AEMC

REVIEW

Australian Energy Market Commission

FINAL REPORT

Request for Advice on Cost Recovery for Mandated Smart Metering Infrastructure

Commissioners

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30 November 2010

Reference: EPR0018
Final Report
EMBARGO until 22 December 2010

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Reference: EPR0018

Citation

AEMC 2010 , Request for Advice on Cost Recovery for Mandated Smart Metering Infrastructure, Final Report, 30 November 2010, Sydney

About the AEMC

The Council of Australian Governments, through its Ministerial Council on Energy (MCE), established the Australian Energy Market Commission (AEMC) in July 2005 to be the rule maker for national energy markets. The AEMC is currently responsible for rules and providing advice to the MCE on matters relevant to the national energy markets. We are an independent, national body. Our key responsibilities are to consider rule change proposals, conduct energy market reviews and provide policy advice to the Ministerial Council as requested, or on AEMC initiative.

Summary

This report sets out the Australian Energy Market Commission's (Commission's) final advice and proposed Rule amendments to the Ministerial Council on Energy (MCE) on whether Chapter 6 of the National Electricity Rules (Rules) most efficiently accommodates cost recovery for smart metering infrastructure (SMI), which is mandated by a Ministerial determination.

We find that the existing Chapter 6 framework would adequately accommodate the recovery of the efficient costs of mandated SMI expenditure, net of any reasonably achievable network operational benefits, subject to the following incremental amendments being made:

- specifying the classification of smart meter provision and installation and smart meter data provision as separate standard control services, and requiring these services to be unbundled from the distribution use of system charges (DUOS);
- including a revenue adjustment during the distribution determination process to ensure that distribution network service providers (DNSPs) are neutral to any differences between the forecast and actual timing of mandated smart meter roll-outs;
- requiring DNSPs to provide annual information to the Australian Energy Regulator (AER) on the actual costs and benefits of mandated smart meter roll-outs, pilots and trials they are undertaking. The AER would be required to make such information public;
- including a new interim determination process to require the AER to amend its distribution determination during a regulatory control period, where a DNSP is required to incur costs in undertaking a mandated smart meter roll-out, but these costs have not been incorporated in the relevant distribution determination;
- not permitting the recovery of the stranded costs of existing meters through accelerated depreciation following a mandated smart meter roll-out. Instead, DNSPs would be required to continue to recover the costs of these meters through DUOS charges based on their current asset lives; and
- including greater prescription in relation to how tariffs for smart metering services must be structured by DNSPs, to provide for the efficient allocation of costs and the unbundling of separate tariffs for smart metering services.

These amendments would provide greater regulatory certainty for stakeholders and improve the AER's application of the Chapter 6 Rules when it makes regulatory determinations for mandated SMI. We have sought to ensure that the Rules promote the efficient management of the costs and provision of services resulting from mandated SMI and also facilitate the realisation of the potential benefits of SMI. This would be achieved through incentivising DNSPs to capture costs savings, and enabling the AER to consider such benefits in making its regulatory determinations.

Importantly, through accommodating the treatment of mandated SMI within the existing Chapter 6 framework, our proposed amendments would allow mandated SMI to be regulated under the same in principle framework as SMI provided by the DNSPs on a commercial basis. This would provide for a consistent approach to cost recovery for SMI and reduces regulatory uncertainty for DNSPs.

Two amendments are proposed to improve the effectiveness of the current distribution determination process. The first provides for a revenue adjustment to reflect differences in the actual timing of a mandated smart meter roll-out compared with the timing forecast in the previous distribution determination. The second ensures that the AER has sufficient information to make regulatory determinations, by requiring DNSPs to provide annual information on any mandated smart meter roll-outs, pilots or trials they are undertaking. These two amendments recognise that SMI is a relatively new technology. They would also assist in alleviating the impact of uncertainty in relation to the efficient costs and benefits of mandated SMI on the effectiveness of the cost recovery process.

In regard to the adequacy of the cost pass through provisions, we recommend that the current cost pass through provisions should continue to be applied to mandated smart meter pilots and trials, subject to some mechanical amendments to improve the transparency and certainty of the process. However, the current cost pass through provisions are not able to accommodate the scope and complexity of mandated smart meter roll-outs. Therefore, jurisdictional Ministers should seek to align the timing of a Ministerial roll-out determination with the distribution determination process, so that expenditure for a mandated roll-out commences with the start of the next regulatory control period.

There are significant benefits in aligning the consideration of mandated smart meter roll-out expenditure with the distribution determination process. The distribution determination process provides the most effective and rigorous mechanism for the recovery of the net efficient costs of mandated smart meter roll-outs. Aligning these timeframes is feasible as the current timing of the distribution determination cycles provides each relevant jurisdictional Minister with a reasonable opportunity to coincide a Ministerial roll-out determination with the start of the next distribution determination process.

To address the situation that the timing of these processes are not aligned, we have proposed an interim determination process that the AER would be required to undertake within a regulatory control period to allow DNSPs to seek cost recovery for mandated smart meter roll-outs. This interim determination process would use similar decision making criteria and be in a similar form to the current distribution determination process. However, this is considered a second best solution compared to the relevant jurisdictional Minister aligning the timing of the roll-out with the start of the next regulatory control period.

In addition, we recommend that more prescription is required in the Rules on how mandated smart metering services are classified and how the costs for mandated SMI are allocated and charged to retailers. The current Rules could permit a wide range of

possible tariffs and the DNSP may have an incentive to set tariffs for mandated SMI in a manner which acts as a barrier to future competition. Therefore these amendments are necessary to promote efficiency and transparency in relation to the costs of mandated SMI. We also recommend that the costs of a mandated roll-out are recovered through fixed charges rather than consumption based charges, and that any unbundled smart metering charge is levied once the individual customer has received an installed and functioning smart meter.

With respect to how best to allocate the costs of mandated SMI across different distribution tariffs, we stress that this is dependent upon whether contestability occurs in the future and the arrangements for contestability. The allocation of costs would also be influenced by the range of ancillary commercial services which arise from the SMI. We have developed our recommendations to reflect that initially the services would be provided under a mandated monopoly position with the prospect of moving to a supplier led model, with contestability for SMI services. We recommend that as the MCE develops its policy and arrangements for future contestability of smart metering services, it reviews our recommendations to ensure that they remain appropriate.

We also note that the recommendations set out in this report for a cost recovery framework for mandated SMI represent only one of many factors which will affect the realisation of the potential benefits of smart meters. Smart meters will enable tariffs to vary by time and place, and facilitate new types of retail offers and services. However, the successful capture of the benefits associated with SMI will depend on the willingness and ability of participants, including customers, retailers and DNSPs, to pursue such opportunities. An appropriate tariff framework which enables variability in tariffs and also provides sufficient protection to customers will be key factors in the realisation of potential benefits.

Contents

1 Purpose of this report

This report outlines the Commission's final advice in response to the Ministerial Council on Energy's (MCE's) request for advice on whether Chapter 6 of the National Electricity Rules (Rules) most efficiently accommodates cost recovery for smart metering infrastructure (SMI) mandated by a Ministerial determination.

Our assessment finds that the existing processes for cost recovery are adequate and have the potential to accommodate the recovery of the efficient costs of mandated SMI, net of reasonably achievable network operational benefits. No fundamental changes are therefore required to support the MCE's policy on smart meters.

We do, however, recommend that some incremental amendments to the Rules be implemented to better accommodate the nature of expenditure relating to mandated SMI. Such amendments seek to alleviate the impact of uncertainty in relation to the costs and benefits of a mandated smart meter roll-out, provide more investment certainty to distribution network service providers (DNSPs), and improve the transparency of the cost recovery and tariff arrangements for mandated SMI. These changes to the Rules are set out in a proposed Rule change request attached to this report.

This Chapter outlines the background to our advice to the MCE and also explains how we have considered the range of network activities and services that may be provided using mandated SMI. Chapter 2 sets out our key recommendations and highlights where these have changed from the recommendations in our Draft Report. Chapters 3 to 6 contain further detail and reasoning to support our recommendations. Chapter 7 provides advice on the implementation of our proposed changes to the Rules. Supporting information for our recommendations is provided in the appendices.

Our final advice is based on analysis undertaken during the Review, the legal advice we have received, and the issues that have been raised in submissions and stakeholder discussions.[1] Further information on our approach to this Review, including the decision making criteria and the scenarios we applied to assess the adequacy of the current Rules, is provided in Appendix B.

1.1 The MCE's Request for Advice

The MCE is currently applying a staged approach to facilitating a national roll-out of SMI in areas where the benefits outweigh the costs. It has provided for mandated smart meter roll-outs to be exclusively performed by DNSPs, as it considered that the potential benefits of a roll-out are split between various parties in such a way that any individual party is unlikely to independently establish a positive business case for

1 Copies of the submissions are available from the AEMC website at: www.aemc.gov.au. Our legal advice we have received from Allens Arthur Robinson was published with our Draft Report and is also available on the AEMC website (see AAR, 2010, Advice in Response to MCE Request for Advice on Cost Recovery for Mandated Smart Metering Infrastructure, 18 June).

investing in a roll-out.[2] To facilitate this, amendments have been made to the National Electricity Law (NEL) to enable Energy Ministers in participating jurisdictions to make a determination to require DNSPs (operating predominately in their jurisdiction) to roll-out smart metering services to customers within their jurisdiction.[3] To help inform this process, the amendments to the NEL also enable a Minister to direct a DNSP to conduct pilots and trials of SMI and other related technologies, including direct load control.

