the costs incurred under the winning contract compare with the cost of similar arrangements elsewhere (i.e. through benchmarking). Where the contract costs are not inconsistent with those benchmarks the regulator will be able to have more confidence that the tender process was competitive.
  - In the case of the AMI program, the tender arrangements might provide that final contractual details are subject to negotiation between the distributor and the successful contractor. The regulator will need to be satisfied that these negotiations are carried out on a competitive basis and that the outcomes are appropriate. It would not be consistent with a competitive tender process if the successful contractor was selected through an appropriate tender process but the negotiated outcomes bore little resemblance to the final tender submitted or introduced substantial variations to the original tender. This is particularly the case where the winning tenderer is a related party or where the tender outcomes result in a substantial amount of risk being allocated the distributor (and, by implication, its customers). The regulator will therefore review key elements of the final

contractual arrangements entered into with the successful contractor and compare them with submitted bids. Amongst other things the regulator will review:

- the incentive arrangements, if any, under the contract
- the manner in which legal, technical, financial and other risks are shared between the distributor and the successful contractor
- Distributors should provide:
  - information that demonstrates that the services provided under the contract are aligned with the services for which a distributor can seek cost recovery under the revised Order
  - details of how the contract price compares with industry benchmarks or published list prices, including how the industry benchmarks have been calculated
  - full details of the relationships between the parties
- Where necessary, the regulator may require the provision of information directly from the business providing the outsourced services.
- The ESCV acknowledges there may be many situations where the regulator might consider that it is more likely than not that expenditure will not be incurred. For example:
  - where the forecast expenditure on a particular cost item is so much greater than what the regulator considers a reasonable distributor should spend on that item.
  - where expenditure on a specific cost item is not likely to be incurred to any extent. For example, this might include a contingency amount which the regulator considers is not likely to eventuate
- The regulator 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 on a case by case basis and on its merits in determining whether it involves a substantial departure from the commercial standard that a reasonable business would exercise in the circumstances.
- In the event that the regulator considers that the contracts did not follow from a competitive tender process it will need to consider whether the costs under the contract are likely to be incurred, and then whether the expenditure represents a substantial departure from the commercial standard a reasonable business would exercise in the circumstances. In doing so the regulator will consider the following specific matters relevant to related party contracts:
  - 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.

## 2.4 Summary of submissions

CitiPower (CP) and Powercor (PC) made a joint submission relating to the proposed positions on the analytical framework. Submissions were also received from SP AusNet (SPA) and Origin and a joint submission from Jemena Electricity Networks (Vic) Ltd (JEN) and United Energy Distribution (UED).

### 2.4.1 Analytical framework

In their submission JEN/UED stated that the revised Order is based on the premise that all costs are to be passed through unless the regulator is able to establish that the expenditure is outside scope or not prudent. The revised Order appropriately seeks to reduce regulatory discretion, thereby minimising regulatory risk. Specifically, the revised Order clearly defines the prudence test, with little discretion in how the test is to be applied.

JEN/UED also stated that the tests are markedly different to the efficiency tests applied in other regulatory settings. They drew attention to the use in the revised Order of the word ‘establish’ rather than ‘determine’, which they state is often used in other regulatory settings. They conclude that the regulator, therefore, cannot simply ‘determine’ that the tests for approval have not been met, but must establish, as a legal fact, that disapproval is warranted. The onus of proof is therefore on the regulator.

CP/PC stated that the regulator’s power to establish a framework and approach paper and information templates does not extend to requiring distributors to provide information to which the regulator cannot permissibly have regard in discharging those functions and powers.



SPA stated that the onus of proof is on the regulator with respect to the scope and prudency tests. The consultation paper positions misinterpret the revised Order and seek to shift the onus of proof onto distributors.

SPA also stated that the regulator should recognise the limitations of the flowchart shown in the consultation paper, as it does not fully capture the requirements of the revised Order.

#### **2.4.2 Is expenditure within scope?**

JEN/UED stated that scope, as defined in the revised Order, defines recoverable costs as those reasonably required for the provision of the services and to meet regulatory obligations or requirements. SPA makes a similar statement. JEN/UED also stated that schedule 2 is not a list of activities which the distributor must undertake – it simply lists specific activities that do or do not meet the scope test. Additionally, JEN/UED and SPA stated that for any activity not explicitly mentioned in the detailed part of Schedule 2, the overarching scope test applies.

SPA stated that the regulator is not to determine whether expenditure is within scope but whether it is outside scope.

In their submission JEN/UED stated that it is inappropriate to examine cost levels as part of scope test, including by comparing across businesses

SPA stated that information requested by the regulator must be relevant to its limited task. Templates that are directed to a list of expenditure against each scope line item have no foundation in the revised Order for the purposes of determining if expenditure is outside scope

In its submission SPA stated that seeking information on the financial value of individual scope items confounds the 2 tests. Specifically, the prudency test deals with the level of costs, while the scope test does not. Therefore there is no role for the list of information required as set out in the consultation paper.

JEN/UED stated that it is inappropriate to consider double recovery. Similarly, SPA stated that double recovery is not an issue as there is independent audit certification of expenditure.

In their joint submission CP/PC stated that comparison across distributors of expenditure by scope line items is not an appropriate part of assessing whether expenditure is within scope. It is not appropriate due to scope differences and therefore it is not within the regulator's power to undertake it.

SPA DBs have different approaches and they need flexibility without fear of not meeting a mythical 'one size fits all' scope test

In its submission Origin stated that where distributors are to provide expenditure against each of the scope line items, the regulator should seek detailed information to ensure that there is no double recovery of overheads. Origin is not convinced that comparisons between distributors will be sufficient and it encourages the development of alternative benchmarks.

JEN/UED stated that applying the auditor requirements from clause 5I.3 of the revised Order to all years (rather than the requirements from clause 5H.2) appears to imply disregarding clause 5H.2. Such an approach would not be consistent with the revised Order.

Origin stated its support for tripartite type arrangements to cover the whole period.

JEN/UED agreed with the view that it is not inappropriate for the regulatory accounts auditor to conduct AMI audits.

SPA stated that the consultation paper does not recognise that the regulator must approve the auditor's appointment if certain criteria are met.

### **2.4.3 Is expenditure a contract cost?**

JEN/UED stated that most of the information sought is not relevant to establishing whether a certain item of expenditure is a contract cost.

Similarly, SPA stated that it will provide information which relates expenditure to contract costs. It considers that as long as payments are made pursuant to contractual obligations there is no need for further information.

In their submission JEN/UED stated that the proposed requirements would be an onerous compliance burden, especially with respect to payment schedules and breaking payments down into the four categories provided. Additionally, much of the information sought is subject to non-disclosure and confidentiality agreements, but that once broken down at the level required in the data templates vendors' competitors will be able to determine contract prices.

Origin stated that the regulator needs a detailed understanding of the contracts and that this is complicated by related party issues.

### **2.4.4 A competitive tender process**

The submission from JEN/UED stated that the consultation paper focused on matters which would be relevant if the task was to determine whether contract costs are efficient. Instead, the prudency test in the revised Order is limited to consideration of whether a competitive tender process was followed. Since the test is focused on the tender process, there is no scope for the regulator to consider tender outcomes in determining whether a competitive tender process was followed. In addition, they stated that there is no provision in the revised Order for the regulator to infer things when applying the relevant tests.

CP/PC stated that cost recovery risk is materially increased, based on the consultation paper, relative to that on the face of the revised Order. Specifically, the contracting criteria set out in the consultation paper do not give them confidence that they will recover costs actually incurred consistent with the 'pass through' model established in the revised Order.

The joint submission from CP/PC also states that clauses 5C.10 and 5I.9 state what the regulator 'must have regard to' and by inference require that the regulator have regard to no other considerations. The revised Order does not permit inferences to be drawn from tender process outcomes in respect of the competitiveness of the tender

process. Therefore outcomes and the costs and benefits with respect to related party contracts are not permissible relevant considerations. The regulator has no power to undertake industry benchmarking of tender outcomes. Benchmarking of prices is also not appropriate as the prudence of prices is determined under the revised Order as being from a competitive tender process.

Similarly, SPA stated that relevant matters are set out in clauses 5C.10 and 5I.9 of the revised Order. Outcomes are not included, only process. An inference regarding outcomes is not sufficient to establish as a fact that the process was not competitive. The submission also states SPA's view that the regulator is not required to consider and determine whether a competitive tender process has taken place, and the distributor is not obliged to demonstrate that it has. The task of the regulator is to establish that a contract was not let in accordance with a competitive tender process. The regulator cannot consider material that simply goes to its 'confidence' in the process.

CP/PC also stated that the regulator cannot realistically apply criteria retrospectively to a process that took place over the last two years and which was undertaken in good faith. Additionally, the proposed requirements impose unjustifiable compliance costs. These include the costs of providing business cases for contractual vs. internal provision of services, demonstrating synergies where joint tenders are undertaken and re-engaging the probity auditor as the scope adopted is not consistent with that set out in the consultation paper.

In its submission, Origin supports the proposed positions relating to consideration of tender outcomes, probity, process requirements and additional scrutiny if related party issues apply.

#### **2.4.5 More likely than not that expenditure will be incurred**

JEN/UED stated that the regulator is required to approve expenditure unless it can establish, rather than simply consider, that it is more likely than not that the expenditure will be incurred. They also stated that the first example provided in the consultation paper is not relevant as the test does not include consideration of the level of costs that a reasonable distributor should incur.

The submission from SPA states that the test described in the consultation paper is different from what is in the revised Order. The revised Order refers to the regulator establishing that it is more likely than not that expenditure will be incurred. The consultation paper instead refers to a "situation where the (regulator) considers..." SPA also stated that the move from an incentive based to a pass through framework was to eliminate contingency and reward and penalty payments and that therefore the concern with them shown in the consultation paper is unnecessary.

Origin stated its concern that the balance of probabilities under the test will lead to the regulator reaching overly cautious conclusions. In addition, Origin stated that contingency amounts are not appropriate as the revised Order allows recovery of 120% of approved budget amounts.

#### **2.4.6 A substantial departure from the commercial standard a reasonable business would exercise**

The submission from JEN/UED stated that the consultation paper did not provide the regulator's interpretation of the test. They stated that this is an important test and that guidance on how the regulator intended to apply it would be appreciated. JEN/UED also stated that the main consideration should be whether it was unreasonable for the distributor to incur the expenditure in the way it was incurred, given the other genuine options available to it.

SPA stated that it supported the approach set out in the consultation paper.

In its submission Origin stated that it is concerned that the 'substantial departure' requirement under the test will lead to overly cautious conclusions being reached by the regulator. Additionally, Origin is keen that the relevant concepts are defined more clearly.

#### **2.4.7 Existing contractual arrangements with related parties**

In their submission JEN/UED stated that the revised Order contains no special provisions for related parties. They also stated that the proposed considerations are not appropriate as they appear to introduce economic efficiency tests.

SPA stated that it is unclear how the matters listed in the consultation paper are relevant to establishing the commercial standard, the circumstances of the distributor and that the distributor departed from the commercial standard a reasonable business would exercise in the circumstances.

SPA also drew attention to clause 5C.9 of the revised Order and stated that audit certification is only relevant to actual expenditure in 2009. SPA also noted that this clause deems auditor certified expenditure to be within scope – it does not say that uncertified expenditure is outside scope.

### **2.5 Issues, AER considerations and AER approach**

Having had regard to submissions to the consultation paper published by the ESCV and the requirements of the revised Order, the AER's approach to the analytical framework is set out below.

#### **2.5.1 Analytical framework**

One of the key decisions the regulator must make revolves around whether actual and forecast expenditure is to be included in revised charges. The revised Order is prescriptive as to the matters the regulator must consider when making this decision.

SPA stated that the regulator should recognise the limitations of the flowchart shown in the consultation paper, as it does not fully capture the requirements of the revised Order.

The flowchart included in this final decision is to provide a visual overview of the tests. It is not intended to replace the revised Order or reproduce its requirements entirely.

In relation to the decision points in the flowchart the consultation paper stated that the regulator would be ‘determining whether expenditure is within scope’ and ‘determining whether expenditure is a ‘contract cost’’. It also referred to the regulator ‘determining whether expenditure is prudent or not’.

The submission from JEN/UED drew attention to the use in the revised Order of the word ‘establish’ rather than ‘determine’. They conclude that the regulator, therefore, cannot simply ‘determine’ that the tests for approval have not been met, but must establish, as a legal fact, that disapproval is warranted.

The AER acknowledges that the revised Order uses the word ‘establish’ and the AER will be establishing the facts as required by the revised Order.

SPA’s response to the consultation paper stated that the onus of proof is on the regulator and that the consultation paper misinterprets the revised Order and seeks to shift the onus of proof onto distributors.

The AER has considered the approach taken in the ESCV paper and considers it does not misinterpret the revised Order in this regard. This final decision sets out the AER’s approach to applying the tests in the revised order.

JEN/UED stated that the revised Order appropriately seeks to reduce regulatory discretion, thereby minimising regulatory risk. Specifically, the revised Order clearly defines the prudency test, with little discretion in how the test is to be applied.

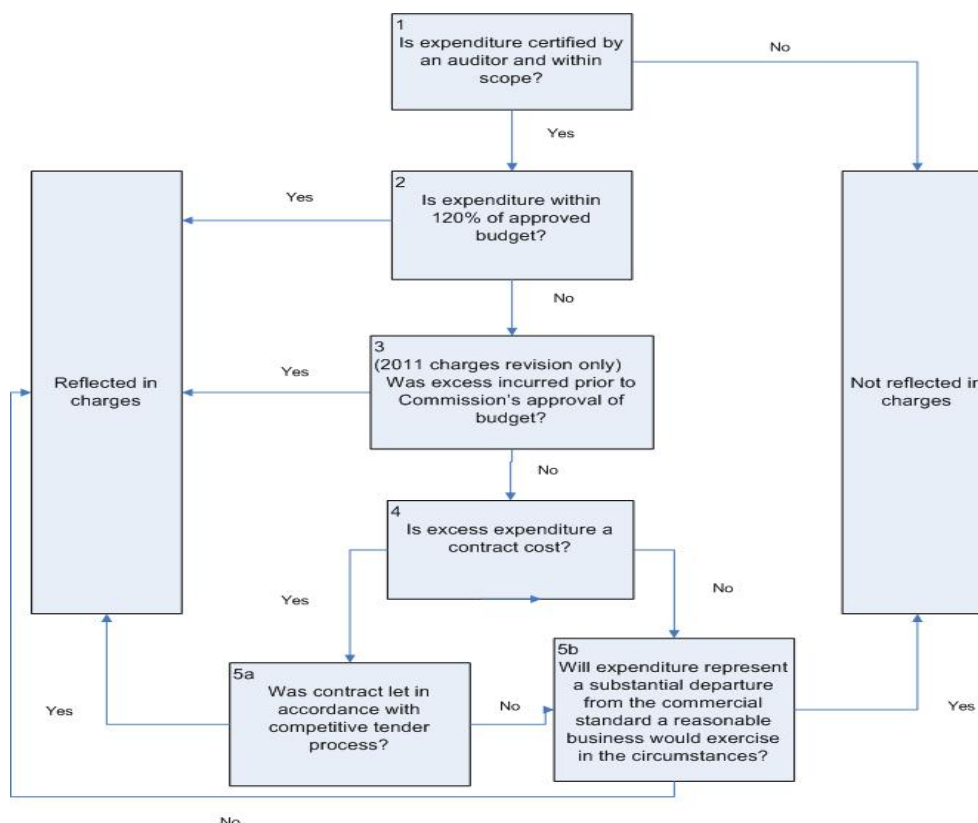
The revised Order sets out a framework under which charges for the provision of AMI services will be set. This framework includes a number of tests and sets out some of the matters the regulator must have regard to when applying the tests. The regulator has the power to exercise its discretion when applying the tests, as long as that discretion does not result in the tests being applied contrary to the revised Order.

CP/PC stated that the regulator’s power to establish a framework and approach paper and information templates does not extend to requiring distributors to provide information to which the regulator cannot permissibly have regard in discharging those functions and powers.

The AER considers that the information sought under this framework and approach final decision and its associated data templates is information which is appropriate for the regulator to have regard to when conducting the tests set out in the revised Order.

The decision flowchart (figure 2.1) is a representation of the process applying to charges revisions applications, and is included as an example of the decision making requirements under the Order. It includes decisions relating to scope and whether costs are prudent which are similar to those in relation to a budget application.

**Figure 2.1 Decision flowchart for assessing charges revisions applications in initial AMI budget period**



As can be seen from the flowchart the main decision points include:

- establishing whether expenditure is within scope
- establishing whether expenditure is a ‘contract cost’
- establishing whether a contract was let in accordance with a competitive tender process
- establishing whether expenditure will represent a substantial departure from the commercial standard a reasonable business will exercise in the circumstances.

In relation to making a determination of the original budget against which actual expenditure can be compared (step 2) the regulator is required to approve a budget proposed by a distributor unless the regulator can establish that the expenditure is

- for activities that are outside scope at the time of the commitment to that expenditure and at the time of the budget determination or
- is not prudent.

In establishing whether expenditure is prudent the regulator is required to follow steps three to five in the above flowchart. The matters discussed below are therefore relevant both to the budget application and charges revision application process.

### **2.5.2 Is expenditure within scope?**

A key element of the revised Order is that the regulator is only required to determine charges that are based on expenditure that is ‘within scope’ at the time of commitment to or incurring that expenditure.

In the consultation paper it was stated that Schedule 2 to the revised Order consists of a list of activities that the distributor must undertake in order to give effect to the AMI rollout and also indicates certain activities which are outside scope. It stated that Schedule 2 is essentially a description of the activities that need to be undertaken and which are associated with the provision, installation, maintenance and operation of advanced metering infrastructure and associated services and systems.

In response to the consultation paper a number of distributors stated that scope defines recoverable costs as those reasonably required for the provision of the services and to meet regulatory obligations or requirements. JEN/UED also stated that schedule 2 is not a list of activities which the distributor must undertake—it simply lists specific activities that do or do not meet the scope test.

In establishing whether expenditure is within scope the AER will be applying the definition of scope in the revised Order. The AER agrees that the test is based on the definition and that Schedule 2 lists activities which are agreed to be inside or outside scope. Activities not on Schedule 2 may be within scope, or not, based on whether they are reasonably required for the provision of regulated services and to comply with a metering regulatory obligation or requirement.

In the consultation paper it was proposed that in order to review whether expenditure is within scope it will be necessary for the regulator to receive information which relates the expenditure to the scope – i.e. a list of expenditure against each item of scope.

In its submission SPA stated that templates that are directed to a list of expenditure against each scope line item have no foundation in the revised Order for the purposes of determining if expenditure is outside scope

A number of distributors stated that it is inappropriate to examine cost levels as part of scope test, including by comparing across businesses.

The AER understands that the scope test requires it to establish whether expenditure is for activities that are outside scope and to apply this test it will not be seeking information on the financial value of individual scope line items. This is reflected in the data templates released along with this final decision.

It will apply this test by seeking to understand how the expenditure proposed relates to the activities being undertaken, and how these activities relate to the scope, based on the definition and having regard to Schedule 2.

In the consultation paper it was stated that one of the ways in which the regulator may conduct an initial review of whether expenditure is within scope (particularly in respect of budget applications) is to compare expenditure on a category-by-category basis across the distributors. Where expenditure in one area for a particular distributor is significantly different from the other distributors the regulator will seek information from that distributor in order that it can further investigate whether expenditure is within scope.

In their joint submission CP/PC stated that comparison across distributors of expenditure by scope line items is not an appropriate part of assessing whether expenditure is within scope due to scope differences.

SPA referred to the fear of not meeting a mythical 'one size fits all' scope test.

In contrast, Origin stated that it is not convinced that comparisons between distributors will be sufficient and it encourages the development of alternative benchmarks.

The AER recognises that distributors have differences in the scope of activities they will be undertaking, for example due to differences in the starting point of each business with respect to the level of development of IT systems. The AER does not therefore intend to apply a 'one size fits all' approach to scope.

With respect to the comparison of expenditure between businesses, and potentially against other benchmarks as suggested by Origin, the AER does not intend to compare expenditure across businesses, or against benchmarks, broken down by scope line item, as part of the scope test.

The revised Order contemplates that initial budget applications and charges revision applications may be accompanied by an audit report which certifies that expenditure incurred is within scope. However, where this is the case the regulator is bound to accept the certification in respect of initial budget applications and in respect of the charges revision application for 2011 charges. However this is not the case for charges revision applications in other years. For these other years the regulator will pay close regard to that certification when forming its view of whether expenditure is within scope. However ultimately the decision on whether expenditure is within scope must be made by the regulator on a case-by-case basis. Further discussion of the audit certification is provided below.

Another matter which relates to scope is the allocation of business overheads to the AMI project. The distributors will incur a substantial level of overheads and management costs associated with the AMI process. The distributors will also incur similar costs associated with the provision of general services and for which recompense has been provided through DUoS charges.

In the consultation paper it was stated that it is important that the distributors are not able to 'double recover' these costs through both DUoS charges and AMI charges.



The regulator will need to be provided with information that demonstrates that this double recovery has not occurred and will closely review overheads and management costs.

In their submissions a number of distributors stated that it is inappropriate or unnecessary to consider double recovery.

Conversely Origin stated that the regulator should seek detailed information to ensure that there is no double recovery of overheads.

The AER notes that it is required by the revised Order to establish whether expenditure is for activities which are within scope. Overheads and management costs that are not related to AMI activities would not be within scope and given the nature of these costs it is appropriate that the AER considers whether the activities they relate to are within the AMI scope. As noted above in this section, the regulator is bound by the auditor's certification for 2011 charges, but not for other years, and it is appropriate that it makes its own evaluation, applying the test as it is required to.

In considering the matter of scope it is also necessary to take into account the relevant specifications for providing the services. For performance in excess of the minimum Victorian specifications, distributors will need to provide a separate cost/benefit analysis quantifying benefits to the distributor, retailers and end customers, and demonstrating why regulated tariffs should provide the revenue required.

Finally, it should be noted that expenditure and revenue in relation to exit and restoration fees, unmetered supplies and customer requested services is deemed to be outside scope by the revised Order.

#### **2.5.2.1 Timing**

When considering a budget application or charges revision application in order for the regulator to establish that activities are not within scope it must establish that those activities:

- were outside scope at the time of commitment to that expenditure and
- were outside scope at the time of the budget determination or incurring of that expenditure.

This implies that if expenditure was within scope at the time it was committed to, but outside scope at the time it was spent, the regulator must include it in the revised charges.

#### **2.5.2.2 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 revised Order also contemplates that an AMI budget period application may be accompanied by an audit report. In each case, the report must certify that the expenditure incurred is within scope (in the case of an AMI budget application this must be at the time of the commitment and the time of the audit report), and has been incurred in the amount claimed.

The revised Order makes clear that in the case of a budget application and a charges revision application for 2011 charges, the auditor must be approved by the regulator or in default of approval, nominated or engaged by the regulator. The revised Order also specifies the qualifications that the auditor must hold and requires an auditor to have a formal duty to both the regulator and the distributor to conduct audits independently.

Similar provisions do not apply in the case of charges revision applications for years other than 2011. However, the consultation paper included the view is that it is also desirable that the audit appointment process for charges revision applications in other years complies with the same requirements.

In its response to the consultation paper Origin stated its support for tripartite type arrangements to cover the whole period.

However JEN/UED stated that applying the auditor requirements from clause 5I.3 of the revised Order to all years (rather than the requirements from clause 5H.2) appears to imply disregarding clause 5H.2. Such an approach would not be consistent with the revised Order.

The AER considers that the Order does not support requiring the audits for charges revision applications for years other than 2011 to be subject to requirements similar to those in clause 5I.3 of the revised Order, notwithstanding that this may be desirable. Therefore the appropriate requirements for charges revision applications for years other than 2011 are those set out in clause 5H.2 of the revised Order.

For the charges revision application for 2011, prior to the audit process commencing, the AER will provide the auditors with a briefing as to what matters they should consider and how they should ultimately form a view as to whether expenditure is within scope. Given that the revised Order binds the regulator to the auditor's view in respect of budget applications and in respect of the charges revision application for 2011 charges (but not charges revision applications for other years), this will enable the AER to have the maximum confidence in the eventual audit report.

In the consultation paper it was proposed that, in order to minimise costs and ensure consistency, it would not be inappropriate for the auditors appointed to audit the distributors' regulatory accounts to undertake this AMI audit. This is particularly the case for the audit certification which is required to be included with the charges revision application for 2011 charges, and which will need to provide certification on incurred expenditure from 2006 to 2009.

JEN/UED agreed with the view that it is not inappropriate for the regulatory accounts auditor to conduct AMI audits and the AER also supports this view.

Finally, SPA's submission stated that the consultation paper does not recognise that the regulator must approve the auditor's appointment if certain criteria are met. The AER is aware of this requirement, as set out in clause 5I.3 of the revised Order.

### **2.5.3 Is expenditure a 'contract cost'?**

In considering the matter of whether expenditure is prudent, the regulator must also consider whether expenditure is a 'contract cost'. The revised Order provides a

different threshold for approving expenditure incurred pursuant to a ‘contract’ compared to other expenditure. This threshold ensures that as long as a distributor legitimately commits to expenditure pursuant to a major contract then it will be able to recover that expenditure.

The term ‘contract cost’ is defined in the context of an AMI budget application as:

expenditure incurred pursuant to a contract entered into by a distributor:

(a) prior to the day on which a distributor makes its initial AMI budget period budget application or subsequent AMI budget period budget application (as the case may be); or

(b) if a revised initial budget application has been made by the distributor pursuant to clause 5B.3, prior to the day on which that application was made,

but does not include expenditure incurred pursuant to a variation of that contract where that variation is entered into or takes effect after that day.

A similar definition applies to contract cost in the context of a charges revision application.

The definition is silent on when expenditure is incurred, referring solely to when the contract is entered into.

A key issue for the regulator will be determining whether expenditure is in fact incurred pursuant to a contract and does not represent:

- expenditure that is not related to any contract
- expenditure that may be related to a contract but is not consistent with the terms of the contract

In relation to the latter point, while some contracts will be for fixed amounts, other contracts may provide for:

- payment to be based partly on the actual costs incurred by the contractor (eg for materials)
- variable payments e.g. based on the number of meters installed
- performance-based penalties or rewards
- other margins or contingencies.

The consultation paper proposed that in order to establish whether expenditure has been incurred pursuant to a contract, the regulator will need to be provided with details relating to each contract. The detailed information required is set out in the consultation paper and includes the requirement that payments made under the contract to date are separated into fixed payments, variable payments, performance based penalties or rewards and other margins or contingencies.

A number of distributors stated that most of the information sought is not relevant to establishing whether a certain item of expenditure is a contract cost and that as long as payments are made pursuant to contractual obligations there is no need for further information.

JEN/UED stated that the proposed requirements would be an onerous compliance burden, especially with respect to payment schedules and breaking payments down into the four categories provided. Additionally, much of the information sought is subject to non-disclosure and confidentiality agreements, but that once broken down at the level required in the data templates vendors' competitors will be able to determine contract prices.

Origin stated that the regulator needs a detailed understanding of the contracts and that this is complicated by related party issues.

The AER agrees with Origin that the regulator needs a detailed understanding of the contracts. Much of the information proposed in the consultation paper is required for the application of the contract cost test. The regulator needs a sufficient understanding of the contracts to be able to identify expenditure that is not related to any contract or that may be related to a contract but is not consistent with the terms of the contract.