The MCE has agreed that DNSPs should be able to recover the direct costs associated with complying with any Ministerial determinations through a regulatory process, but that cost recovery should be limited to efficient costs and net of reasonably achievable network operational benefits.[4] This is to ensure that such benefits are passed promptly and directly to consumers. The MCE has asked the Commission to review the current Rules and provide advice on whether any additional changes to the regulatory framework are needed to support these principles.

In its Request for Advice, the MCE has raised a number of issues regarding how the Australian Energy Regulator (AER) would determine the level of allowed revenue to compensate a DNSP for mandated SMI expenditure, either through the five yearly distribution determination process or via an adjustment within a regulatory control period under the cost pass through provisions. The MCE has also asked for advice on matters relating to how the costs of mandated SMI should be translated into customer tariffs. This includes whether it is appropriate to unbundle tariffs for smart metering services from the common distribution use of system (DUOS) charges. We have also been asked whether the mechanisms in the Rules would allow the tariff impact of a mandated smart meter roll-out to be smoothed. A copy of the MCE's Request for Advice is at Appendix A.

1.2 Updated Victorian AMI Program Costs and Benefits

On 13 October 2010, the MCE wrote to the AEMC requesting that the finalisation of the Final Report be delayed to allow the AEMC the opportunity to consider the updated cost benefit analysis for the Victorian roll-out (which was published on 3 September 2010). The MCE provided an extension of time for the provision of this Final Report to 29 November 2010.

The updated Victorian Cost Benefit Analysis includes a number of consultancy reports which discuss and quantify the range of costs and benefits associated with both the Advanced Metering Infrastructure (AMI) roll-out and the AMI program. The AMI program is additional to the roll-out and includes the processes and systems which enable and support the capturing of associated benefits from the technology. The analysis has been very useful in improving our understanding of the degree of

2 MCE, 2008, *Smart Meter Decision Paper*, 13 June, p. 1.

3 The *National Electricity (South Australia) (Smart Meters) Amendment Act 2009* was passed in the South Australian Parliament on 29 October 2009. It commenced operation on 1 January 2010.

4 MCE, 2008, *Smart Meter Decision Paper*, 13 June, p. 8.

uncertainty about future costs and benefits, in addition to assessing the various methods to allocate the costs of a mandated roll-out across customers. The AEMC notes that this analysis includes an additional 21 categories of benefits which had either not been foreseen or quantified in the MCE's 2008 National Cost Benefit Study on Smart Metering and Direct Load Control.

The total cost of the Victorian AMI Program is now estimated to be $1.81 billion (plus or minus $249 million) over the 2008 - 2028 program timeframe. This is estimated to be 24 per cent more than the business as usual costs of metering, manual meter reading and connection activities, if the AMI Program had not occurred. The benefits of the AMI Program over this 20 year period are estimated to range from $2.58 billion to $5.04 billion. Using the low case benefits and expected cost case, this would result in net benefits of $764 million (i.e. a benefit cost ratio of 1.25). Net benefits would equal $3.19 billion, if the high case benefits were used (i.e. a benefit cost ratio of 2.76). Most of the difference between the low and high cases is due to the potential for customer benefits from demand response and home area network operations. This category of benefits is estimated at $556 million in the low case to $3.1 billion in the high case. It is recognised that this category will be dependent upon retailer tariffing and decisions by customers to install home area networks.

In regards to who the benefits accrue to, the study states that in the low benefits case 75 per cent of benefits will accrue to DNSPs in the form of network and metering operational cost savings; 22 per cent will accrue to consumers as a result of demand response and the use of home area networks; and 2 per cent will accrue to retailers. In the high benefits case, it is assumed that consumers and DNSPs would each receive close to 50 per cent of the benefits, with the share of benefits to retailers unchanged. The difference between the high and low benefit scenarios is the level of discretionary action which is taken by retailers and consumers to provide and respond to time varying prices.

1.3 Smart metering services under consideration

'Smart meters' are meters which are capable of two-way communications. When connected to a communications network, they can allow 'real time' data and instructions to flow to and from the network and the customer's site. SMI includes the smart meter and the required communications and IT equipment which connects the smart meter to a distribution network. SMI has the potential to significantly expand the range of functions that traditional meters can provide. They are capable of facilitating functions such as time of use pricing, remote connection and disconnection, and direct load control. These expanded functions provide opportunities for improved efficiency in the use and management of the electricity network. SMI also provides customers with a greater capacity to manage their electricity consumption.

In considering the smart metering services that may be provided by DNSPs, we have grouped these services in terms of 'core services' and 'non-core' or ancillary services. Core services are smart metering services that a DNSP would be mandated to provide under a Ministerial smart meter determination and would form the essential services in

that determination. In other words, the provision of these core services would represent the underlying purpose of the Ministerial smart meter determination. These core services would include the following services that a DNSP is mandated to provide under a Ministerial smart meter determination:

- smart meter provision and installation;
- recovery of the costs of stranded meters;
- meter data provision; and
- smart meter pilot and trial services.

Importantly, under a Ministerial smart meter determination, DNSPs would have exclusivity over these core services they are required to provide. It is recommended that these core services be classified as standard control services, in order to provide greater regulatory certainty for DNSPs on how these services would be regulated and how costs would be recovered. A standard control services classification would also reduce the potential for variations in the process for cost recovery for these core services both across different DNSPs and over multiple regulatory control periods. As a result, the AER would have no discretion in classifying these services through the distribution determination process. We discuss this recommendation further in section 3.2 of this report. Importantly, under a Ministerial smart meter determination, DNSPs would have exclusivity over the core services they are required to provide.

'Non-core' services or ancillary services would include any other smart metering services that a DNSP provides using its mandated SMI. This could include smart metering services that a DNSP is required to provide under a Ministerial smart meter determination consistent with the functionality of the smart meter and also any services that a DNSP decides to voluntarily provide using its mandated SMI. These 'non-core services' could include services such as remote connect and disconnect services, and supply capacity limiting services. In contrast, to the core services discussed above, DNSPs may not have exclusivity over the provision of these services.

As there are a range of possible ancillary services that may be provided by DNSPs, it is considered that the AER should maintain its current discretion in the Rules to determine the most appropriate service classification for each ancillary service. The nature of competition is also likely to differ for different types of ancillary services. In some cases where similar services are provided on a competitive basis, it may be appropriate for an ancillary service to remain unregulated or be classified as a negotiated service.

A summary of how we have approached smart metering services in this report and the implications for service classification are outlined in Figure 1.1 below. Further detail regarding our recommendations on service classification can be found in Chapter 3. Finally we note that the National Stakeholder Steering Committee on Smart Meters (NSSC) is currently developing a Rule change package for the MCE to include definitions for 'required smart metering infrastructure' and 'smart metering services' in the Rules. In light of this work, our draft Rules may need to be reviewed for

consistency once the NSSC and the MCE have finalised the NSSC's Rule change package.

Figure 1.1 Smart metering services by service classification

	Core services				Non-core services
Activities	**Smart meter provision and installation**	**Meter data provision**	**Recovery of stranded meter costs**	**Mandated smart meter pilot and trial services**	**Ancillary services** - May be mandated under a Ministerial determination or voluntarily provided by DNSPs using their mandated SMI (e.g. supply capacity limiting services, remote connect/disconnect services etc)
Service classification	Standard control service - specified in the Rules. No AER discretion over service classification.	Standard control service - specified in the Rules. No AER discretion over service classification.	Standard control service - specified in the Rules. No AER discretion over service classification.	Standard control service - specified in the Rules. No AER discretion over service classification.	AER maintains current discretion to classify these services in accordance with Rule 6.2 in the current Rules.

2 Key recommendations and changes from the Draft Report

2.1 Summary of key recommendations and changes from the Draft Report

The Commission published its Draft Report on the MCE's Request for Advice on 18 June 2010 for public consultation. The Draft Report set out the Commission's draft advice on the appropriate cost recovery arrangements for mandated SMI and proposed a number of changes to the Rules. A total of 10 submissions were received on the Draft Report.[5] After considering these submissions and undertaking further analysis, the Commission has determined to make a number of changes to its draft advice in this Final Report.[6] To assist stakeholders in identifying the changes in the Commission's advice from the Draft Report to the Final Report, outlined below are the key recommendations in our final advice and the changes in this advice from the Draft Report.

The Commission's final advice is set out in further detail in Chapters 3 to 7 of this report. These chapters also set out the reasons for the changes between our draft and final recommendations.