This final decision has clarified these requirements. In particular the AER's framework and approach paper does not include the requirement proposed in the consultation paper to submit, with each charges application, a breakdown of payments made under the contract to date separated into fixed payments, variable payments, performance based penalties or rewards and other margins or contingencies. This level of breakdown is restricted to the budget application, which should ease compliance concerns.

With respect to confidentiality and competition issues, the level of detail sought in the data templates approved as part of this final decision is different to the proposed positions and should not enable contract prices to be determined. Should confidential information be required to support a budget or charges application, then the distributor should ensure it is identified as such.<sup>4</sup>

For the AER to establish whether expenditure has been incurred pursuant to a contract it will need to be provided with the following as part of each budget application:

- an overview of each contract entered into, including the third party contractor and the nature of the services provided
- the total estimated value of the contract
- payment schedules
- details of the financial terms of the contract including:

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<sup>4</sup> The AER's obligations regarding confidentiality and the disclosure of information provided to it by a DNSP are governed by the *Trade Practices Act 1974* and as appropriate the National Electricity Law (NEL) and the NER. For further information see the ACCC/AER's Information Policy, which is available on the AER's website.

- fixed payments
- variable payments
- performance based penalties or rewards
- other margins or contingencies

A charges application will need to relate the contract expenditure incurred to the contract information which was provided as part of the budget application process.

Where expenditure is incurred pursuant to a variation to a contract, which is entered into or takes effect after the day the distributor made its budget application, the regulator is required to consider that expenditure alongside other non-contract expenditure.

#### **2.5.4 A competitive tender process**

Under the revised Order the regulator must consider whether a contract was let in accordance with a competitive tender process in the following circumstances:

- when reviewing initial budget applications under clause 5C.3
- making a determination of revised charges under clause 5I.7.

The revised Order provides that in assessing whether a contract was let pursuant to a competitive tender process the regulator is required to have regard to:

- the competitive tender process of the distributor
- whether there has been compliance with that process
- whether the request for tender unreasonably imposed conditions or requirements that prevented or discouraged the submission of any tender that is consistent with the tender process.

The consideration of whether a competitive tender process has taken place is relevant in the case of both:

- ‘new’ contracts awarded for AMI-related activities
- AMI work that is undertaken pursuant to existing contracts

Where the regulator has determined that a competitive tender process has not been followed, then the expenditure is assessed against different thresholds if it is to be reflected in charges.

##### **2.5.4.1 General approach**

The submission from JEN/UED stated that the consultation paper focused on matters which would be relevant if the task was to determine whether contract costs are efficient. Instead, the prudency test in the revised Order is limited to consideration of whether a competitive tender process was followed.

CP/PC stated that cost recovery risk is materially increased, based on the consultation paper, relative to that on the face of the revised Order.

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.

A number of distributors stated that clauses 5C.10 and 5I.9 state what the regulator 'must have regard to' and by inference require that the regulator have regard to no other considerations. The revised Order does not permit inferences to be drawn from tender process outcomes in respect of the competitiveness of the tender process. Therefore outcomes and the costs and benefits with respect to related party contracts are not permissible relevant considerations.

The AER does not consider that clauses 5C.10 and 5I.9 of the revised Order exhaustively set out the matters the regulator can have regard to. Neither clause limits the matters the regulator can have regard to.

Additionally, the AER does not consider that the revised Order prevents the regulator from making inferences when applying the tests, including inferences from tender outcomes.

In its submission, Origin supports the proposed positions relating to consideration of tender outcomes, probity, process requirements and additional scrutiny if related party issues apply and the AER for the most part supports those positions and has affirmed them in this final decision.

In establishing whether a competitive tender process has taken place the AER will have regard to, amongst other things, the actual tender process documented, the process carried out by the distributor and the tender outcomes. This is because although a distributor's documentation may suggest that an appropriate tender process has been carried out, the outcomes of the tender could represent a substantial departure from a competitive outcome (eg in relation to prices, risk sharing etc).

As part of the budget application, and if requested by the AER to support a charges revision application, the distributor is to provide a probity auditor's report prepared by a suitably qualified independent probity expert, who was not involved in designing, validating or operating the distributor's tender or probity processes. The report may consider past or future tender processes, dependent on the completeness of the processes at the time of the report.

CP/PC stated that the proposed requirements impose unjustifiable compliance costs. These include the costs of providing business cases for contractual vs. internal provision of services, demonstrating synergies where joint tenders are undertaken and re-engaging the probity auditor as the scope adopted is not consistent with that set out in the consultation paper.

The AER understands that CP and PC are concerned that the requirement to provide business cases for contractual vs. internal provision of services means they will be expected to provide a business case for services that they would never contemplate providing internally. An example is the purchase of meters; they are concerned that they will be required to provide a business case showing why they chose not to manufacture meters themselves. The proposed position does not envisage the creation of a detailed business case to address this question.

This requirement has been clarified in this final decision. An explanation will be required stating why the choice was made for contractual rather than internal provision of services. Where the AER considers that it needs to examine the choice more fully the distributor may be required to provide a business case.

CP and PC have explained that joint purchasing is the usual approach they take to obtaining services and that each business does not seek information from providers on what the costs would be if the services were provided to that business only.

The requirement to demonstrate synergies is set out in this final decision as requiring businesses to explain why they consider each joint tender to be appropriate for each distribution business. Where the AER considers that it needs to examine the choice more fully the distributor may be required to provide details of the synergies obtained.

With respect to re-engaging the probity auditor, the AER considers that it is important that the scope of the probity audits meets the AER's requirements, given the importance of the competitive tender process test. In some cases this may involve re-engaging the probity auditor.

CP/PC also stated that the regulator cannot realistically apply criteria retrospectively to a process that took place over the last two years and which was undertaken in good faith. Whilst it is recognised there is a general presumption against retrospectively applying legislative instruments in the law, the AER does not consider it is appropriate in this instance to not apply the approach set out in this framework and approach paper in its considerations of whether a distributor's tender process, which may have commenced prior to the revised Order was competitive. The contrary view would undermine a fundamental tenet of the AER's role under the revised Order.

Accordingly, the AER intends to assess without exception whether a contract a distributor may have entered into was not let in accordance with a competitive tender process as appropriate.

#### **2.5.4.2 Tender processes**

In establishing whether a competitive tender process has taken place (or will occur), considerations the AER will take into account include whether the distributor has demonstrated:

- that the initial request for tender documentation is made widely available to all parties that might be interested in tendering
- that, if adopted, any multi-stage tendering process is appropriate given the nature of the services sought and the number and prospects of potential bidders

- that the issued tender documentation:
  - provides adequate information about the background to the AMI program and the distributor
  - details the tender process
  - provides a detailed specification of the services sought
  - adequately addresses matters such as risk sharing and contractual terms and conditions
  - where appropriate, sets out the tender evaluation criteria
- that adequate time has been allowed for bid preparation and between tender stages, taking into account the scope and complexity of information sought from tenderers
- that the request for tender does not unreasonably impose conditions that prevent or discourage the submission of any tender. For example, these might include the payment of high fees for receiving tender documentation, technical requirements that are unreasonably high given the nature of the tender, unreasonable liability requirements, or any other requirements that impose unduly high expenses on potential tenderers
- that detailed and appropriate tender evaluation criteria have been developed and applied. The design of the tender and the evaluation criteria need to ensure that, as far as possible, competing bids are easily comparable.
- that any ‘bundling’ of different services into a single contract is appropriate and that the advantages of doing so (economies of scale, reduced administration costs) outweigh the costs (less competition)
- that appropriate tender briefings have been conducted and tenderers have been provided with the opportunity to clarify aspects of the tender
- that the distributor has taken appropriate steps to verify the information provided in tender responses, including referee interviews, field trials, and other checks
- that any post-tender negotiations with the successful tenderer are consistent with the tender and do not call into question the original selection decision
- that the outcome of major tenders have been considered and approved by the distributors’ boards of directors
- that for large contracts, a probity audit of the tendering process has been conducted.

The AER may also have regard to whether the tender has been carried out in accordance with the relevant Australian Standards.



The probity auditor's report is to address the issues raised above, and also set out the scope of the probity audit and state whether, if a probity plan was in place, it has been complied with.

In addition to the above, the AER will also consider, where it considers appropriate, whether there is a clear business case demonstrating why contractual arrangements are likely to lead to better outcomes than internal provision of services. To support this distributors are required to state why the choice was made for contractual rather than internal provision of services. Where the AER considers that it needs to examine the choice more fully the distributor may be required to provide a business case.

Relevantly, where it is evident that distributors have conducted tender processes simply because:

- contract costs have a different regulatory approval threshold under the revised Order, or
- it is likely that a related party will win the contract

this may be indicative of the tender process not being competitive.

The AER will also consider the following matters and seek information from the distributors that confirms:

- that the tender process is consistent with the distributors' overall procurement program and risk management strategy
- that where a 'multi-vendor' approach to procurement has been selected, that this approach has clear benefits compared to a single-vendor approach
- where competing technologies are available for a certain application (e.g. metering solutions for suburban environments), distributors have considered seeking bids for each of these competing technologies from multiple vendors.

Where distributors undertake joint tenders they are to explain why they consider each joint tender to be appropriate for each distribution business. Where the AER considers that it needs to examine the choice more fully the distributor may be required to provide details of the synergies obtained. In some cases this may require standalone costs relating to each distributor to be demonstrated by market testing standalone, individual distributor, projects.

Naturally the degree of complexity and detail surrounding the tender process will be related to the size of the contract. In relation to large contracts, the AER acknowledges that the distributors may seek external assistance or advice regarding the design and implementation of the tendering process.

In respect of contracts with existing related parties, the AER will also examine the circumstances in which the contract was entered into, for example, whether the contract was entered into on a stand alone basis or whether it was entered as part of a broader set of commercial arrangements or part of a broader transaction.

The AER does not consider it appropriate to approve, before the fact, a specific tender process. The AER will assess each tender process and outcome case by case on its merits, taking into account any information provided on the process.

#### **2.5.4.3 Tender outcomes**

The revised Order provides for the regulator to establish whether a contract was let in accordance with a competitive tender process. The AER considers that it is useful and appropriate to review tender outcomes when establishing whether a contract was let in accordance with a competitive tender process.

In considering whether a contract was let in accordance with a competitive tender process the AER will have regard to the outcomes of the tender, including:

- the number of respondents to the tender
- the identity of the successful contractor, and specifically whether the successful contractor is a related party
- the final contractual agreement with the successful contractor.

The higher the number of responses to a tender in general the greater the degree of confidence the AER will have that a tender process was competitive. At the same time the AER accepts that a low number of responses does not automatically mean that a tender process has not been competitive. This is particularly the case with the AMI project where economies of scale and technical complexity may reduce the pool of potential respondents. However, the AER expects that maximising the number of potential respondents will have been addressed by the distributors in designing their tender processes.

In relation to the identity of the successful tenderer, the AER will place particular scrutiny on a tender process and its outcomes where the successful tenderer is a related party.<sup>5</sup> There are several reasons for this, including:

- where the successful tenderer is a related party this may suggest that there was not a 'level playing field' for the tender process
- the possibility that related party contracts may include matters that are out of scope or prices that are not competitive.

The AER will therefore review contractual outcomes in the case of all tenders, including contracts with related parties. One of the matters the AER will examine is how the costs incurred under the winning contract compare with the cost of similar arrangements elsewhere (i.e. through benchmarking). Where the contract costs are not inconsistent with those benchmarks the AER will be able to have more confidence that the tender process was competitive.

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<sup>5</sup> For the avoidance of doubt, in referring to a party being 'related' to a distributor the AER is not referring to the definition of a related party in the Corporations Act 2001 or in any Australian accounting standard. Rather, it is referring to other parties to the contract, with whom the distributor may have a relationship.

In the case of the AMI program, the tender arrangements might provide that final contractual details are subject to negotiation between the distributor and the successful contractor. The AER will need to be satisfied that these negotiations are carried out on a competitive basis and that the outcomes are appropriate. It would not be consistent with a competitive tender process if the successful contractor was selected through an appropriate tender process but the negotiated outcomes bore little resemblance to the final tender submitted or introduced substantial variations to the original tender. This is particularly the case where the winning tenderer is a related party or where the tender outcomes result in a substantial amount of risk being allocated the distributor (and, by implication, its customers). The AER will therefore review key elements of the final contractual arrangements entered into with the successful contractor and compare them with submitted bids. Amongst other things the AER will review:

- the incentive arrangements, if any, under the contract
- the manner in which legal, technical, financial and other risks are shared between the distributor and the successful contractor

The distributors should therefore bear the above matters in mind when providing information to support their applications under the revised Order. For example, the distributors should provide:

- information that demonstrates that the services provided under the contract are aligned with the services for which a distributor can seek cost recovery under the revised Order
- details of how the contract price compares with industry benchmarks or published list prices, including how the industry benchmarks have been calculated
- full details of the relationships between the parties

Where necessary, the AER may require the provision of information directly from the business providing the outsourced services.

### **2.5.5 More likely than not that expenditure will not be incurred**

When considering as part of a budget application within-scope expenditure that is not a contract cost or does not meet the contract cost threshold test, the regulator must establish whether:

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

The consultation paper provided the following two examples of situations where the regulator might consider that it is more likely than not that expenditure will not be incurred:

- where the forecast expenditure on a particular cost item is so much greater than what the regulator considers a reasonable distributor should spend on that item.

- where expenditure on a specific cost item is not likely to be incurred to any extent. For example, this might include a contingency amount which the regulator considers is not likely to eventuate

In response JEN/UED stated that the first example provided in the consultation paper is not relevant as the test does not include consideration of the level of costs that a reasonable distributor should incur.

The submission from SPA states that the revised Order refers to the regulator establishing that it is more likely than not that expenditure will be incurred. The consultation paper instead refers to a “situation where the (regulator) considers...”

The AER recognises that in applying the test the revised Order requires the regulator to establish that it is more likely than not that the expenditure will not be incurred.

The AER also understands that the test does not introduce an efficiency test. Therefore the AER is not able to exclude costs, under this test, by seeking to demonstrate that the proposed costs are greater than those a reasonable distributor would incur.

However, if expenditure items proposed represent the aggregated costs of undertaking a number of activities, the AER may seek to understand, for each activity, whether it is more likely than not that the expenditure related to it will be incurred.

If the AER establishes that it is more likely than not that the expenditure related to a particular activity will not be incurred then the aggregated expenditure proposed will be reduced by this amount. This is not an efficiency test but an appropriate application of the test set out in the Order.

SPA also stated that the move from an incentive based to a pass through framework was to eliminate contingency and reward and penalty payments and that therefore the concern with them shown in the consultation paper is unnecessary.

Similarly, Origin stated that contingency amounts are not appropriate as the revised Order allows recovery of 120% of approved budget amounts.

The AER agrees that there may be examples of contingency amounts which are excluded by the operation of this test. Other examples may include such things as reward and penalty payments, overheads and management costs.

In addition, Origin stated its concern that the balance of probabilities under the test will lead to the regulator reaching overly cautious conclusions. With respect to Origin’s concern, 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.

### **2.5.6 A substantial departure from the commercial standard a reasonable business would exercise**

When considering within-scope 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, the regulator must also consider whether incurring the expenditure:

involves a substantial departure from the commercial standard that a reasonable business would exercise in the circumstances

In doing so the revised Order requires that the regulator take into account and give weight to the circumstances of the distributor or other person incurring or managing the expenditure at the time the commitment was made to incur or manage the expenditure or the expenditure excess (as applicable) including:

- information available to the business or other person
- the nature of the provision, installation, maintenance and operation of advanced metering infrastructure and associated services and systems
- the nature of the roll out obligation
- state of the technology relevant to the provision, installation, maintenance and operation of advanced metering infrastructure and associated services and systems
- risks inherent in a project of the type involving the provision, installation, maintenance and operation of advanced metering infrastructure and associated services and systems
- market conditions relevant to the provision, installation, maintenance and operation of advanced metering infrastructure and associated services and systems
- any metering regulatory obligation or requirement.

In the consultation paper it was proposed that this test will be applied on a case-by-case basis in establishing whether it involves a substantial departure from the commercial standard that a reasonable business would exercise in the circumstances.

JEN/UED stated that the consultation paper did not provide the regulator's interpretation of the test. They stated that this is an important test and that guidance on how the regulator intended to apply it would be appreciated.

In contrast, SPA stated that it supported the approach set out in the consultation paper.

In its submission Origin stated that it is concerned that the 'substantial departure' requirement under the test will lead to overly cautious conclusions being reached by the regulator.

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 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.

### **2.5.7 Existing contractual arrangements with related parties**

A number of distributors currently have existing contractual relationships with related parties. Some of these contracts are longstanding, while others have been entered into specifically in relation to the AMI rollout. The revised Order is clear in relation to how the regulator must consider a budget application which reflects expenditure to be incurred pursuant to these contracts:

- first the regulator must establish whether the expenditure is within scope
- second, the regulator must establish whether contracts have been entered into following a ‘competitive tender process’. This will be undertaken on a case by case basis, and having regard to the matters set out in section 2.5.4. As noted, this will include the circumstances in which the contracts were entered into

In the event that the regulator establishes that the contracts did not follow from a competitive tender process it will need to establish whether the costs under the contract are likely to be incurred, and then whether the expenditure represents a substantial departure from the commercial standard a reasonable business would exercise in the circumstances. Under the proposed position the regulator would consider specific matters relevant to related party contracts.

In response to the proposed position JEN/UED stated that the revised Order contains no special provisions for related parties. They also stated that the proposed considerations are not appropriate as they appear to introduce economic efficiency tests.

The revised Order sets out the tests that the regulator is to conduct in determining approved budgets and charges. It also sets out matters which the regulator must have regard to when conducting the tests. However the Order does not exhaustively define the matters the regulator may have regard to when conducting the tests.

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.

Additionally, in response to the consultation paper SPA stated that clause 5C.9 of the revised Order deems auditor certified expenditure to be within scope – it does not say that uncertified expenditure is outside scope. The AER accepts this view and this final decision does not state that uncertified expenditure is outside scope.

## 3 Technical issues

### 3.1 Introduction

This chapter sets out the AER's approach to specific issues associated with the building blocks calculation including:

- the WACC
- the efficiency carryover mechanism (ECM)
- calculation of taxation
- value of the RAB
- depreciation.

The broader issues associated with regulatory consideration of capital and operating expenditure budgets and charges applications were discussed in chapter 2.

### 3.2 Requirements of the revised Order

In determining charges for regulated services clause 4(1)(b) of the revised Order requires the regulator to adopt a 'building blocks' approach under which the building blocks are:

- a return on capital (i.e. a weighted average cost of capital (WACC) multiplied by the regulatory asset base (RAB))
- depreciation (of the RAB)
- maintenance and operating expenditure
- a benchmark allowance for corporate income tax
- other building blocks relating to, where relevant:
  - net costs (or revenue) associated with providing metering services from 1 January 2006 to 31 December 2008
  - the amount by which DUoS taxation liability was reduced as a result of the ESCV's consolidation of DUoS taxation and metering services in the current price determination
  - the value of any efficiency carryover arising from the current price determination
  - expenditure from 1 January 2006 to 31 December 2008 on trials conducted in accordance with the ISC or as directed or agreed by the Department of Primary Industries



- expenditure from 1 January 2006 to 31 December 2008 on installing, commissioning and maintaining telecommunications and IT systems required to support the AMI infrastructure
- other relevant expenditure incurred from 1 January 2006 to 31 December 2008 on project management and other preparation
- expenditure from 1 January 2006 to 31 December 2008 attributable to interest rate hedging costs and exchange rate hedging costs.

As discussed in chapter 2, these ‘other costs’ do not form part of the initial budget application process and many of these costs are not subject to review by the regulator, except in respect of whether they are related to AMI services or not.

In most regulatory price determinations the building blocks are based on forecasts of operating expenditure, capital expenditure, taxation and volumes. However, under the cost-recovery approach established in the revised Order the building blocks are ultimately based on actual outcomes.

### 3.3 Proposed positions

In its consultation paper, the ESCV described the proposed positions in relation to the building blocks calculation as follows:

- For the calculation of the net costs (or revenue) associated with providing metering services from 1 January 2006 to 31 December 2008 the ESCV proposed that this clause refers to the net actual building block costs in respect of prescribed metering services under the current price determination. The actual building block costs for the calculation of the net costs (or revenue) associated with providing metering services from 1 January 2006 to 31 December 2008 were proposed to be:
  - a return on capital (using the actual regulatory asset base for prescribed metering services over the period)
  - depreciation of the asset base, using the actual regulatory asset base and the asset lives established in the current price determination
  - actual maintenance and operating expenditure
  - a benchmark calculation of tax in respect of prescribed metering services
- The WACC was proposed to be calculated as a ‘nominal vanilla’ WACC in accordance with the following formula:

$$WACC = k_e \frac{E}{V} + k_d \frac{D}{V}$$

where:

$k_e$  = the expected rate of return on equity or cost of equity

$k_d$  = the expected rate of return on debt or cost of debt

$\frac{E}{V}$  = the market value of equity as a proportion of the market value of equity and debt, which is  $1 - D/V$

$\frac{D}{V}$  = the market value of debt as a proportion of the market value of equity and debt

- The cost of equity was proposed to be determined using the CAPM, calculated as follows:

$$k_e = r_f + \beta_e MRP$$

where:

$r_f$  = the nominal risk free rate of return

$\beta_e$  = the equity beta

$MRP$  = the expected market risk premium

- The expected cost of debt was proposed to be calculated in accordance with the following formula:

$$k_d = r_f + DRP$$

where:

$r_f$  = the nominal risk-free rate of return

$DRP$  = the debt risk premium

- At the time of the distributors' budget applications in February 2009, the AER will not have issued its final Statement of Regulatory Intent (SORI), and therefore the methodology to be adopted in determining the WACC will not be established. The ESCV proposed that distributors include a WACC in their budget applications, calculated using the methodology for market observable parameters as set out in the AER's proposed statement of regulatory intent, published in December 2008, as an indicative proxy for the WACC to be applied during the initial AMI WACC period. The ESCV proposed that the regulator would subsequently revise the calculation of the market observable parameters in accordance with the AER's final statement of regulatory intent (which will be published on 31 March 2009) in making its draft decision on the distributors' budget applications.
- The ESCV proposed that the equity raising costs to be recovered be the actual costs incurred, and not benchmark costs. Therefore if no costs were incurred, no cost recovery would need to occur.

- To ensure a ‘like for like’ comparison, and hence ensure that volume changes are not reflected in the ECM as required by the revised Order, the ESCV proposed to make adjustments to the benchmarks set out in the current price determination.
- Benchmark unit costs for meter replacement (customer service), meter data services operating costs and meter maintenance, along with total benchmark costs for metering data services, being maintenance (IT) and operating costs, as set out in the current price determination were reproduced in the consultation paper.
- In the absence of an offsetting incentive, the ESCV proposed that the regulator would need to be provided with evidence from the distributors that all the direct expenditure on metering data services, meter maintenance and meter replacement (customer service) costs have been reported.
- The ESCV proposed that efficiency gains or losses would be retained for five years. Consequently in respect of a gain or loss in 2008 the relevant amount would be applied to the revenue requirement in each year from 2009 to 2013.
- Should a net negative carryover occur it was proposed that it would be applied.
- In order to reflect the benchmark tax losses for metering services for 2006 to 2010, the ESCV proposed to sum the amounts for those years, provided in a table in the consultation paper, adjusted to reflect the time value of money, and to include this amount in the 2010 charges.
- As all capital expenditure for AMI will be new, it was proposed that a more detailed and accurate calculation of benchmark taxation be undertaken than is normally the case.
- The ESCV proposed, in relation to the value of imputation (franking) credits, that the gamma value adopted be that established by the AER in its most recent SORI.
- In determining revised charges for the next year of the initial and subsequent AMI budget periods (i.e. year t+1), the regulator will be required to make an estimate of the metering asset base at that time. The proposed position was that the metering asset base should be calculated consistent with the approach for calculating the opening metering asset base. Thus, for example, when establishing revised charges for 2011 the metering asset base would reflect:
  - actual capital expenditure to 2009 (to the extent that it is within scope and prudent).
  - the most recent approved budget for capital expenditure in 2010 and 2011
  - actual disposals in 2009 and the most recent approved budget for disposals in 2010 and 2011
  - depreciation calculated consistently with the capital expenditure and disposal assumptions and the asset lives in clause 4.1(g) of the revised Order.

- With respect to regulatory asset lives, the ESCV proposed that where it may not be clear as to whether assets are ‘meters and measurement transformers’ or ‘telecommunications assets’ that distributors should clearly outline the reason for the chosen classification.
- For assets which will require depreciation to be accelerated over the period 2010 to 2013 such that their value is zero at the end of 2013, it was proposed that distributors clearly set out in their submissions the number and regulatory asset value of these meters, and the profile of the depreciation.
- Straight line depreciation was proposed.

### **3.4 Summary of submissions**

CitiPower (CP) and Powercor (PC) made a joint submission relating to the proposed positions on technical issues. Submissions were also received from SP AusNet (SPA) and Origin and a joint submission from Jemena Electricity Networks (Vic) Ltd (JEN) and United Energy Distribution (UED).

#### **3.4.1 Net costs (or revenue) associated with providing metering services from 1 January 2006 to 31 December 2008**

Origin stated that the regulator needs to carefully analyse these costs and recognise the net present value to distributors.

#### **3.4.2 Weighted average cost of capital**

CP/PC and SPA stated that WACC is not part of the initial AMI budget period budget application to be submitted on 27 February 2009. SPA pointed out that the SORI conclusions, due to be published on 31 March 2009, can be incorporated in the WACC information provided on 1 June 2009 as part of the 2010-11 initial charges application.

Origin urged the regulator to ensure that debt raising costs are not recovered twice.

SPA stated that actual equity raising costs, not benchmarks, should be used, and Origin stated that an independent auditor should comment on the actual equity raising costs.

JEN/UED stated that typically a bond is chosen with a term that matches the regulatory period. They state that the consultation paper does not provide this term, but that in their view it should be 1 January 2009 to 31 December 2015.

#### **3.4.3 Efficiency carryover mechanism**

CP/PC stated that the IT costs included in table 3.3 of the consultation paper should not be included in the calculation as they are not on the pages listed in clause 5D.4(c)(i) of the revised Order. Their submission also stated that gains and losses are to be retained for six years, being the year of loss or gain and the following five years.

With respect to the negative carryover, SPA stated that the proposed approach seems consistent with the requirements of the revised Order. SPA also stated that it would

appear that the regulator is required to accept the value of expenditure where it is clear from the regulatory accounting statements.

Origin stated that the regulator should consider treating the reading of manually read interval meters the same as that of accumulation meters.

#### **3.4.4 Taxation**

Origin stated that it supports the proposed position, however SPA stated that the gamma for years before 2009 should be 0.5, as per the current price determination, rather than the gamma determined by the AER in its SORI.

#### **3.4.5 Value of the metering asset base**

SPA stated that the consultation paper incorrectly refers to actual capital expenditure to 2009 being included in the asset base, to the extent that it is within scope and prudent. SPA referred to the note to clause 5D.5 of the revised Order and stated that the regulator has no discretion to reject expenditure on the basis that it is not prudent, but only the discretion to determine whether the distributor has correctly calculated the values for the three variables.

#### **3.4.6 Regulatory depreciation**

SPA stated that it agreed with the proposed approach. Similarly, Origin stated that it supports straight line depreciation.

Origin proposed that the regulator provide clearer guidelines on whether assets are 'meters' or 'telecommunications assets' for depreciation purposes, perhaps based on independent expert advice.

The question of whether accelerated depreciation will apply to manually read interval meters installed after the cancellation of IMRO was posed by Origin.