Further details regarding our assessment of the Rules and the alternative options we considered during the Review can be found in our Draft Report and the Options Paper that was published with the Draft Report.[7]

2.1.1 Mechanism to address timing uncertainty

In the Draft Report, we recommended that the Rules be amended to provide for a revenue adjustment at the next distribution determination process where there is a difference between the actual timing of a mandated roll-out of smart meters and associated infrastructure and the earlier forecast timing in the previous distribution determination. The purpose of this mechanism was to ensure that DNSPs remain revenue neutral to differences between the actual and forecast timing of the mandated roll-out. This counteracts incentives for DNSPs to delay the timing of a mandated smart meter roll-out within a regulatory control period and removes the potential financial impact on DNSPs of enforced delays or other changes in the roll-out schedule.

5 A copy of the submissions that were received on the Draft Report are available from the AEMC's website at www.aemc.gov.au. A summary of the issues raised is contained in Appendix C.

6 Under the MCE's Request for Advice, the Commission was required to submit its Final Report to the MCE by 31 August 2010. After reviewing submissions on our Draft Report, we considered that further time was required to assess the issues raised in submissions. On 16 August 2010, an extension of time to 17 September 2010 for the submission of the Final Report to the MCE was approved by the Chair of the MCE Standing Committee of Officials.

7 Our Draft Report on the Request for Advice and accompanying Options Paper are available from the AEMC website: www.aemc.gov.au.

This revenue adjustment also compensates a DNSP where it undertakes a mandated roll-out faster than forecast in its distribution determination.

This mechanism has been retained in our final recommendations in this Report. We note that submissions mostly supported this mechanism and asked for more detail on how the mechanism would be applied. To address this, we have clarified that the revenue adjustment would apply to both variable and fixed costs, and would be made at the next distribution determination process. Revenue would be adjusted to reflect differences between the forecast and actual roll-out schedule for variable costs, such as the. number of meters provided and installed.

There would also be an adjustment to reflect differences between the forecast and actual roll-out schedule for fixed costs, such as the installation of IT and communications equipment. The AER would determine the level of these forecast costs and the timing profile of this expenditure in its distribution determination. The revenue adjustments would be based on the cost assumptions in the previous distribution determination, to ensure that the DNSPs continue to have an incentive to seek cost efficiencies. This amendment would apply to all mandated smart meter roll-outs, as the current incentives in the Rules would not lessen with experience or more information.

2.1.2 Annual reporting on the costs and benefits of mandated smart meter roll-outs & pilots and trials

In the Draft Report, we recommended that the Rules be amended to require DNSPs to provide annual information to the AER on the actual costs and benefits of mandated smart meter roll-outs, pilots and trials they are undertaking. It was proposed that this new reporting requirement also be extended to Victorian DNSPs in relation to the advanced metering infrastructure (AMI) roll-out which is currently underway. In submissions to the Draft Report, some stakeholders questioned the need for this additional information requirement, while other submissions noted that it would provide transparency to the implementation of mandated SMI.

The Commission has retained this reporting requirement in its Final Report. The Commission has proposed that the AER should also be required to publish the information that is provided by DNSPs each year. This would provide greater transparency regarding mandated smart meter roll-outs, pilots and trials for potential new entrants and consumers. The AER would also be provided with the discretion not to apply this reporting requirement, where it considers that the required information is already being provided under alternative reporting requirements.

2.1.3 Mechanisms to address expenditure uncertainty

In the Draft Report, we recommended that the Rules be amended to provide the AER with the discretion to apply additional regulatory mechanisms in making a distribution determination where it considers there is a substantive degree of uncertainty regarding the quantum of the efficient costs and expected operational benefits of mandated SMI.

These additional mechanisms included rolling forward the regulatory asset base (RAB) on the basis of forecast rather than actual depreciation for short lived mandated SMI assets, and a cost sharing mechanism under which the AER could determine how any difference between forecast and actual expenditure would be shared out between the DNSP and consumers to reflect the level of uncertainty.

The Commission has not recommended either of these two additional regulatory mechanisms in its final advice. It considers that, in respect to efficiency incentives, it is important to have the same regulatory framework applying to mandated SMI as to commercially provided SMI. Consistent treatment with respect to efficiency incentives will promote effective regulation and regulatory certainty and would remove a potential disincentive on DNSPs to undertake commercially driven roll-outs of SMI. We also note that a number of DNSPs argued against changing the treatment of depreciation from forecast to actual depreciation solely for mandated SMI.

The AER would retain its current discretion to reduce the incentives for operational efficiencies for mandated SMI by excluding SMI operating expenditure from the Efficiency Benefit Sharing Scheme (EBSS). We note that the AER would also retain its current ability to extend the EBSS to include capital expenditure associated with SMI. However, in exercising this discretion the AER would need to consider the practicality of separately identifying and excluding SMI expenditure, and the trade-off between reducing the potential for windfall gains and reducing the incentives to make genuine efficiency improvements which can be passed through to customers.

We continue to consider that the potential uncertainty in relation to the level of efficient SMI expenditure may affect the effectiveness of the cost recovery arrangements in Chapter 6 of the Rules. The proposals for both the timing uncertainty mechanism and annual reporting by DNSPs would assist in addressing this expenditure uncertainty. Undertaking pilots and trials of SMI prior to a Ministerial roll-out determination would also assist in developing experience and practical knowledge on the implementation of SMI. This is likely to significantly reduce the materiality of uncertainty in relation to the level of efficient SMI expenditure.

2.1.4 Classification of services for mandated smart meter roll-outs, pilots and trials

In the Draft Report we recommended that where mandated smart metering services are classified as alternative control services, the distribution determination process has the potential to provide for the recovery of net efficient costs.

The Commission has determined that where 'core' smart metering services are mandated under a Ministerial smart meter determination, greater certainty should be provided to DNSPs regarding how the costs of these services would be recovered and regulated. Therefore, the Commission has proposed an amendment to the Rules to specify that specific core smart metering services which are provided by DNSPs under a Ministerial smart meter determination must be classified as standard control services. As a result, the AER would have no discretion in determining the appropriate service classification for these services through the distribution determination process. These

'core' smart metering services would include the following service which are mandated under a Ministerial smart meter determination: smart meter provision and installation; meter data provision; the recovery of stranded meter costs; and smart meter pilots and trials. This amendment would reduce the potential for variations in the cost recovery process for these core services.

Where a Ministerial smart meter determination is made in the current regulatory control period, this amendment would also ensure that DNSPs in NSW, ACT, SA and Qld can recover the costs of meeting their mandated obligations under the Chapter 6 Rules, as types 1-4 metering services have been classified as unregulated in the AER's current distribution determinations for these jurisdictions.[8]

For non-core smart metering services, which would include any other services that a DNSP provides using its mandated SMI, the AER would be required to classify these services using the existing principles in Rule 6.2 of the Rules. Service classification would then determine how the costs of these non-core services are recovered, consistent with the current requirements for cost recovery in the Rules. We continue to recommend that the existing arrangements in Chapter 6 would facilitate the recovery of the net efficient costs of non-core services, consistent with the MCE's policy principles for smart meters.

2.1.5 Interim determination for mid period mandated roll-outs

In the Draft Report, the Commission recommended that where DNSPs are mandated to roll-out smart meters within a regulatory control period and the costs of this roll-out have not been incorporated in a relevant distribution determination, the AER would be required to defer making a decision on cost recovery until the next distribution determination process.

The Commission has not recommended the proposed ex-post review process in its final advice. DNSPs argued against deferring the assessment of expenditure until the next distribution determination process on the grounds that it would increase funding uncertainty and regulatory risk and would be a fundamental change to the current regulatory arrangements. Instead we propose that where a Ministerial roll-out determination is made within a regulatory control period, the AER should be required to make an 'interim determination' to determine the allowed revenue for that roll-out until the end of the current regulatory control period. This interim determination process would use similar decision making criteria and be in a similar form as the current distribution determination arrangements.

Where there is insufficient time for an interim determination process to be completed in the current regulatory control period, the AER would be required to incorporate the costs for the mandated smart meter roll-out in the distribution determination process for the next regulatory control period or undertake the interim determination process even if it would not be completed until part way through the next regulatory control

8 We note that this would only occur if this Rule commences before any relevant Ministerial smart meter determination.

period. Where this occurs, the AER would be required to approve any costs (including any financing costs) that a DNSP may incur in the remainder of the regulatory control period, where the AER considers that these costs are prudent and efficient. The AER would also be able to consider these costs under the standard distribution determination process, where a DNSP is required to incur costs for a mandated roll-out prior to the next regulatory control period which have not been incorporated in a relevant distribution determination.

However, this interim determination process represents the second best solution for cost recovery for mandated smart meter roll-outs, as the distribution determination process provides the most effective and efficient mechanism for the recovery of net efficient costs. Therefore, Ministers should seek to align the timing of a Ministerial roll-out determination with the distribution determination process, so that a DNSP is only required to undertake expenditure at the start of the next regulatory control period. We note that the current cycle of distribution determinations provides an opportunity for each jurisdictional Minister to achieve this.

2.1.6 Materiality threshold and the cost pass through process for mandated smart meter pilots and trials

In the Draft Report, the Commission stated that the AER had sufficient flexibility under the Rules to determine the most appropriate materiality threshold for mandated smart meter pilots and trials, where a DNSP is required to seek cost pass through for the costs of a mandated smart meter pilot or trial under clause 6.6.1 of the Rules.

The Commission now considers there would be merit in providing greater certainty regarding the AER's materiality threshold for mandated smart meter pilots and trials and has determined to specify this materiality threshold in the Rules. The Commission has recommended that the materiality threshold for mandated smart meter pilots and trials should be equivalent to the AER's administrative costs of assessing a pass through application. We note that this is the same threshold that the AER has determined should apply in recent distribution determinations for smart meter pass through events.

We have also retained the amendments we proposed in our Draft Report in regards to the process for cost pass through for mandated smart meter pilots and trials. As a result, the AER would be able to extend its timeframe for making a cost pass through determination to a maximum of six months for mandated smart meter pilots and trials. The AER would also be required to undertake an efficiency assessment in determining the appropriate pass through amount. However, these amendments would only be applied to mandated smart meter pilots and trials.

If a Ministerial pilot determination is made in the 13 months prior to the next regulatory control period, but the associated costs of the mandated pilot are not incurred until the next regulatory control period, the current Rules would prevent cost recovery under the cost pass through arrangements. We have included an amendment to remove this risk. As this is a general risk for all pass through events, it is proposed that this amendment apply to all pass through events and not just be limited to

mandated smart meter pilots and trials. Stakeholders generally supported this amendment.

We have also proposed an amendment specifically for mandated smart meter pilots and trials, to allow DNSPs to include its forecast expenditure for a mandated smart meter pilot or trial in its revised regulatory proposal during the distribution determination process, even where the AER has not referred to the mandated pilot or trial in its draft distribution determination. This would allow a DNSP to recover the costs of mandated pilots and trials through the distribution determination process rather than the cost pass through provisions, where a Ministerial pilot determination is made after the publication of the AER's draft distribution determination but before the timeframe for the DNSP to submit its revised regulatory proposal.

2.1.7 Unbundling of smart metering services from DUOS

In the Draft Report, the Commission recommended that the AER should have the discretion to unbundle smart metering services from DUOS and should be required to make this decision in accordance with a new set of principles defined in the Rules (referred to as the 'SMI Pricing Principles').

In its final advice, the Commission has determined that the two main services of smart meter provision (plus installation) and meter data provision should be separately unbundled from DUOS charges. This would provide consumers and potential new entrants with greater transparency regarding the costs of mandated smart meter roll-outs, promote competition, and facilitate economic decisions by consumers. Therefore, neither the AER nor DNSPs would have discretion in relation to whether these core smart metering services are unbundled from DUOS charges. The other core services, of recovering the costs of stranded meters and mandated smart meter pilots and trials, would be recovered through the DUOS charge and therefore would not be unbundled. We also recommend that the unbundling of tariffs should occur at the start of the roll-out, as there are broader benefits associated with unbundling beyond the promotion of future competition.

'Non-core' smart metering services would be classified under the existing Rules and the AER would retain its current discretion to unbundle these services from DUOS by classifying them as an alternative control service. We consider that the current Rules would promote separate charges in relation to these services where appropriate.

2.1.8 Efficient allocation of the costs of mandated roll-outs

Under the current Rules, DNSPs must comply with a number of high level principles when determining annual tariffs.[9] Hence there is a range of possible tariffs, between the stand alone cost and the avoidable cost of the roll-out, which would comply with the current Rules and each DNSP would have the discretion to determine which of these possible tariffs should apply. In the Draft Report we recommended that a

9 These pricing principles are set out in clause 6.18.5 of the Rules.

'beneficiary pays principle' should be used to allocate SMI costs, in order to best promote efficiency. A number of submissions argued against the beneficiary pays principle on the grounds that it would too hard to apply in practice as the quantity and scope of benefits could be uncertain.

The current Rules would permit a wide range of possible tariffs and the DNSP may have an incentive to set tariffs for mandated SMI in a manner which acts as a barrier to future competition. Therefore we recommend that more prescription is required on how mandated SMI costs are allocated across different tariffs levied on retailers for the range of services. We recommend that the most efficient method to allocate the costs for non-core services is for tariffs to reflect the incremental cost of providing these services.

With respect to the remaining SMI costs, we considered two broad approaches:

- Sharing the costs between the separate unbundled SMI charges and DUOS charges based on the beneficiary pays principle; or
- Allocating both separate unbundled SMI charges and DUOS charges in accordance with an objectives based methodology. This methodology would depend on the nature of the costs and level of contestability in the level of relevant service, such that:
    - the unbundled tariffs for meter and data provision would reflect the costs of such services that are variable to the individual service (i.e. cost of meter); and
    - the remaining costs which are mainly the fixed IT systems, communications, back-office support expenditure would be allocated to DUOS charges.

The Commission continues to support the application of the beneficiary pays principle as the methodology for allocating the remaining SMI costs. However we note that in practice that there may not be a material difference in pricing outcomes between these two approaches. A worked example, which uses data from the updated Victorian Cost Benefit analysis, is set out in Chapter 6 of this report which demonstrates how the beneficiary pays principle could be applied in practice.

In relation to non-core smart metering services, the AER would not be required to calculate the relative proportion of benefits for each service in order to apply a beneficiary pays principle. Instead, we consider that the existing pricing principles in clause 6.18.5 of the Rules (in conjunction with the SMI pricing principles) and the AER's decision on service classification, should ensure that the tariffs for such services reflects the incremental costs. This will help to reduce the administrative costs of applying a beneficiary pays principle.

We are also proposing the following two additional conditions in relation to the allocation of mandated SMI costs for the core services:

- firstly, any unbundled smart metering charge should only be levied on retailers after a customer has an installed and functioning smart meter. There are benefits from aligning the separate charging with the date of the receipt of the meter in trigging the desired changes in customer behaviour. Without an operational smart meter, customers would be unable to capture the potential benefits of the meter; and

- secondly, as most of the costs of a mandated roll-out would involve fixed costs that would not vary with consumption, the costs of a roll-out should be recovered through a fixed charge per customer. This charge should not necessarily be in the form of a standardised charge per a customer and could vary by location, depending on whether the costs and benefits of the roll-out can be attributed to a specific group of customers.

We consider that it would be unnecessary to also apply these two conditions to the tariffs for the non-core services given the nature of such services.

We recommend that as the MCE develops its policy and arrangements for future contestability of smart metering services, it reviews our recommendations to ensure that they remain appropriate in light of the policy for contestability.

2.1.9 Mechanisms to smooth the tariff impact of mandated roll-outs

The Commission has maintained both of its recommendations regarding the treatment of depreciation for stranded metering infrastructure and the use of the X factor to smooth the tariff impact of mandated SMI within a regulatory control period. In the draft Rules, we have ensured that stranded metering assets cannot be removed from the RAB. This would ensure that DNSPs will be able to continue to recover these costs after the meters have been taken out of service. As discussed above, the costs of these stranded metering assets would remain in DUOS charges until the end of the current lives.

In the Draft Report, we also proposed a further amendment to the Rules, to allow the AER to back-end depreciation for mandated SMI assets to smooth the tariff impact of a mandated roll-out over multiple regulatory control periods. The majority of stakeholders disagreed with this proposal. The Commission has noted concerns that back-ending depreciation could increase administrative costs and could have a negative impact on future contestability by creating higher switching fees. We also recognise that back-ending depreciation could also increase the negative impact of any technology risk associated with SMI and negatively impact on the cash-flows of the DNSP, as it defers cost recovery into the future.

The MCE stated in its 2008 Smart Meter Decision Paper that the AER should consider mechanisms to smooth the tariff impact of a smart meter roll-out.[10] As a result, we have developed a proposed amendment to the Rules for the MCE's consideration, which could enable the AER to redistribute the profile of SMI cost recovery. We

[10] MCE, 2008, *Smart Meter Decision Paper*, 13 June, p. 8.

recommend that such an amendment should be limited to only the communication and IT costs since a) a declining depreciation profile could only be consistent with the nature of such assets and b) deferral of cost recovery for such assets should not result in a barrier to any later introduction of contestability. Under the proposed amendment, the AER would be required to take into account defined criteria in order to have proper consideration of the risks and issues associated with this.

2.2 Proposed Rules have been limited to mandated SMI

We have considered whether there is merit in extending some of our proposed amendments across Chapter 6 of the Rules to apply to distribution investments more generally. In the Draft Report, we asked for stakeholder comments on this. Stakeholder responses were in broad agreement that our amendments should be limited to mandated SMI only, as more general amendments were outside the scope of the MCE's Request for Advice.[11]

As our proposed amendments address specific issues raised in the MCE Terms of Reference and arise from the assessment of the Rules against the MCE's policy objectives for smart meters and in recognition of the specific characteristics of mandated SMI, we have limited the drafting of our Rules amendments to SMI which is mandated under a Ministerial smart meter determination. The one exemption to this is to address the 'dead zone' in the cost pass through provisions. This is a general cost recovery risk for all pass through events that has been previously identified by DNSPs and the general amendment was supported by stakeholders.