### **3.5 Issues, AER considerations and AER approach**

Having had regard to submissions to the consultation paper published by the ESCV and the requirements of the revised Order, the AER's approach to the building blocks calculation is as set out below.

#### **3.5.1 Net costs (or revenue) associated with providing metering services from 1 January 2006 to 31 December 2008**

Clause 5D.4(a) of the revised Order requires that the regulator must determine additional expenditure relating to:

the building block costs incurred offset by the revenue earned by a distributor in respect of prescribed metering services (not being metering services to unmetered supply points to which clause 6 applies) under the Current Price Determination during the period from 1 January 2006 until the Start Date. For the purposes of this clause 5D.4(a), the weighted average cost of capital in the Current Price Determination shall be applied, adjusted for inflation.

The AER interprets this clause to refer to the net actual building block costs in respect of prescribed metering services under the current price determination. Therefore the building block costs will be:

- a return on capital (using the actual regulatory asset base for prescribed metering services over the period)
- depreciation of the asset base, using the actual regulatory asset base and the asset lives established in the current price determination
- actual maintenance and operating expenditure
- a benchmark calculation of tax in respect of prescribed metering services.

In relation to the WACC to be used to determine the return on capital the revised Order requires the WACC in the current price determination to be used, adjusted for inflation.

Origin's submission stated that the regulator needs to carefully analyse these costs and recognise the net present value to distributors. The AER notes that the revised Order prescribes that net present value (time value of money) is to be addressed by applying a WACC to the net costs (or revenue) associated with providing the services. Attention is drawn to clause 5D.6 of the revised Order which states that the actual expenditure for 2006 to 2008 inclusive is to be derived from distributors' regulatory accounting statements. The AER's analysis of this expenditure will be carried out in this context.

### **3.5.2 Weighted average cost of capital**

The weighted average cost of capital is the financial return that investors seek when considering and assessing an investment decision. To provide sufficient remuneration for investors to invest, the rate of return should reflect the opportunity cost of their capital — that is, the return should be commensurate with the returns that an investor could expect to earn from other investment opportunities in the market, after adjusting for the different levels of risk that different investments entail.

Submissions from CP/PC and SPA stated that WACC is not part of the initial AMI budget period budget application to be submitted on 27 February 2009. SPA pointed out that the SORI conclusions, due to be published on 31 March 2009, can be incorporated in the WACC information provided on 1 June 2009 as part of the 2010-11 initial charges application.

The AER agrees that the provisions of the revised Order do not require WACC to be included in the initial AMI budget period budget application. As discussed in chapter 5 of this final decision, WACC is not included in the initial AMI budget period budget application data templates. As required by the revised Order it will be included in the 2010-2011 initial charges application templates, to be submitted on 1 June 2009.

The cost of capital for a particular investment is determined by the market. It is based on the aggregate demand and supply of investment funds and the riskiness of the potential cash flows generated by the investment in question relative to the riskiness of the cash flows generated by other investments.

However, the cost of capital cannot be observed in the same manner in which prices for other goods and services may be observed. Instead, the risk adjusted price for

investment capital must be estimated from available capital market data and can be interpreted using models drawn from finance theory and practice.

The AER has historically calculated the WACC, and the National Electricity Rules mandate that the WACC be calculated, as a 'nominal vanilla' WACC in accordance with the following formula:

$$WACC = k_e \frac{E}{V} + k_d \frac{D}{V}$$

where:

$k_e$  = the expected rate of return on equity or cost of equity

$k_d$  = the expected rate of return on debt or cost of debt

$\frac{E}{V}$  = the market value of equity as a proportion of the market value of equity and debt, which is  $1 - D/V$

$\frac{D}{V}$  = the market value of debt as a proportion of the market value of equity and debt

The cost of equity is determined using the CAPM, calculated as follows:

$$k_e = r_f + \beta_e MRP$$

where:

$r_f$  = the nominal risk free rate of return

$\beta_e$  = the equity beta

$MRP$  = the expected market risk premium

The expected cost of debt is calculated in accordance with the following formula

$$k_d = r_f + DRP$$

where:

$r_f$  = the nominal risk-free rate of return

$DRP$  = the debt risk premium

The prescribed formula set out in the NER prevents debt (and equity) raising costs from being compensated through the WACC. However the NER do not prevent such costs from being compensated through other mechanisms such as the capital or operating expenditure allowances, provided they meet the requirements in the NER for these allowances.

### 3.5.2.1 Revised Order

The revised Order contains a number of specific provisions that dictate the way in which the WACC must be calculated. A key requirement is that a single WACC will apply for the period 1 January 2009 to 31 December 2013 (the initial AMI WACC period) and another WACC will apply for the period 1 January 2014 to 31 December 2015 (the subsequent AMI WACC period). (Note that the initial and subsequent AMI WACC periods do not coincide with the initial and subsequent AMI budget periods.)

The revised Order also provides that for the initial AMI WACC period:

- measurement of the market observable parameters (nominal risk free rate and DRP) will occur in the last 10 business days of November 2008 and the first 5 business days of December 2008 and will be determined in accordance with the AER's SORI
- the WACC must be calculated using the non-market observable parameters from the current price determination
- a debt raising cost of 12.5 basis points for the initial AMI WACC period shall be adopted
- equity raising costs for the initial AMI WACC period will be recovered as a maintenance and operating expense.

### 3.5.2.2 Market observable parameters and the statement of regulatory intent

The NER provide that the AER may review the WACC parameters to be adopted in determinations for electricity transmission and distribution network service providers. Reviews are to be conducted every five years with the first review concluded by 31 March 2009, at which time the AER will release a final SORI.

The AER released its proposed statement of regulatory intent on the revised WACC parameters<sup>6</sup> and an accompanying explanatory statement<sup>7</sup> in December 2008.

The proposed SORI states that the:

- Nominal risk free rate is to be calculated on a moving average basis from the annualised yield on Commonwealth Government bonds with a maturity that matches the term of the regulatory control period
- As required by the NER, a DRP maturity period (benchmark Australian corporate bond) is to be used which matches the maturity period used to calculate the risk free rate.
- The benchmark credit rating to be used to calculate the DRP is given as A-.

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<sup>6</sup> See:  
[http://www.aer.gov.au/content/item.phtml?itemId=724617&nodeId=fb2c5e92712b75c4a5daf6d65f5ae441&fn=Proposed%20statements%20\(11%20December%202008\).pdf](http://www.aer.gov.au/content/item.phtml?itemId=724617&nodeId=fb2c5e92712b75c4a5daf6d65f5ae441&fn=Proposed%20statements%20(11%20December%202008).pdf)

<sup>7</sup> See:  
[http://www.aer.gov.au/content/item.phtml?itemId=724642&nodeId=dc61681b46489076b1fd720cc10af39e&fn=Explanatory%20statement%20\(11%20December%202008\).pdf](http://www.aer.gov.au/content/item.phtml?itemId=724642&nodeId=dc61681b46489076b1fd720cc10af39e&fn=Explanatory%20statement%20(11%20December%202008).pdf)



As required by the revised Order the AER will adopt the methodology set out in the SORI to determine the market observable parameters for the initial AMI WACC period. It will then apply this methodology to establish the WACC for the initial AMI WACC period, using market data for the last 10 business days in November 2008 and the first 5 business days in December 2008.

The joint submission from JEN/UED stated that typically a bond is chosen with a term that matches the regulatory period. They stated that the consultation paper does not provide this term, but that in their view it should be 1 January 2009 to 31 December 2015.

The revised Order, however, splits the regulatory period, 1 January 2009 to 31 December 2015, into two WACC periods. The initial AMI WACC period is from 1 January 2009 to 31 December 2013 and the subsequent AMI WACC period is from 1 January 2014 to 31 December 2015.

The initial AMI WACC period is coincident with the period of the AMI rollout, which is to be completed by 31 December 2013, and the AER considers that an appropriate term is one that matches this period. The term will therefore be 1 January 2009 to 31 December 2013.

#### ***Debt raising costs***

In its submission Origin urged the regulator to ensure that debt raising costs are not recovered twice.

As noted above, the revised Order mandates that a debt raising cost of 12.5 basis points be adopted for the initial AMI WACC Period, This margin will be added to the DRP. Debt raising costs are therefore not to be included as capital expenditure or maintenance and operating expenditure, in either distributors' budget or charges applications. Auditors should make themselves aware of this requirement, and the AER will bear it in mind when considering distributors' applications.

#### ***Non market observable parameters***

The revised Order requires that non-market observable parameters from the current price determination be used in the calculation of WACC for the initial AMI WACC period. The relevant parameters are as follows:

**Table 3.1 Non market observable parameters – current price determination**

MRP ( $R_m - R_f$ )	6.00%
Equity beta $\beta_e$	1.00
Franking credit value (y)	0.50
Gearing (D/V)	60%
Inflation	2.56%

#### ***Equity raising costs***

In the past the AER has considered whether a business should be compensated for equity raising costs on a case-by-case basis. The AER has undertaken its analysis using a cash flow analysis (based on the benchmark gearing ratio) and assuming that

raising external equity is the last and least preferred option to funding capital expenditure

However, for the initial AMI WACC Period the revised Order requires equity raising costs to be recovered as a maintenance and operating expense. Consistent with the nature of the revised Order, the AER considers that the equity raising costs recovered should be the actual costs incurred (and not benchmark costs). Thus, if a distributor does not incur costs associated with raising equity to fund the AMI program, no cost recovery needs to occur.

The submission from SPA supported this approach, stating that actual equity raising costs, not benchmarks, should be used.

Origin's submission stated that an independent auditor should comment on the actual equity raising costs.

As noted above, the revised Order requires equity raising costs to be recovered as maintenance and operating expenses. Consequently, they will be subject to the same audit requirements as other maintenance and operating expenses incurred by the distributors.

#### *Time value of money*

The revised Order requires the time value of money to be taken into account by the regulator when determining expenditure for the 2006 to 2008 period. The revised Order requires this value to be calculated by reference to the WACC in the current price determination, adjusted for inflation. The WACC, in real after-tax 'vanilla' terms, is 5.90%.

### **3.5.3 Efficiency carry over mechanism**

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. Clause 5D.4(c) requires charges to reflect:

the total value of benefit or burden which the distributors would have enjoyed or suffered from efficiency gains or losses arising from the Current Price Determination including those flowing from the efficiency carryover mechanism in the Current Price Determination limited to efficiency improvements (not volume changes) in operating expenditure for:

- (i) metering data services (as described on pages 543, 544 and 545 of the Current Price Determination (Volume 1));
- ii) meter maintenance (as described on pages 539 and 540 of the Current Price Determination (Volume 1)); and
- (iii) meter replacement costs (customer service costs) (as described on pages 542 and 543 of the Current Price Determination (Volume 1)).

In the current price determination the ESCV established an efficiency component on operating and expenditure on metering services which operated in the same manner as the efficiency carryover mechanism applying to DUoS charges. The purpose of the mechanism was to reward (penalise) the distributors for efficiency gains (losses) in

relation to metering operating expenditure by carrying over the benefits (losses) into the next regulatory period.

In giving effect to the requirements of the revised Order, there are a number of matters that need to be taken into consideration:

- The forecasts in the current price determination were based on the assumption that interval meters would be rolled out during 2006 to 2008. This did not occur and in some cases there is a need to ensure a ‘like for like’ comparison of costs
- How the 2006 to 2008 efficiency gains or losses will be reflected in charges.
- Whether there should be a ‘no negative carryover’ principle applied.

### 3.5.3.1 Ensuring a ‘like for like’ comparison

#### *Adjusting the benchmarks*

The revised Order requires the efficiency carryover mechanism (ECM) to consider operating expenditure on metering data services, meter maintenance and meter replacement costs (customer service costs). To ensure a ‘like for like’ comparison, and ensure that volume changes are not reflected in the ECM, as required by the revised Order, it is necessary to make adjustments to the benchmarks set out in the current price determination<sup>8</sup>.

Each of the proposed adjustments is outlined below.

#### *Meter replacement costs (customer service costs)*

The current price determination set out a unit price for customer service costs associated with replacement meters. The adjusted benchmarks will be calculated using these costs. The costs are set out in table 3.2.

	<i>Alinta AE</i>	<i>CitiPower</i>	<i>Powercor</i>	<i>SP AusNet</i>	<i>United Energy Distributio n</i>
Cost per meter	15.00	16.20	10.60	11.70	10.60

#### *Metering data services*

The metering data services operating costs were established on a per unit basis with a separate cost per meter read and per customer for data management for accumulation and interval meters. These costs are shown in table 13.31 of volume 1 of the current price determination and are reproduced in table 3.3.

Origin’s submission stated that the regulator should consider treating the reading of manually read interval meters the same as that of accumulation meters. In further

<sup>8</sup> There are two ways the ‘like for like’ comparison could be made – firstly by adjusting the benchmarks, or secondly by adjusting the actual outcomes. Regulators have historically taken the position that it is simplest to adjust the benchmarks.

discussions with Origin this was understood to mean that, where manually read interval meters have been installed, but have been read as accumulation meters, then for the purposes of the metering data services benchmark adjustment these should be treated as accumulation meters.

The revised Order requires ECM impacts to be limited to efficiency improvements, not volume changes. The AER therefore requires distributors to provide the numbers of meters being read as accumulation meters, and the numbers being read as interval meters, to be used for adjusting the metering data services benchmark.

**Table 3.3 Unit cost for metering data services operating costs, real \$2004**

	<i>Alinta AE, Citipower, United Energy</i>	<i>Powercor, SP AusNet</i>
Cost per read (accumulation meter)	0.75	1.50
Cost per read (interval meter)	1.50	2.50
Meter data management (per customer pa, accumulation meter)	4.50	4.50
Meter data management (per customer pa, interval meter)	6.20	6.20

The consultation paper included a table showing benchmark IT costs and a discussion of how these could be addressed in the ECM. The joint submission from CP/PC stated that the IT costs included in table 3.3 of the consultation paper should not be included in the calculation as they are not on the pages of the current price determination which are listed in clause 5D.4(c)(i) of the revised Order. The AER agrees with this position and IT costs are therefore not included in the ECM.