We note that there should be further consideration as to whether some of our proposed amendments should also apply to commercial driven roll-outs, especially where the AER has classified such roll-outs as standard control services. In particular, our amendments relating to the revenue adjustment to address timing uncertainty for mandated smart meter roll-outs and the tariffs for mandated smart metering services, could be applied to commercial smart meter roll-outs. Doing so, would provide for greater consistency in how SMI assets are regulated by the AER. We recommend that the possible extension of our recommendations could be explored further under the Rule change assessment process.

During this Review, we identified a concern with respect to the high powered expenditure incentives for network assets which have relatively short asset lives (i.e. less than 15 years). Under the current Rules, DNSPs would be exposed to a substantial share of the difference between forecast and actual capital expenditure, which could either lead to significant gains for the DNSP or expose the DNSP to a high risk of expenditure over-runs. We acknowledge that this concern is not limited to SMI assets but to all network investments which have short asset lives. Therefore, as noted above, we have not recommended any additional regulatory mechanisms to address expenditure uncertainty by dampening these high powered expenditure incentives.

11 See submissions on the Draft Report from: NSSC, pg. 4; EnergyAustralia, pg. 2; Jemena, pg. 4; Energy Networks Association, pg. 1; Energex, pg. 1; Origin Energy, pg. 3; Citipower/Powercor, pg.1.

However, we recommend that this matter should be considered in any future review of the broad framework for the economic regulation of distribution networks.

3 Distribution determination process

This Chapter outlines our final advice in regards to cost recovery under the distribution determination process for mandated SMI. It also includes our final advice in regards to the service classification for smart metering services, and the appropriateness of the incentives under the current regulatory regime for mandated SMI.

3.1 Cost recovery under the distribution determination process

This section outlines our advice regarding the adequacy of the current distribution determination process to provide for the recovery of the efficient costs, net of reasonably achievable network operational benefits, of mandated SMI (including any third party costs).

3.1.1 Summary of our assessment of the Rules

In considering how the distribution determination process would be applied to mandated SMI, we have assessed whether DNSPs would have a legal ability to seek cost recovery. We have then considered whether the distribution determination process would provide for the recovery of net efficient costs, under scenarios of differing levels of certainty regarding the costs and potential benefits of mandated SMI.

Under the current distribution determination process, DNSPs can seek cost recovery for mandated SMI, on the basis that DNSPs are entitled to seek cost recovery under the NEL and Rules where expenditure is required to meet their regulatory obligations or requirements.[12] Where there is certainty regarding the level of efficient costs and network operational benefits of mandated SMI, the distribution determination process has the potential to provide for the recovery of efficient costs, which are net of reasonably achievable network operational benefits, as the AER is required to take into account the NEL Revenue and Pricing Principles, the National Electricity Objective (NEO) and the capital and operating expenditure criteria in making a determination.[13]

In determining whether a DNSP's forecast expenditure reflects the capital and operating expenditure criteria, the AER would have an obligation to consider whether a DNSP's forecast expenditure reflects any 'reasonably achievable network operational benefits' associated with the mandated SMI, including any network operational benefits that would be expected to be achieved by an efficient and prudent DNSP over the regulatory control period.[14] Where the AER is not satisfied that a DNSP's forecasts

12 AAR, 2010, Advice in response to MCE Request for Advice on Cost Recovery for Mandated Smart Metering Infrastructure, 18 June, pp. 3-4.

13 See: ss.16(2)(a)(1) and 16(1)(a) of the NEL and clauses 6.5.6(c) and 6.5.7(c) of the Rules.

14 Clause 6.5.6(e) of the Rules.

reflect the capital and operating expenditure criteria, it must not accept those forecasts and must substitute its own assessment of the DNSP's required forecast expenditure.[15]

However, where there is uncertainty regarding the timing of a mandated roll-out or the efficient costs and benefits of mandated SMI expenditure, there is a risk that the distribution determination process may not provide for the recovery of net efficient costs. It is difficult to predict the level of uncertainty that may exist when a future distribution determination is made by the AER as the level of uncertainty will depend on the nature and timing of a Ministerial determination, the processes that lead to this Ministerial determination, and the degree of experience and information on mandated SMI that exists at the time. Pilots and trials of SMI are likely to inform the AER on the potential costs of a mandated roll-out, but are unlikely to provide information on the achievable network operational benefits of a large scale roll-out.

Where the timing of a mandated roll-out is not specified in a Ministerial determination, DNSPs may have an increased incentive to delay the timing of the roll-out during the regulatory control period, which may affect how quickly the roll-out is undertaken and when the potential benefits of the roll-out begin to be realised. This may occur as DNSPs would be able to charge prices based on its higher revenue requirement, despite its actual costs being lower. Conversely, DNSPs would be penalised under the distribution determination if they roll-out smart meters faster than forecast, as DNSPs would not receive any additional return on capital or depreciation for bringing this expenditure forward.

Where a Ministerial determination does set out roll-out targets (and potentially incentives for out-performing these targets), failure to achieve these targets by a DNSP would be considered a breach of the NEL and would be addressed by mechanisms outside of the Rules.[16] Ultimately, it is the interaction between these mechanisms and the incentives in a distribution determination that would determine the overall incentives that are faced by DNSPs.

Where there is a general degree of uncertainty regarding the efficient costs and benefits of mandated SMI expenditure, DNSPs may seek to include a higher level of contingency in its forecast expenditure for mandated SMI in its regulatory proposal. There is also a risk that the AER may approve a higher than efficient level of expenditure during the distribution determination process, as the AER can only substitute its own assessment of forecast expenditure where it is reasonably satisfied that a DNSP's forecast expenditure does not reflect efficient and prudent costs.[17]

The approval of this higher level of expenditure, in combination with the incentives on DNSPs for capital and operational expenditure efficiencies during the regulatory

15 Clauses 6.5.6(d), 6.5.7(d). 6.12.1(3)(ii) and 6.12.1(4)(ii) of the Rules.

16 Where a DNSP breaches the NEL, the AER may be able to seek a court injunction to require the DNSP to comply with the Ministerial determination. See AAR, 2010, Advice in response to MCE Request for Advice on Cost Recovery for Mandated Smart Metering Infrastructure, p. 33.

17 See clauses 6.5.6(c) and 6.5.7(c) of the Rules. In addition, under the NEL Revenue and Pricing Principles, the AER is required to provide DNSPs with a reasonable opportunity to recover at least their efficient costs.

control period and the relatively short asset lives of SMI, may lead to excess profits being made by DNSPs.[18] This may occur as the effect of this uncertainty is magnified by the strong incentives for relatively short lived assets in the current Rules. The impact of uncertainty is smaller for mandated smart meter pilots and trials compared to mandated smart meter roll-outs due to the lower level of expenditure required and the reduced likelihood of operational benefits.

It is recognised that the effect of the current incentives for short lived assets in Chapter 6 of the Rules is a general issue for all distribution assets, rather than for just mandated SMI. Therefore, the appropriateness of these incentives and the potential for DNSPs to achieve windfall gains as a result of these incentives needs to be considered in the broader framework of the economic regulation of DNSPs. We also note that the AER currently has discretion under the Rules to determine the appropriate treatment of depreciation in rolling forward the RAB, which is a key determinant of the power of these incentives.[19]

Another mechanism that is available to the AER under the current Rules to reduce the potential windfall gains that DNSPs may retain in relation to the operating expenditure of mandated SMI is to exclude SMI-related expenditure from the EBSS. However, the exclusion of SMI related expenditure may be difficult in practice as it would require the separation of SMI expenditure and non-SMI expenditure by the AER and DNSPs.

The level of uncertainty facing the AER and the risk that DNSPs may recover more than their net efficient costs may also be reduced where the AER is able to obtain reliable information on the efficient costs and reasonably achievable network operational benefits of mandated roll-outs, pilots and trials that have occurred or are taking place. The AER has general information gathering powers under the NEL, which it can use where it can demonstrate that the requested information is reasonably necessary for the performance or exercise of its functions or powers under the NEL or Rules.[20] As the AER is not currently required to monitor the outcomes of mandated roll-outs or pilots, we consider that the AER would only be able to request information on the actual costs and benefits of mandated SMI where it can demonstrate that such information is reasonably necessary for it to make a regulatory determination.[21] This could include a cost pass through determination or a distribution determination. Therefore, the AER would not be able to request information under its current NEL

18 Modeling which demonstrates the impact of short lived assets on the proportion of capital expenditure savings retained by DNSPs is outlined in our Draft Report.

19 Clause 6.12.1(18) of the Rules.

20 See ss. 28C, 28D and 28F of the NEL. Under section 28 of the NEL, the AER also has a general power under the NEL to serve a notice on a person to obtain information or documents the AER requires for the performance or exercise of its functions or powers under the NEL or Rules.

21 AAR, 2010, Advice in response to MCE Request for Advice on Cost Recovery for Mandated Smart Metering Infrastructure, 18 June, pp. 42-43.

powers to ensure benefits are being achieved in a reasonable timeframe by DNSPs, outside of a regulatory determination process.[22]

DNSPs may also incur third party costs, which may include any retailer costs, in undertaking a mandated roll-out, pilot, or trial. The distribution determination process should provide for the recovery of these costs, where the expenditure is necessary to meet a DNSP's regulatory obligations under a Ministerial determination and the AER is reasonably satisfied that the forecast expenditure reflects the operating expenditure criteria. This is the way that all third party costs are currently assessed and ensures that only efficient and prudent third party costs are approved by the AER. We consider that the current Rules are also appropriate for any third party costs that may be incurred by DNSPs in undertaking a Ministerial determination.

We have also had regard to whether a mandated smart meter roll-out or pilot should be subject to the Regulatory Test.[23] The objective of the Regulatory Test is to ensure that DNSPs conduct a transparent economic assessment to determine the most cost effective option to an identified need for investment.[24]

As the specific parameters for a mandated roll-out or pilot would be outlined in the relevant Ministerial determination, DNSPs would have a limited ability to consider alternative investment options. Further, there would be limited benefits in undertaking further consultation under the Regulatory Test, as Ministers are already required to undertake consultation under the NEL amendments prior to making a Ministerial determination.[25] Requiring a DNSP to undertake a Regulatory Test in these circumstances is likely to lead to unnecessary regulatory costs for the DNSP and has the potential to delay the timing of a mandated roll-out or pilot. Therefore, it is recommended that the Regulatory Test (nor the Regulatory Investment Test for Distribution, if implemented) not apply to a smart meter roll-out or pilot which is mandated under a Ministerial determination.

3.1.2 Recommended changes to the Rules

Addressing incentives for DNSPs to delay a mandated roll-out

To ensure that DNSPs remain neutral to any differences between the actual and forecast timing of mandated smart meter roll-outs within a regulatory control period, the Rules would be amended to provide for an explicit revenue adjustment at the time of the next distribution determination to:

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22 Item 12.3 of the MCE's Request for Advice asked for advice on whether the Chapter 6 framework allows the AER to obtain the necessary information to ensure benefits are being realised in a 'reasonable timeframe'.

23 In September 2009, the Commission submitted its Final Report on its Review of National Framework for Electricity Distribution Network Planning and Expansion to the MCE. In this Final Report, the Commission recommended that the Rules should be amended to replace the current Regulatory Test in clause 5.6.2 of the Rules with the Regulatory Investment Test for Distribution. The MCE is currently considering the Commission's recommendations on this Review.

24 Clause 5.6.2(g) of the Rules.

- Remove any additional revenue earned by a DNSP, where a DNSP has rolled out smart meters and/or associated infrastructure slower than forecast in the previous distribution determination and allowed for in revenues for that period; and

- Compensate a DNSP for costs above allowed revenues where a DNSP has rolled out smart meters and/or associated infrastructure faster than forecast in the previous distribution determination.

The AER would be required to calculate this revenue adjustment as part of its subsequent distribution determination. Revenue would be adjusted to reflect differences between the forecast and actual timing of fixed costs (e.g. IT and communications equipment). There would also be an adjustment to reflect differences between the forecast and actual timing of variable costs (e.g. number of meters rolled out in each year). The amount of revenue which is removed or compensated would be based on the cost assumptions (e.g. unit meter cost or IT cost) contained in the previous distribution determination, thus preserving incentives for DNSPs to achieve cost efficiencies. The AER would be required to implement this mechanism for mandated smart meter roll-outs and would not have the discretion to not apply this mechanism for mandated roll-outs.

Providing the AER with additional information to make regulatory determinations

The Rules would be amended to require DNSPs to provide annual information to the AER on the actual costs and network operational benefits, that accrue directly to the DNSP, of any mandated smart meter roll-out, pilot or trial they are undertaking. The objective of this reporting requirement would be to provide the AER with relevant information to assist it in estimating the efficient benchmark costs of a mandated smart meter roll-out, pilot or trial in making regulatory determinations. The AER would be required to publish the information that it receives from DNSPs each year. This reporting requirement would also apply to Victorian DNSPs, who would be required to report on the AMI roll-out which is currently underway.

The AER would be required to publish a guideline, following stakeholder consultation, which sets out the nature and format of information that DNSPs must provide. The AER would have the discretion to not apply this reporting requirement, where it considers that the required information is being provided under alternative reporting requirements.

3.1.3 Reasoning for our recommended changes to the Rules

Addressing incentives for DNSPs to delay a mandated roll-out

Our proposed revenue adjustment would counteract incentives for DNSPs to delay a mandated roll-out. This would ensure that revenues reflect the costs actually incurred and promote the realisation of the potential benefits of a mandated roll-out. In its

25 See Sections 118E and 118C of the NEL.

submission to the Draft Report, Energex considered that DNSPs should not be unduly penalised by this revenue adjustment and that it should not apply to commercially provided smart meter roll-outs.[26] EnergyAustralia did not support this proposed revenue adjustment as it considered that it places too much discretion with the AER and does not acknowledge that DNSPs may incur higher costs where there is a roll-out delay that is beyond the DNSP's control.[27] The Energy Networks Association (ENA) suggested that the revenue adjustment should provide regulatory certainty to DNSPs, be symmetrical, and consistent with the NEL Revenue and Pricing Principles.[28] Integral Energy and Jemena agreed in principle with the proposed revenue adjustment, but Integral considered that the AER should be required to consider the individual circumstances of each DNSP.[29]

Under our proposed amendments, this revenue adjustment would be symmetrical as additional revenue would be removed where a DNSP's roll-out is slower than forecast and DNSPs would be compensated where their roll-out is faster than forecast. DNSPs would be revenue neutral as a result of this amendment as it would be based on differences between the forecast and actual timing of when costs for the roll-out are incurred. As a result, DNSPs would be able to recover at least their efficient costs under this revenue adjustment, in accordance with the NEL Revenue and Pricing Principles.

Where DNSPs have specific individual circumstances which may affect how a roll-out may be implemented, we consider that these individual circumstances would be reflected in the AER's forecast costs for the roll-out. We note that the AER is required to undertake widespread consultation in determining these forecast costs under the distribution determination process.

The incentives on DNSPs to minimise the costs of the roll-out would also be maintained as the adjustment would be based on the unit operating and capital costs originally forecast at the beginning of the previous regulatory control period. This would promote the efficient management of costs and provide greater incentives for DNSPs to manage any implementation risks.

This revenue adjustment would also be applied under the interim determination process we have proposed in Chapter 4, where a DNSP is required to roll-out smart meters within a regulatory control period. This would ensure that a consistent regulatory approach is used for all mandated roll-out expenditure.

Decision not to include Draft Report expenditure uncertainty mechanisms

At the time the AER is required to make a distribution determination for a mandated smart meter roll-out, pilot or trial, there is the potential for some uncertainty to remain regarding the efficient costs and benefits of mandated SMI. The extent of this

26 Energex, Submission on the Draft Report, pg. 3.

27 EnergyAustralia, Submission on the Draft Report, pg. 6.

28 ENA, Submission on the Draft Report, pg. 5.

29 See submissions on the Draft Report from: Integral Energy, pg. 3; Jemena, pg. 4.

uncertainty will largely depend on the adequacy of the processes that lead to and inform the Ministerial determination.

As discussed above, this uncertainty may lead to the approval of higher than efficient expenditure by the AER. The combination of these higher approved expenditure levels with the current high-powered incentives in the Rules for short lived assets, has the potential to result in substantial profits for DNSPs. Conversely, where a DNSP is faced with costs substantially above expected levels, they would incur a significant loss.

In the Draft Report, we recommended that the AER should have the discretion to implement additional regulatory mechanisms, where it considers that there is substantive uncertainty regarding the efficient costs and expected network operational benefits of mandated SMI at the time it is making its distribution determination. It was proposed that these additional regulatory mechanisms could include either rolling forward the RAB on the basis of forecast rather than actual depreciation for short lived mandated SMI assets, or a cost sharing mechanism.[30]

In submissions to the Draft Report, DNSPs and the NSSC generally did not support the proposed mechanism relating to the roll-forward of the RAB, as it would weaken incentives for efficiency and create greater investment uncertainty, financing risk and complexity.[31] The AER and the NSSC indicated a preference for the proposed cost sharing mechanism as it provides greater flexibility, while the ENA suggested that DNSPs should have the ability to choose which mechanism is applied to them.[32] EnergyAustralia and Integral Energy did not support either of the proposed mechanisms.[33] There was general agreement between stakeholders that these mechanisms should only be applied to mandated SMI and not to distribution investments more generally, as this would be beyond the scope of the MCE's terms of reference.[34]

In considering this issue, we acknowledge that the appropriateness of the incentives in Chapter 6 of the Rules for short lived assets is an issue for all distribution investments, rather than solely for mandated SMI. Further, where possible, DNSPs should not be subject to a substantially different regulatory regime where they are required to roll-out smart meters under a Ministerial determination, compared to where they decide to roll-out smart meters on a commercial basis. Therefore, we have determined not to maintain our Draft Report recommendation to allow the AER to implement additional regulatory mechanisms where uncertainty remains in relation to the efficient costs and network operational benefits of mandated SMI. Rather, we note that the incentives for

30 AEMC, 2010, Request for Advice on Cost Recovery for Mandated Smart Metering Infrastructure, *Draft Report*, 18 June, pp. 28-31.