#### ***Meter maintenance***

Benchmarks for meter maintenance were set on a per meter basis in the current price determination, as shown in table 3.4. Adjusted benchmarks for meter maintenance will be calculated using these unit costs.

**Table 3.4 Unit costs for meter maintenance, real \$2004**

	<i>Alinta AE</i>	<i>CitiPower</i>	<i>Powercor</i>	<i>SP AusNet</i>	<i>United Energy Distributio n</i>
Cost per customer	2.11	1.95	1.52	1.64	0.81

#### ***Reported costs***

Under the usual operation of the ECM the businesses can maximise their carryover amount by reducing their reported expenditure. However this incentive to minimise reported expenditure is offset by the fact that their future cost forecasts are based on the reported expenditure.

In the case of AMI the offsetting incentive does not exist. 2006 to 2008 operating expenditure is not being used as a benchmark to set future forecasts due to the fundamentally different nature of operating expenditure under the AMI framework. Further, from 2009 expenditure is being recovered on an actual cost basis not an incentive basis.

It is therefore incumbent upon the regulator to scrutinise the distributors' reported actual expenditure from 2006 to 2008 on ECM items in order to ensure that the figures provided are accurate.

Accordingly, the consultation paper stated that the regulator will need to be provided with evidence from the distributors that all the direct expenditure on metering data services, meter maintenance and meter replacement costs have been reported.

In its submission SPA stated that it would appear that the regulator is required to accept the value of expenditure where it is clear from the regulatory accounting statements.

Clause 5D.6 of the revised Order refers to distributors providing details of actual expenditure for 2006 to 2008 derived from their regulatory accounting statements. It states that this requirement is "in addition to the information and documents required pursuant to clause 5". Clause 5.4 requires that applications must include the information specified by the regulator's framework and approach paper.

Therefore, the AER requires that, as proposed in the consultation paper, distributors provide evidence that all the direct expenditure on metering data services, meter maintenance and meter replacement costs have been reported.

### **3.5.3.2 Reflecting the efficiency gains or losses in charges**

The consultation paper stated that under the ECM mechanism applied by the ESCV efficiency gains or losses are retained for five years. It also stated that in respect of a gain or loss in 2008 the relevant amount would be applied to the revenue requirement in each year from 2009 to 2013.

In their joint submission CP/PC stated that gains and losses are to be retained for six years, being the year of loss or gain and the following five years.

The consultation paper's statement that gains or losses are retained for five years is consistent with statements made in the current price determination and reflects how this issue has been considered by the regulator. However, as is shown by the reference to 2008 gains or losses being applied to the revenue requirement for each year from 2009 to 2013, the consultation paper reflected an interpretation of this which is consistent with CP/PC's remarks.

The AER will be calculating ECM amounts for actual expenditure from 2006 to 2008 consistent with the approach in the current price determination, while reflecting the requirements of the revised Order as described in this final decision.

The revised Order requires the regulator to reflect the ECM amounts when determining the 2010-11 initial charges. This requirement will be met by summing the

efficiency carryover amounts for 2009 to 2013, adjusted to reflect the time value of money, and incorporating this amount in 2010 charges.

### **3.5.3.3 Negative carryovers**

The matter of whether there should be a zero floor for the ECM amount, thus preventing penalties for inefficient performance being carried from one regulatory period to the next, has previously been considered both by the ESCV and the AER. While regulated utilities have argued that this should be the case, both regulators have previously concluded that in general it is not possible for the ECM to achieve its objectives if it is not symmetrically applied both within and across regulatory periods.

In the current price determination the ESCV did not set a zero floor approach and instead indicated that:

the efficiency carryover mechanism relating to the prescribed metering price control will ... apply to operating and maintenance expenditure and negative carryovers will be carried out into the next period<sup>9</sup>.

The revised Order appears to contemplate that potential net negative carryovers should be part of the mechanism. The AER will therefore apply negative carryovers where they occur.

With respect to the negative carryover, SPA's submission stated that the proposed approach seems consistent with the requirements of the revised Order.

### **3.5.4 Taxation**

Under the revised Order taxation needs to be considered in two separate areas. First, the revised Order requires that in determining charges for 2010 and 2011 the regulator must include the value of taxation liability from 2006 to 2010 in the current price determination which was reduced as a result of the consolidation of the DUoS and metering services taxation calculation.

Second, the revised Order requires that taxation is one element of the cost building blocks for determining charges.

#### **3.5.4.1 Taxation adjustment for 2006 to 2010**

In the current price determination the ESCV forecast the distributors' tax liabilities in aggregate for DUoS services and prescribed metering services. The aggregate reflected a tax liability position in respect of DUoS services, which was partly offset by stand-alone tax losses forecast under the metering price control. However, because the IMRO rollout foreshadowed in the current price determination did not take place the tax losses for the metering price control were, in general, not realised. As a result the distributors have been liable for higher benchmark tax amounts than were calculated in the current price determination.

The aggregate benchmark taxation amounts (losses) for metering services included in the current price determination are set out in table 3.5.

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<sup>9</sup> Current price determination, Volume 1, p.577.

Table 3.5 **Benchmark taxation losses for metering services 2006 to 2010, \$million, real \$2004**

	2006	2007	2008	2009	2010
Alinta AE	0.67	2.54	2.98	3.06	2.29
CitiPower	0.0	2.50	4.61	4.25	2.88
Powercor	0.0	4.64	10.77	13.63	12.45
SP AusNet	1.98	2.48	6.58	9.98	9.72
United Energy Distribution	0.0	1.50	5.53	8.37	7.86

The revised Order requires the regulator to reflect these taxation amounts when determining the 2010-11 initial charges. The AER will meet this obligation by summing the taxation amounts for 2006 to 2010, adjusted to reflect the time value of money, and incorporating this amount in 2010 charges.

#### 3.5.4.2 Calculation of taxation in the building blocks

A forecast tax liability is normally included in the building blocks where a ‘vanilla’ WACC is adopted as it provides an after-tax return. Clause 4.1 (b) of the revised Order provides that a benchmark allowance for corporate income tax (as distinct from the actual tax incurred) be reflected in charges.

In calculating the taxation allowance regulators often apply benchmark assumptions for many of the inputs related to the taxation calculation. That is, rather than attempt to capture all of the detail of Australian taxation law, benchmark assumptions are made that reflect the major features and implications of the taxation law. The application of benchmarks when determining projected taxation liabilities provides distributors with the incentive to put in place efficient financing arrangements.

The revised Order requires the following matters to be benchmarked:

- the tax depreciation method and rate
- the value of debt as a proportion of equity and debt, and the return on debt, with both to be benchmarked consistently with the calculation of WACC for the relevant year
- the value of imputation (franking) credits.

The revised Order also provides that if there is an estimated tax loss in any particular year the allowance for tax must be set to zero with the loss to be carried forward to offset future taxable income.

Tax depreciation is usually benchmarked with assets allocated into broad taxation depreciation classes. This is primarily done because of the costs and difficulties associated with splitting a vast and existing asset base into detailed asset categories. However, in the case of the AMI project, all capital expenditure will be new. While some benchmark assumptions will still need to be made, the AER considers that it should be possible to make a more detailed and accurate calculation of actual taxation

than is normally the case. Taxation building block amounts included in distributors' applications will be reviewed with this expectation in mind.

In relation to the value of imputation or franking credits (gamma), the ESCV and the AER have previously adopted a value of 0.5. However, the value of gamma is being reviewed by the AER as part of its review of the WACC. The proposed SORI released in December 2008 provided for a gamma of 0.65<sup>10</sup>.

Origin stated that it supports the proposed position, however SPA stated that the gamma for years before 2009 should be 0.5, as per the current price determination, rather than the gamma determined by the AER in its SORI.

Taxation losses for 2006 to 2010 from the current price determination will be treated as required by the revised Order as set out in section 3.5.4.1. Where taxation benchmark allowances are included in distributors' applications, the gamma to be applied in relation to 2006 to 2008 will be 0.5, consistent with the current price determination. The gamma for 2009 and later years will be that established by the AER in its most recent SORI.

### 3.5.5 Value of the metering asset base

The revised Order provides that in determining the initial charges for 2010 and 2011 the opening value of the metering asset base at 31 December 2008 for each distributor must be calculated as follows:

$$\text{Opening Metering Asset Base}_{\text{SD}} = \text{Opening Metering Asset Base}_{2006} + \text{Capital Expenditure}_{2006\text{-SD}} - \text{Depreciation}_{2006\text{-SD}} - \text{Disposals}_{2006\text{-SD}}$$

Where:

Opening Metering Asset Base<sub>SD</sub> is the closing value of the metering asset base at 31 December 2008

Opening Metering Asset Base<sub>2006</sub> is the opening regulatory asset base set out in Table 13.35 of Volume 1 of the current price determination. (This table shows that the value of the opening metering asset base for each distributor for 2006 was zero)

Capital Expenditure<sub>2006-SD</sub> is the actual capital expenditure between 1 January 2006 and 31 December 2008 inclusive

Depreciation<sub>2006-SD</sub> is the actual depreciation between 1 January 2006 and 31 December 2008 inclusive

Disposals<sub>2006-SD</sub> is actual disposals between 1 January 2006 and 31 December 2008 inclusive

Distributors' calculation of the opening value of the metering asset base as at 1 January 2009, as reflected in their 2010-11 initial charges application, should therefore apply the above formula.

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<sup>10</sup> See:

[http://www.aer.gov.au/content/item.phtml?itemId=724617&nodeId=fb2c5e92712b75c4a5daf6d65f5ae441&fn=Proposed%20statements%20\(11%20December%202008\).pdf](http://www.aer.gov.au/content/item.phtml?itemId=724617&nodeId=fb2c5e92712b75c4a5daf6d65f5ae441&fn=Proposed%20statements%20(11%20December%202008).pdf)



In addition to the ‘opening’ metering asset base calculations, in determining revised charges for the next year of the initial and subsequent AMI budget periods (i.e. year t+1), the regulator will be required to make an estimate of the metering asset base at that time.

As part of the example relating to establishing charges for 2011, the consultation paper proposed that the metering asset base would include actual capital expenditure to 2009 (to the extent that it is within scope and prudent).

In its submission SPA stated that the consultation paper incorrectly refers to actual capital expenditure to 2009 being included in the asset base to the extent that it is within scope and prudent. The regulator has no discretion to reject expenditure on the basis that it is not prudent, but only the discretion to determine whether the distributor has correctly calculated the values for the three variables.

Correct understanding of the example requires the reference in the consultation paper to actual capital expenditure to 2009 is to be read as including 2009 capital expenditure. Clause 5D.5 of the revised Order, to which SPA refers, applies only to actual expenditure under clauses 5D.4(d) to (g) of the revised Order, not all categories of expenditure, and only that which was incurred before 1 January 2009. This does not therefore exclude considerations of scope and prudence, as established by the revised Order, in relation to expenditure after 1 January 2009.

The AER considers that the metering base should be calculated consistent with the approach for calculating the opening metering asset base. Thus, for example, when establishing revised charges for 2011 the metering asset base will reflect:

- the opening metering asset base at 1 January 2009 calculated in accordance with clause 5D.2 of the revised Order
- actual capital expenditure for 2009 (to the extent that it is within scope and prudent)
- the most recent approved budget for capital expenditure in 2010 and 2011
- actual disposals in 2009 and the most recent approved budget for disposals in 2010 and 2011
- depreciation calculated consistently with the capital expenditure and disposal assumptions and the asset lives in clause 4.1(g) of the revised Order.

### **3.5.6 Regulatory depreciation**

Regulatory depreciation is a component of the revenue requirement for regulated services and represents the annual rate at which accumulated capital is returned to investors. It is a function of the regulated asset base and the period over which the assets are depreciated.

As noted above, the revised Order stipulates that actual depreciation should be used for the period 1 January 2006 to 31 December 2008.

Clause 4.1(g) of the revised Order also stipulates the asset life for remotely read meters and measurement transformers as 15 years and for telecommunications and information technology assets as 7 years. For some assets it may not be clear as to whether they are ‘meters and measurement transformers’ or ‘telecommunications assets’. Where this is the case the consultation paper proposed that distributors should clearly outline the reason for the chosen classification.

In response, Origin suggested that the regulator provide clearer guidelines on whether assets are ‘meters’ or ‘telecommunications assets’ for depreciation purposes.

Given the different technologies which distributors may adopt, and the complex nature of the communication and metering networks which will be created, the AER considers that requiring distributors to clearly outline the reason for the chosen classification will be more effective than attempting to provide clear guidelines, to which inevitably there will be exceptions.

The revised Order also provides that in respect of accumulation meters and manually read interval meters the depreciation period should end no later than 2013. This will require depreciation to be accelerated over the period 2010 to 2013 for some of these meters such that their value is zero at the end of 2013.

Origin posed the question of whether accelerated depreciation will apply to manually read interval meters installed after the cancellation of IMRO. From discussions with Origin it was understood that Origin was exploring the question of whether manually read interval meters installed after the cancellation of IMRO should be treated as accumulation meters. For example, that the cost which is depreciated should be the cost of an accumulation meter, rather than the actual cost of the manually read interval meter.

Clause 5D.2 prescribes how the metering asset base at 1 January 2009, which will include the manually read interval meters referred to, is to be calculated. This refers to actual capital expenditure, and the AER considers that this relates to the actual cost of the meters, and that it is not appropriate in this case to substitute the cost of another meter. Accelerated depreciation is applied to assets which are part of this opening asset base, and so it does not seem appropriate to apply different costs to the assets for the purposes of the accelerated depreciation than those at which they are included in the asset base.

Distributors will need to clearly set out in their submissions the number and regulatory asset value of those meters for which depreciation needs to be accelerated, and the profile of the depreciation.