31 See submissions on the Draft Report from: Citipower/Powercor, pg. 2; ENA, pp. 7-8; Energex, pp. 2, 4; EnergyAustralia, pp. 6-7; Jemena, pp. 3-6; NSSC, pp. 7-9.

32 See submissions on the Draft Report from: AER, pg. 3; NSSC, pg. 9; ENA, pg. 7.

33 See submissions on the Draft Report from: EnergyAustralia, pp. 6-7; Integral Energy, pp. 3-4.

34 See submissions on the Draft Report from: Origin Energy, pg. 3; Jemena, pg. 4; Citipower/Powercor, pg. 2; Energex, pg 4; EnergyAustralia, pp. 6-7; ENA, pg. 1; Ergon Energy, pg. 2.

short lived assets in the Chapter 6 Rules may need to be addressed as part of any future review of the framework for the economic regulation of distribution networks. Uncertainty regarding the efficient costs and network operational benefits of mandated SMI may be addressed in part by our proposed information requirement on DNSPs, which is discussed below. Processes which are undertaken to inform the making of a Ministerial roll-out determination may also assist in reducing the materiality of any expenditure uncertainty associated with mandated SMI, prior to a roll-out.

Providing the AER with additional information to make cost recovery determinations

We continue to consider that there is the potential for some uncertainty to remain when the AER makes its distribution determinations which may have an impact on the recovery of net efficient costs. As a result, we have retained our Draft Report recommendation to require DNSPs to provide annual information to the AER on the actual costs and network operational benefits of mandated smart meter roll-outs, pilots and trials they are undertaking. A specific reporting requirement in the Rules is preferred over a reliance on the AER's existing information gathering powers in the NEL, as it would provide certainty and clarity to DNSPs regarding this new requirement and reduce the risk of delays in the provision of information. In providing this information, a DNSP would only be required to report on any costs and benefits which accrue directly to the actual DNSP. DNSPs undertaking the AMI roll-out in Victoria would also be subject to this annual information requirement, to ensure the AER has information on the scale effects of a roll-out and the potential network operational benefits that a roll-out may provide.

In submissions to the Draft Report, DNSPs raised concerns about the scope of this reporting requirement and considered that it was unnecessary as the AER's NEL information gathering powers are sufficient.[35] The ENA also suggested that the reporting requirement should be time limited, least cost, procedurally balanced, and purpose focused.[36] Energex raised concerns about confidentiality issues and the need for published information to be fully representative.[37] The NSSC and Origin noted that DNSPs should only be required to report on benefits which accrue to the DNSP.[38] However, Origin suggested that annual reporting may have general educational benefits, confirm the cost-benefit assumptions that underpinned the network investment, and facilitate future determinations.[39] The AER supported the proposed reporting requirement, but highlighted that it would also need access to third party information where DNSPs have contracted out their obligations.[40]

35 See submissions on the Draft Report from: Citipower/Powercor, pg. 3; ENA, pp. 9-10; EnergyAustralia, pp. 7-8; Integral Energy, pg. 4; Ergon Energy, pg. 3.

36 ENA, Submission on the Draft Report, pg. 10.

37 Energex, Submission on the Draft Report, pg. 4.

38 See submissions on the Draft Report from: NSSC, pp. 7-8; Origin Energy, pg. 3

39 Origin Energy, Submission on the Draft Report, pg. 3.

40 AER, Submission on the Draft Report, pg. 4.

Our proposed reporting requirement would allow the AER access to additional information when making regulatory determinations for mandated SMI. This is likely to provide for more efficient outcomes and the prompt pass through of benefits to consumers. This information would also assist the AER in determining the appropriate level of net efficient costs, when it makes regulatory determinations for commercially provided SMI. Further, as DNSPs would be required to provide this information to the AER each year, the reporting process should assist both DNSPs and the AER to prepare for the five yearly distribution determination process as it may provide supporting information for future expenditure forecasts for SMI. To implement this new reporting requirement, the AER would be required to publish a guideline, following public consultation, on the type and format of information to be provided. This would provide clarity to DNSPs and stakeholders regarding this new requirement and ensure that this requirement would not impose an onerous regulatory burden on DNSPs. We consider that the information that DNSPs provide the AER with should be audited, to ensure that this information is accurate. However, we note that the AER would be able to include this requirement in its guidelines.

The AER would also have the discretion not to apply this proposed reporting requirement, where it considers that the required information is being provided under alternative reporting requirements. This would assist in minimising the regulatory burden on DNSPs and reduce the likelihood of overlapping reporting requirements. As the Rules can only bind Registered Participants, this reporting requirement may not allow the AER to seek information from third parties who may be contracted by a DNSP to meet their obligations in a Ministerial determination. We consider that, at a minimum, DNSPs should be able to provide the AER with information on the charges that third party contractors are levying on DNSPs for their services. However, where the AER considers that further information is required from third parties who are not Registered Participants, the AER would be required to use their information gathering powers under Section 28 of the NEL.

The AER would be required to publish the information that is provided by the DNSPs each year. This would provide transparency on the implementation of mandated smart meter roll-outs, pilots and trials for consumers and jurisdictional Governments. It is considered that publishing this information would also assist in improving the efficiency and effectiveness of future mandated smart meter roll-outs and pilots. It may also assist DNSPs who are considering whether to undertake a commercial pilot or roll-out of SMI, to develop their business case.

3.2 Service classification for smart metering services

This section outlines our advice on service classification for smart metering services which are provided using mandated SMI, and the implications of service classification for cost recovery under the distribution determination process.

3.2.1 Summary of our assessment of the Rules

In making a distribution determination, the AER must classify direct control services as either standard control services or alternative control services using the factors in clause 6.2.2(c) of the Rules. These factors include, amongst other factors: the potential for competition; the impact on administrative costs; the desirability for a consistent regulatory approach to similar services; and the extent to which costs are directly attributable to the customer to whom the service is provided.[41] As there is little guidance in the Rules as to how alternative control services must be regulated, the AER has discretion in designing the control mechanism for such services in making its distribution determination and may adopt elements of the building blocks approach for standard control services, with or without modification.[42] An alternative control services classification would also result in the costs of the service being recovered through a separate tariff paid by individual customers requesting the service, rather than through the general DUOS charges paid by most network customers.

As discussed in Chapter 1, we have considered the types of services that may be provided under a Ministerial determination, in terms of 'core services' and 'non-core' or ancillary services. It is considered that 'core services' would include services which are integral to a Ministerial determination. In this category of 'core services', we have included activities such as smart meter provision and installation, metering data services, and cost recovery for stranded metering assets. In regards to smart meter provision and installation and associated metering data services, DNSPs would have exclusivity in providing these services under a Ministerial roll-out determination in accordance with the initial Rule for the NEL amendments. We have also considered mandated smart meter pilot and trial services as core services.

'Non-core' or ancillary services would include any smart metering services that are provided using mandated SMI, which are not 'core services'. This could include services that a DNSP is required to provide under a Ministerial determination and also services that a DNSP chooses to voluntarily provide using their mandated SMI.

In terms of how ancillary services would be classified by the AER, it is possible that service classification would differ across the range of different ancillary services that are provided. At this stage it is difficult to ascertain what types of ancillary services may be provided by DNSPs. Certain ancillary services may be provided on a competitive basis and may therefore remain unregulated by the AER in accordance with the Chapter 6 Rules.[43] However, it is considered that the current Rules regarding service classification provide sufficient prescription regarding how these services should be classified.

41 Clause 6.2.2(c) of the Rules.

42 Clause 6.2.6(c) of the Rules.

43 Other ancillary services may only be provided as a result of a customer request and may be classified as alternative control services. There is also the possibility that the AER may consider that there is limited potential for competition in relation to some ancillary services and determine that a standard control service classification is appropriate.

Under the NEL, the AER is required to take into account the NEL Revenue and Pricing Principles and the NEO when making a regulatory determination in relation to alternative control services.[44] These obligations would require the AER to provide DNSPs with a reasonable opportunity to recover at least their efficient costs of undertaking mandated smart meter roll-outs or pilots, irrespective of how services are classified. Therefore, the current regulatory framework has the potential to provide for the recovery of net efficient costs under the distribution determination process, where ancillary smart metering services are classified as alternative control services.

3.2.2 Recommended changes to the Rules

The Rules should be amended to require the AER to classify the following 'core services' that a DNSP is mandated to provide under a Ministerial smart meter determination as standard control services:

- smart meter provision and installation;
- meter data provision;
- recovery of the costs of stranded metering assets; and
- smart meter pilot and trial services.

However, the AER should retain its current discretion in relation to service classification for ancillary smart metering services, which may be provided by DNSPs using their mandated SMI. These ancillary smart metering services could be provided on a mandated basis or a voluntary basis by DNSPs.