### **3.5.6.1 Form of depreciation**

While the revised Order specifies the asset lives to be used it does not specify the form of depreciation to be adopted. Most regulatory regimes adopt straight line depreciation on the basis that it is well understood and transparent. However, for assets in areas of rapid technological change, it may be more appropriate to adopt a form of depreciation that provides a greater level of return of capital in the early years of their life. This may better reflect the more rapid diminishment in value.

In response to the ESCV's August 2007 consultation paper there was no support identified for alternatives to straight line depreciation. While one respondent did acknowledge the likely accelerated depreciation for metering and telecommunications systems, the benefits of increased transparency and consistency with the current price determination were felt to be more important.

In its December 2007 framework and approach paper the ESCV therefore proposed to use straight-line depreciation to determine regulatory depreciation in each year of the regulatory period. Similarly, the ESCV proposed straight line depreciation in its consultation paper under the revised framework.

In its submission SPA stated that it agreed with the proposed approach. Similarly, Origin stated that it supports straight line depreciation.

The AER's final decision is that straight line depreciation will be used.

## 4 Charges

### 4.1 Introduction

This chapter sets out the AER's approach to the calculation and setting of charges. These charges are those levied by the distributor on the retailers for the provision of the AMI services. These include charges for exit fees, restoration fees and for the provision of metering services to unmetered connection points.

### 4.2 Requirements of the revised Order

The revised Order contains specific provisions relating to the calculation of individual charges, including charges for 2009. It also requires the regulator to determine maximum charges for exit fees, restoration fees and for the provision of metering services to unmetered connection points. Finally, it sets out certain requirements the regulator must have regard to in setting these charges.

### 4.3 Proposed positions

In its consultation paper, the ESCV described the proposed positions in relation to price controls as follows:

- The following pricing principles were proposed by the ESCV in December 2007 and were considered to not be inconsistent with the revised Order:
  - **Cost of service provision:** a distributor's charge and terms and conditions for a prescribed metering service must be based on the costs incurred by the distributor in providing the prescribed metering service.
  - **Cost allocation:** in respect of the costs incurred by a distributor in providing a prescribed metering service:
    - those costs must not include costs in respect of which the distributor is remunerated under the distributor's distribution tariff or excluded service charges or charges for metering services to unmetered supply points, and
    - those costs must only include an appropriate allocation of any shared or common costs incurred by the distributor in providing the prescribed metering service and in providing any other goods or services, whether in the conduct of a distributor's business as a distributor or any other business.
  - **Cost differentials:** a distributor's charge and terms and conditions for a prescribed metering service must be the same for all customers, regardless of whether an accumulation meter or an interval meter is installed, unless there is a material difference in the costs of providing the prescribed metering service to different customers or classes of customers. Different charges and terms and conditions for different

customers or classes of customers must only be attributable for differences in:

- the volume or quantity of the prescribed metering service provided
  - the places to or from which the prescribed metering service is provided
  - the time of day at which the prescribed metering service is provided, unless the costs for providing the service at a different time of day to that class of customer have been included in the revenue requirement
  - the performance characteristics at which the prescribed metering service is provided, or
  - any other legitimate differences in the costs of providing the prescribed metering service.
- **Simplicity:** charges and terms and conditions for prescribed metering services should be simple and easily comprehensible.
  - Any rebalancing constraint must operate subject to clause 4.1(o) of the revised Order which provides that charges must be designed so that the net present value of building block costs incurred to date must equal the net present value of revenue incurred to date.
  - It is desirable that distributors make use of clause 4.1(p) of the revised Order, proposing to recover revenue below costs in particular years and recovering the under-recovered amounts in later years, to provide a smooth price path.

With respect to exit and restoration fees, the proposed position was that if the AEMC's final decision on the derogation from the NER, to give distributors exclusivity in the provision of AMI metering to 31/12/2013, was similar to its draft decision, then exit and restoration fees would not be payable in the initial AMI budget period. Consequently, it would be unnecessary for any determinations to be made in the period.

To ensure that charges for the provision of metering services to unmetered connection points are consistent with the formula set out in the revised Order it was proposed that the distributors provide their proposed unmetered supply charges to the regulator at the same time as their DUoS tariff proposals.

Given that the additional service level required by the customer, to which customer requested service fees would apply, is likely to be 'above scope' the ESCV noted that the costs of serving the customer cannot be included in a budget application or a charges application. They therefore need to be included in a separate fees application. Under the revised Order these may be made at any time.

## **4.4 Summary of submissions**

Jemena Electricity Networks (Vic) Ltd (JEN) and United Energy Distribution (UED) made a joint submission relating to the proposed positions on charges. Submissions were also received from SP AusNet (SPA) and Origin Energy (Origin).

### **4.4.1 Price controls**

With respect to the 2 approaches to price controls discussed in the consultation paper, JEN/UED's submission stated that neither of the alternative approaches are relevant or appropriate considerations. They stated that the relevant constraints are set out in clauses 4.1(o) and 4.1(p) of the revised Order and that it is inappropriate for the regulator to apply any additional constraints.

Similarly, SPA stated that it does not support the pricing principles set out in the consultation paper or any additional principles. It considers that the revised Order is prescriptive and that the charges are a pass through based on audited actual costs.

Origin's submission stated that the pricing principles proposed by the ESCV were more practically applicable than those in section 6.18 of the NER. It also stated that the regulator should work closely with distributors to ensure a smooth price path. Origin also proposed that the regulator advise industry of the price path assuming distributors charges are based on the budgets and actual expenditure set out in the applications.

### **4.4.2 Exit and restoration fees**

Origin stated its preference that the regulator provide clear views on the approach to exit and restoration fees prior to the end of the initial AMI budget period. SPA stated that if a distributor makes a fees application for exit or restoration fees then the regulator must make a determination as provided by the revised Order.

SPA stated that exit and restoration fees could apply during the initial AMI budget period should a customer cross the 160MWh per annum boundary.

## **4.5 Issues, AER considerations and AER approach**

Having had regard to submissions to the consultation paper published by the ESCV and the requirements of the revised Order, the AER's approach to the setting of charges is as set out below.

### **4.5.1 Charges for 2009**

The revised Order provides that charges for regulated services for 2009 shall be determined as if the current price determination continued to apply for that year and the regulated services were prescribed metering services.

Pricing arrangements for prescribed metering services are set out in section 4 of volume 2 of the current price determination. Amongst other things the provisions provide for:

- a tariff basket mechanism (similar to the DUoS price control mechanism) that limits the annual increase in average metering service charges

- separate rebalancing controls for meter provision and metering data service charges
- a process whereby the distributors submit proposed tariffs to the regulator on an annual basis for approval prior to being implemented. Tariffs for 2009 were submitted for approval on 3 November 2008 and were approved by the ESCV.

#### **4.5.2 Price controls**

The original Order required that the regulator determine the maximum charges for metering services using a similar price regulation methodology as the methodology that was applied in the current price determination.

However, the revised Order does not contain an equivalent provision. The main requirement governing revenue to be recovered in a particular year is set out in clause 4.1(o) of the revised Order. This clause provides that when determining charges for any year from 2010 to 2015 the regulator shall 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.

In addition, the revised Order provides that the regulator may determine charges which differ in respect of:

- single phase single element meter
- single phase single element meter with contactor
- single phase two element meter with contactor
- three phase direct connected meter
- three phase direct connected meter with contactor
- three phase current transformer connected meter and
- any other customer or metering class proposed by the distributor and approved by the regulator

but may not differ depending upon whether the meter is an accumulation meter, a manually read interval meter or remotely read meter.

Aside from the above and specific provisions relating to exit and restoration fees, the revised Order therefore does not provide any guidance in relation to matters including:

- the way in which individual charges should be calculated including the need for cost reflectivity

- the need for and the level of any rebalancing constraints<sup>11</sup>

In its December 2007 framework and approach paper the ESCV proposed to apply the pricing principles of cost of service provision, cost allocation, cost differentials and simplicity. These principles were reiterated in the ESCV's consultation paper.

The consultation paper also referred to the alternative approach of applying the relevant distribution pricing rules in section 6.18 of the NER, to the extent that these are not inconsistent with the revised Order.

A number of distributors stated that they did not support the pricing principles set out in the consultation paper. The relevant constraints are set out in clauses 4.1(o) and 4.1(p) of the revised Order and it is inappropriate for the regulator to apply any additional constraints.

Origin's submission stated that the pricing principles proposed by the ESCV were more practically applicable than those in section 6.18 of the NER.

The AER does not agree that the price control approaches proposed are inappropriate. The AER considers that the pricing principles set out below are consistent with the revised Order. Distributors are required to consider them when setting charges, and charges may be reviewed for compliance with these principles. Within the broad context set by the revised Order, applying these principles will help ensure that charges are appropriate and explicable to retailers and customers.

- **Cost of service provision:** a distributor's charge and terms and conditions for a prescribed metering service must be based on the costs incurred by the distributor in providing the prescribed metering service, given the customer classes permitted by the revised Order. For example, the charges for serving the class of customers with single phase single element meters should reflect the costs of serving this class of customers.
- **Cost allocation:** in respect of the costs incurred by a distributor in providing a prescribed metering service:
  - those costs must not include costs in respect of which the distributor is remunerated under the distributor's distribution tariff or excluded service charges or charges for metering services to unmetered supply points, and
  - those costs must only include an appropriate allocation of any shared or common costs incurred by the distributor in providing the prescribed metering service and in providing any other goods or services, whether in the conduct of a distributor's business as a distributor or any other business.
- **Simplicity:** charges and terms and conditions for prescribed metering services should be simple and easily comprehensible.

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<sup>11</sup> Rebalancing constraints limit the annual change in the average price of a tariff and aim to limit sharp changes in tariffs where a distributor is moving a tariff to a more cost-reflective level.



The cost differentials pricing principle proposed by the ESCV has not been included. Instead, as required by the revised Order, the AER will consider on its merits any customer class proposed by a distributor.

When considering rebalancing constraints the ESCV noted that clause 4.1(o) of the revised Order provides that charges must be designed so that the net present value of building block costs incurred to date must equal the net present value of revenue incurred to date. Therefore, any rebalancing constraint must operate subject to this provision. Given the significant change which the AMI project represents, the charges setting requirement of clause 4.1(o) and the impact of the pricing principles set out above, the AER does not consider that rebalancing constraints are appropriate and they will not be applied to charges in the initial AMI budget period.

The ESCV noted that clause 4.1(p) enables distributors to propose to recover revenue which is less than building block costs, and recover any under-recovered amount in later years. Origin stated that the regulator should work closely with distributors to ensure a smooth price path.

While the AER agrees with the ESCV that it is desirable for distributors to make use of this provision to provide customers with a smooth price path where possible, it notes that the revised Order leaves it to distributors to propose reduced charges for a particular year – the regulator cannot compel them.

Origin also proposed that the regulator advise industry of the price path assuming distributors charges are based on the budgets and actual expenditure set out in the applications. The price path will be evident to stakeholders once the distributors' charges applications have been published as part of the consultation process.

### **4.5.3 Exit and restoration fees**

The revised Order requires that an exit fee is to be paid by a retailer to a distributor where:

- that retailer becomes the responsible person in respect of a metering installation for a customer with annual electricity consumption of 160 MWh or less which, immediately prior to that time, included a revenue meter that is a remotely read interval meter that has been previously installed by a distributor which complies with the Specifications and
- the responsible person in respect of that metering installation immediately prior to that time was the distributor.

The revised Order requires that a restoration fee is to be paid by the retailer to the distributor where:

- that retailer ceases to be the responsible person in respect of a metering installation for a customer with annual electricity consumption of 160MWh or less which, immediately prior to that time, included a revenue meter that is a remotely read interval meter that has been previously installed by a distributor; and
- the distributor becomes the responsible person in respect of that metering installation.

The AER notes that the Australian Energy Market Commission (AEMC) has issued a draft rule determination pursuant to which it proposes to accept the rule change proposal put forward by the Victorian Government seeking a jurisdictional derogation to implement the AMI rollout. The derogation would establish the distributors as exclusive responsible persons for small customers for the purposes of the rollout. The AEMC is due to publish the final determination on 29 January 2009.

The derogation would grant exclusivity to the distributors until 31 December 2013 (unless there are further amendments to the NER prior to this date which provide for an AMI rollout in other jurisdictions).

The ESCV considered that, if the derogation is ultimately approved in its current form, exit fees and restoration fees would not be payable during the initial AMI budget period. Accordingly, it would be unnecessary for a determination on those fees to be made during this period.

In response to this position, SPA stated that exit and restoration fees could apply during the initial AMI budget period should a customer cross the 160MWh per annum boundary. SPA also stated that if a distributor makes a fees application for exit or restoration fees then the regulator must make a determination as provided by the revised Order.

The AER agrees that the theoretical requirement for an exit or restoration fee determination as set out by SPA exists, and that the revised Order requires the regulator to make a determination should a distributor make an application. Nevertheless, given that the need for a determination is theoretical only, and would in any case apply to a very small number of customers, the AER is not setting out its approach to determining exit and restoration fees at this time.

Origin stated its preference that the regulator provide clear views on the approach to exit and restoration fees prior to the end of the initial AMI budget period. The revised Order requires distributors to make budget and charges applications for the 2012 to 2015 by 28 February 2011 and for the regulator to make a final determination on these applications by 31 October 2011. As part of the consultation process on these applications the AER intends to propose its approach to exit and restoration fees, should it not have done so earlier in response to a distributor's application.

#### **4.5.4 Unmetered supplies**

As with exit and restoration fees, costs and revenues associated with unmetered supplies are excluded from the cost recovery process. Clause 6 of the revised Order specifies the methodology for determining the maximum charges that each distributor may make for the provision of metering services to unmetered connection points.

The revised Order defines an unmetered connection point to mean:

...a connection point at which it is determined that a meter is not necessary in accordance with schedule 7.2 of the National Electricity Rules.

An example of an unmetered connection point is public lighting provided to local councils or Vicroads. The metering services to an unmetered connection point would essentially be the processing and storage of metering data.

The provision of metering services to unmetered connection points will remain a prescribed metering service under the revised Order.

Clause 6 of the revised Order specifies the formula that the regulator must use to determine the revised prescribed metering service charges.

For the period from 1 January 2009 to the commencement of the first subsequent price determination (1 January 2011), the revised Order states that the prescribed metering service charge is:

$$p_t = p_{t-1} \times \left( \frac{CPI_{t-1Q3}}{CPI_{t-2Q3}} \right)$$

where:

- $p_t$  is the price for provision of metering services to unmetered connection points
- $p_{t-1}$  is the price for provision of metering services to unmetered connection points determined under this Order applying on 31 December of the previous year
- $CPI_{t-1Q3}$  is the Consumer Price Index – All Groups Index for the eight state capitals as published by the Australian Bureau of Statistics for the September quarter of the previous year
- $CPI_{t-2Q3}$  is the Consumer Price Index – All Groups Index for the eight state capitals as published by the Australian Bureau of Statistics for the September quarter of the year preceding the previous year.

The AER will require distributors to ensure that their charges for the provision of metering services to unmetered connection points are consistent with the formula set out above. As proposed by the ESCV, this will be achieved via the distributors providing their proposed unmetered supply charges to the AER at the same time as their DUoS tariff proposals.

#### **4.5.5 Customer requested service fee**

Clause 9 of the revised Order enables distributors to seek approval from the regulator for the establishment of a customer requested service fee. This is a fee which is paid by a retailer to a distributor where:

- a retailer's customer requests a regulated service to a standard in excess of that normally provided
- the costs of providing that regulated service can be reasonably attributed to that customer.

To the extent that distributors propose to charge such a fee, they will be required to provide information on:

- the level of extra service that is proposed to be provided
- the extra costs of the extra service, and the manner in which the extra costs have been calculated.

Given that the additional service level required by the customer in such circumstances is likely to be 'above scope' the AER notes that the costs of serving the customer

cannot be included in a budget application or a charges application. They therefore need to be included in a separate fees application. Under the revised Order these may be made at any time.

## **5 Information requirements**

### **5.1 Introduction**

In chapter 2 the AER set out some of the information it is seeking from distributors on specific issues. This chapter sets out the AER's approach to the information that the distributors will need to provide, including in their initial AMI budget period budget applications, and its reasons for that approach. It also sets out the timeframes for the initial AMI budget period.

### **5.2 Requirements of the revised Order**

The regulatory framework set out in the revised Order provides for a relatively intensive exchange of information between the distributors and the regulator. Under a standard incentive-based framework, once an initial price determination has been made, information provision may be limited to the distributors providing the regulator with a list of proposed tariffs on an annual basis which need to be checked against the pre-determined formulae.

However, under the cost recovery based approach of the revised Order several submissions, each containing a large amount of information, will need to be provided to the regulator.

In order to ensure that the regulatory arrangements operate in a smooth and efficient manner, it is important that the regulator and the distributors have a common and well defined view regarding the nature of the information that needs to be provided.

This is particularly the case given that the revised Order generally provides that the regulator is to establish that expenditure should not be included in a budget or charges determination. In such circumstances it is important for the regulator to take a pro active approach to obtaining information so that it can form a view as to whether it can establish or cannot establish certain matters.

Initial AMI budget period information needs to be provided by the distributors associated with the following:

- an initial AMI budget period budget application by 27 February 2009
- an initial charges application by 1 June 2009 including actual expenditure for 2008
- charges revision application by 31 August 2010
- budget variance applications, which may be made at any time.

The revised Order sets out the specific information that must be provided with each of the above submissions. In addition, the revised Order provides that budget and charges applications must include the information specified by:

- any framework and approach paper (as amended from time to time)

- information templates (as amended from time to time).

The revised Order also provides that the regulator may from time to time require provision of further information or documents in order to determine an application.

### 5.3 Proposed positions

In its consultation paper, the ESCV described the proposed positions in relation to the following:

- As general principles for information provision, submissions, including distributors' budget and charges applications, are generally to be made public. Confidential information is to be clearly identified and justified.
- Information provided by distributors must be probative. In addition the regulator may also require provision of internal corroborating business records supporting the information provided initially.
- Expert reports provided by distributors to support their applications should meet an information standard.
- Information is expected to be provided in a timely manner.
- The regulator's powers to require provision of information are those under section 37 of the *Essential Services Commission Act 2001*.
- The data templates for the initial AMI budget period budget application.
- Timeframes for the initial AMI budget period.

### 5.4 Summary of submissions

Jemena Electricity Networks (Vic) Ltd (JEN) and United Energy Distribution (UED) made a joint submission relating to the proposed positions on information requirements. A submission was also received from SP AusNet (SPA) and a joint submission from CitiPower (CP) and Powercor (PC).

The submissions primarily addressed the draft data templates.

CP/PC stated that the draft data templates included items relating to the initial charges application, and not the initial budget application. Similarly, SPA considered that the charges templates should be separate from the budget templates.

CP/PC considered that the draft data templates were inappropriately detailed and JEN/UED stated that the level of detail was such that a cost allocation model would be needed to populate the templates as the businesses do not record financial information at that level of detail. SPA also stated that its financial system is not designed to report at the level of detail shown in the templates.

SPA and CP/PC stated that the draft templates are not consistent with the scope each business has agreed with the Victorian government. JEN/UED stated that it is unlikely

that a single set of templates will suit all distributors and suggested that templates tailored for each business be used. They also proposed that the templates be derived from each distributor's financial model, as this will allow meaningful comparison of actual and budgeted expenditure.

## **5.5 Issues, AER considerations and AER approach**

Having had regard to submissions to the consultation paper published by the ESCV and the requirements of the revised Order, the AER's approach to the issues concerned with information requirements is as set out below.

### **5.5.1 General principles for information provision**

This section sets out the AER's general expectations regarding information provision.

As the AER is committed to an open and transparent process, as a general rule, distributors' budget and charges applications and revisions are to be made public. However, it recognises that some of the documentation will naturally contain confidential information, including information that may harm the commercial interests of the distributor if it were to be released publicly. Any confidential material which forms part of a submission should be clearly identified and justified.

Submissions will be made available on the AER's website at [www.aer.gov.au](http://www.aer.gov.au). Generally, information received by the AER will be treated as public documents. Interested parties are referred to the ACCC/AER's information policy for further information regarding the AER's use and disclosure of information available on the AER's website.

#### **5.5.1.1 Verification of information**

In order to ensure the integrity of the review process and that the requirements of the revised Order are met, it is important that information provided by the distributors must be probative – that is, it must be rationally supported by underlying evidence. Where information is provided by the distributor the information should be:

- relevant
- true and correct, and not misleading or deceptive
- based on internal business records and be capable of corroboration from internal business records
- verified by the distributor.

In relation to verification, an appropriate verification statement in respect of historical information (where that historic information is not addressed by any required audit certification) could be to the effect that the officer has reviewed the information provided, made all relevant and appropriate enquiries in relation to the information provided, and is satisfied it is true and correct and drawn from the internal business records of the distributor. Specifically, budget applications, budget variation applications, charges applications and charges revision applications should include a

verification statement signed by the distributor's chief executive officer or equivalent officer.

In relation to forecast and estimated information, including budget applications, an appropriate statement would set out that the officer has reviewed the basis on which the forecast or estimate is made and is satisfied that the forecast or estimate is a genuine forecast or estimate made on a reasonable basis.

While a verification statement of this nature will be of assistance, ultimately it is a matter for the regulator to decide whether the information provided is sufficient, and whether additional information is required.

The regulator may also require provision of internal corroborating business records. In relation to business/expenditure plans, forecasts and estimates, the corroboration may include:

- a copy of the business planning/expenditure approval processes on which such plans, forecasts or estimates have been made
- a copy of the internal business planning/expenditure approval documentation in relation to a particular expenditure or forecast/estimate
- evidence that such plans, forecasts or estimates have been adopted by the board of the distributor as appropriate
- a statement from an authorised officer verifying that planned or forecast expenditure meets the internal business planning approval/expenditure approval requirements, has been approved and is reasonably anticipated to be incurred, and
- a copy of the internal procedures for ensuring that projects are undertaken prudently and efficiently.

Naturally the scope and detail of additional material required to support information provided by the distributors will vary on a case-by-case basis. For example, an item that is of greater importance and/or materiality is likely to require greater substantiation.

#### **5.5.1.2 Expert reports**

Expert reports provided by distributors to support their applications should include the following:

- a statement as to the particular matter or issue the report is intended to address
- the basis of the qualification of the third party to provide the supporting submission or report
- details as to the factual matters and assumptions on which the report is based and the source of such facts and assumptions, and
- the reasoning and the process of reasoning on which the conclusions and the opinions set out in the report are based.



### **5.5.1.3 Timely provision of information**

The AER expects information to be provided in a timely manner. It is unhelpful for material to be submitted late or outside a consultation period because it undermines the ability of the AER and other relevant stakeholders to properly review and assess the information provided.

The AER expects that the distributors will voluntarily provide information in accordance with their obligations under the revised Order and as set out in this framework and approach paper.

Attention is also drawn to section 37 of the *Essential Services Commission Act 2001* to require provision of information and/or production of documents. This section permits the regulator to require a person, who the regulator has reason to believe has information or a document that may assist in the performance of any of its functions, to give that information or a copy of that document to the regulator. Under the *National Electricity (Victoria) 2005 Act*, the AER is able to exercise these information gathering powers.

## **5.5.2 Initial AMI budget period budget application**

The initial AMI budget period budget application will need to include both written information as well as a set of data templates. The written information is generally discussed in chapters one to four of this final decision.

### **5.5.2.1 Data templates**

The ESCV released a draft set of initial AMI budget period budget application data templates for consultation as an appendix to its consultation paper. Consistent with the ESCV's consideration that it is important that the form and nature of information provided is consistent across the distributors, and across budget applications, initial charges applications and charges revision applications, the data templates were to apply to all distributors and contained detailed information requirements.

In response to the draft data templates released for consultation, a number of distributors stated that the templates were inappropriately detailed and that the level of detail was such that a cost allocation model would be needed to populate the templates as businesses do not record financial information at that level of detail.

Distributors stated that the draft templates are not consistent with the scope each business has agreed with the Victorian government and that it is unlikely that a single set of templates will suit all distributors.

In response to the submissions, and following discussions with the distributors, the draft data templates were reviewed, and the approach revised to address the issues identified.

Given the particular requirements of the regulator's role under the revised Order, it is considered appropriate that individual initial AMI budget period budget application

data templates for each distributor, based on that distributor's scope<sup>12</sup> and financial system capabilities, are used.

This is intended to make comparisons of budget and actual expenditure for each distributor more meaningful, reducing the need for potentially subjective cost allocation methodologies, and more clearly related to each business's scope. It will also enable the distributors to provide information at the lowest level of detail required which their systems can produce. However the templates also have common elements which will make comparisons between distributors, at a higher level of cost aggregation, possible.

The review of the data templates has also ensured that items relating to the initial charges application, and not the initial budget application, are not included. Following further consultation, the AER will release separate templates for the submission of information in initial charges applications and charges revision applications.

### 5.5.3 Timeframes for initial AMI budget period

The AER's indicative timetable for the initial AMI budget period is set out in table 5.1. Dates prescribed in the revised Order are in normal text and milestones identified by the AER are shown in italics.

Table 5.1 **Revised Order - milestones for the initial AMI budget period**

<b>Milestone</b>	<b>Date</b>
Initial prices take effect	1 January 2009
Distributors submit initial AMI budget period budget application	27 February 2009
Distributors submit 2010-11 initial charges application	1 June 2009
<i>Draft determination on initial AMI budget period budget application and 2010-11 initial charges application</i>	<i>31 July 2009</i>
Distributors may submit revised initial AMI budget period budget application to reflect material changes in costs as a result of contracts entered into or new regulatory obligations	31 August 2009
<i>Submissions on draft determination close</i>	<i>11 September 2009</i>
Final determination on initial AMI budget period budget application and 2010-11 initial charges application	31 October 2009
2010-11 initial charges take effect	1 January 2010
Charges revision application to be submitted	31 August 2010
<i>Submissions on charges revision application close</i>	<i>30 September 2010</i>
Determination of revised charges for 2011	31 October 2010
2011 charges take effect	1 January 2011

<sup>12</sup> Inclusion of a line item in an information template does not imply that the AER considers the corresponding expenditure to be for activities which are within scope.

As shown by table 5.1, the revised Order is relatively prescriptive regarding the timeframes to be followed. However, it does not specify dates for draft determinations or the periods during which submissions on draft determinations will be sought.

The AER intends to release a draft determination on the distributors' 2010 and 2011 budget and charges application by 31 July 2009. While it may be desirable to release the draft determination slightly earlier than this, distributors' proposed 2010 and 2011 charges and 2008 actual outcomes will not be provided until 1 June 2009. Consistent with the minimum period specified in the revised Order of 30 business days, based on this draft determination date, submissions will be received until 11 September 2009.

As noted the revised Order does not specify the timeframes by which the building blocks related to 2006 to 2008 expenditure should be provided. As this information is required to make the 2010-11 initial charges determination this information is to be provided to the AER at the same time as the 2010-11 initial charges application – i.e. 1 June 2009. This will ensure that actual 2008 outcomes are known at the time of the submission.

The timetable set by the revised Order allows revised budget applications (which must be submitted by 31 August 2009) to be made after the date proposed for the draft determination (31 July 2009). It is intended that the distributors' proposals be released and submissions sought on the proposals until 11 September 2009, consistent with the submissions to the draft determination.

In relation to the determination of revised charges for 2011, there is a two month period from 31 August 2010 to 31 October 2010 for the regulator to consider distributors' submissions. This is insufficient time for a draft decision to be released. The AER intends that the distributors' proposals be released and submissions sought on the proposals until 30 September 2010. This will allow for consideration of submissions prior to the regulator's determination on 31 October.

## **Appendix A: Information templates**