3.2.3 Reasoning for our recommended changes to the Rules

In the Draft Report, we recommended that no further amendments to the distribution determination process were required to provide for the recovery of net efficient costs where mandated smart metering services are classified as alternative control services.[45] In submissions to the Draft Report, there was a difference of opinion from stakeholders as to whether further prescription was required in the Rules. The AER, Ergon Energy and Integral Energy considered that no further modifications to the Rules were required.[46] However, the NSSC suggested that where mandated smart metering services are classified as alternative control services, the AER should be required to apply the principles for standard control services as set out in Chapter 6 of the Rules, because the AER's discretion in relation to alternative control services is inappropriate for the significant size of mandated roll-out investments.[47] EnergyAustralia considered

44 See sections 16(2)(a)(i) and 16(1)(a) of the NEL.

45 AEMC, 2010, Request for Advice on Cost Recovery for Mandated Smart Metering Infrastructure, *Draft Report*, 18 June, pp. 65-68.

46 See submissions on the Draft Report from: AER, p. 9; Ergon Energy, p. 6; Integral Energy, p. 7.

47 NSSC, Submission on the Draft Report, p. 12.

that a Ministerial imposed obligation to roll-out SMI should be considered primarily as a standard control service.[48]

We recommend that prescription in the Rules is warranted in relation to service classification and the corresponding control mechanism of these core services, as these services would be essential to the successful implementation of a Ministerial determination. This would also ensure that DNSPs have certainty regarding their opportunities for cost recovery and how these services would be regulated, leading to a more efficient and effective provision of services. Therefore, we have determined to amend the Rules to require the AER to classify the core services that a DNSP is mandated to provide under a Ministerial determination as standard control services. As a result, the AER would have no discretion in determining the appropriate service classification for these core services during the distribution determination process. As this amendment would essentially codify how the AER would be likely to classify these services in any event, this amendment is not considered to be a disproportionate change to the Rules.

This amendment would also ensure that DNSPs in NSW, ACT, Qld and SA are able to seek cost recovery where a Ministerial determination is made in the current regulatory control period. As noted by Integral Energy, as the AER has not classified types 1-4 metering services in its current distribution determinations for NSW, ACT, Qld and SA DNSPs. If a Ministerial determination is made within the current regulatory control period which requires DNSPs to provide types 1-4 metering services, these DNSPs would not be able to seek cost recovery.[49]

As our proposed amendment would specify in the Rules that the core services in a Ministerial smart meter determination would be classified as standard control services, if a Ministerial determination is made in the current regulatory control period in NSW, ACT, Qld or SA, DNSPs would be able to seek cost recovery under Chapter 6 of the Rules. For mandated smart meter roll-outs, DNSPs could seek cost recovery under the interim determination process we have proposed in Chapter 4. For mandated smart meter pilots and trials, DNSPs would be able to seek cost recovery under the cost pass through provisions in the Rules, which is discussed in Chapter 5. As a result, this amendment would automatically over-ride any relevant distribution determination which has classified types 1-4 metering services as unregulated services.

The AER would retain its current discretion to classify ancillary smart metering services which may be provided by a DNSP using its mandated SMI. This has the potential to include services that a DNSP is mandated to provide by a Ministerial determination, and other services that a DNSP may voluntarily provide using its mandated SMI. As these services may be contestable or have the potential for competition, it is considered appropriate that the AER maintain its current discretion to determine the most appropriate service classification for these services. Further, there is a risk that specifying the service classification of these ancillary services may limit the future development of these services. Practically, it would also be difficult to

48 EnergyAustralia, Submission on the Draft Report, pp. 11 & 14.

49 Integral Energy, Submission on the Draft Report, pp. 1 & 3.

specify the service classification of these services, as it is unclear what types of ancillary services may be provided by DNSPs using their mandated SMI. Therefore, we have determined to retain the AER's current ability to classify these ancillary services through the distribution determination process.

3.3 Incentives under the current regulatory regime

This section outlines our advice on whether the incentives in the EBSS are appropriate for a mandated smart meter roll-out, and whether the incentives in Chapter 6 of the Rules are sufficient for the competitive purchase of meters and metering services and the management of technology risks. In considering the incentives on DNSPs under the current regulatory regime, we have focused our analysis on mandated smart meter roll-outs. As mandated smart meter pilots and trials would be temporary in nature, they are not expected to provide ongoing benefits to DNSPs or consumers and the materiality of their costs would also be limited.

No further changes to the Rules have been proposed to the incentives under the current regulatory regime to accommodate mandated SMI as the current Rules are considered sufficient.

3.3.1 Summary of our assessment of the Rules

The existing EBSS is appropriate for a mandated smart meter roll-out as it would encourage DNSPs to reveal the net efficient costs of meeting their mandated obligations. Improved information regarding the net efficient costs of undertaking a mandated smart meter roll-out would allow the AER to consider these costs in making future distribution determinations. This would result in more cost savings being passed through to consumers over time.

In their submissions to the Draft Report, Energex and Integral Energy suggested that mandated roll-out costs should be excluded from the EBSS as these costs are not controllable by DNSPs.[50] While DNSPs have a limited ability to control the timing of a Ministerial roll-out determination, we consider that DNSPs retain some control over how they meet their obligations under a Ministerial roll-out determination. However, it is considered appropriate for the AER to retain its current discretion to exempt expenditure from the EBSS, as it preserves the ability of the AER to determine the most appropriate form of regulation that should apply to mandated SMI.

Under the distribution determination process, the incentives for the competitive purchase of meters and metering services relate to the AER's assessment of a DNSP's forecast expenditure for meters and metering services under the capital and operating expenditure criteria. Under the capital and operating expenditure criteria, the AER must approve a DNSP's forecast expenditure for smart meters and smart metering services, if it is satisfied that the forecast reasonably reflects the efficient and prudent

50 See submissions on the Draft Report from: Energex, p. 6; Integral Energy, p. 7.

costs of meeting its obligations under a Ministerial determination.[51] Where the AER is not satisfied that the DNSP's forecast expenditure reasonably reflects the capital and operating expenditure criteria, it must not accept those forecasts and must substitute its own assessment of the DNSP's required forecast capital and operating expenditure, which reflects the capital and operating expenditure criteria.[52]

We consider that the risk of the AER not accepting a DNSP's forecast expenditure and substituting its own forecasts, provides appropriate incentives for the competitive purchase of meters and metering services by DNSPs. Ergon Energy and EnergyAustralia generally agreed with this recommendation.[53] However, the NSSC noted that some of the benefits of a mandated roll-out may increase service levels rather than reduce costs and other benefits may flow directly to consumers rather than delivering a benefit to the DNSP.[54]

It is considered that incentives to increase service levels could be addressed by the AER through changes to the Service Target Performance Incentive Scheme, while investments which provide benefits to consumers rather than to DNSPs could still be approved by the AER where it considers that such investments are prudent and efficient. Therefore, we do not consider that any further changes to the Rules are required to provide incentives for the competitive purchase of meters and metering services.

In regard to the incentives for the management of the technology risks of a mandated smart meter roll-out, it is considered that many of these risks will be addressed by processes being undertaken by the MCE and the NSSC. The MCE's pilots and trials of mandated SMI, in addition to the development of national minimum functionality specifications for smart meters by the NSSC, is likely to reduce the materiality of the technology risks of SMI, prior to a mandated smart meter roll-out. These processes are also likely to provide the AER with information which will assist it in assessing technology proposals by DNSPs, when considering mandated SMI expenditure during the distribution determination process.

EnergyAustralia has raised concerns that aspects of the regulatory regime were established without more risky technologies being considered, but accepts that the magnitude of technology risk can only be properly determined once MCE and NSSC processes are more progressed.[55] Origin Energy highlighted that there should be incentives on DNSPs to optimise investment decisions, such as their choice of communications technology, as it may affect future contestability.[56] We agree that the MCE and NSSC processes will affect the magnitude of the technology risks of a mandated roll-out. As these processes are still in progress, we do not consider that it

51 Clauses 6.5.6(c) and 6.5.7(c) of the Rules.

52 See clauses 6.12.1(3)(ii) and 6.12.1(4)(ii) of the Rules.

53 See submissions on the Draft Report from: Ergon Energy, p. 6; EnergyAustralia, p.15.

54 NSSC, Submission to the Draft Report, p. 16.

55 EnergyAustralia, Submission to the Draft Report, p. 15.

56 Origin Energy, Submission to the Draft Report, p. 4.

would be prudent to make any further changes to the Rules to provide incentives for the management of technology risks.

4 Mid period cost recovery for mandated smart meter roll-outs

This Chapter outlines our final advice in regards to the adequacy of the cost pass through provisions in clause 6.6.1 of the Rules to provide for the recovery of the net efficient costs of mandated smart meter roll-outs. The cost pass through provisions provide a mechanism for DNSPs to seek cost recovery, where a DNSP is required to incur roll-out costs within a regulatory control period which have not been provided for within the relevant distribution determination. Our advice on mid period cost recovery for mandated smart meter pilots and trials is set out in Chapter 5 of this report.

4.1 Summary of our assessment of the Rules

Where possible, the costs of mandated smart meter roll-outs should be recovered through the distribution determination process, as this process provides the most comprehensive and effective mechanism for the recovery of net efficient costs. The current timing of the distribution determination cycles provides an opportunity for each jurisdictional Minister to achieve this, by aligning the timing of a Ministerial determination with the distribution determination process, so that a DNSP is only required to undertake expenditure at the start of its next regulatory control period.

However, where the costs of a mandated roll-out cannot be incorporated within a distribution determination and a DNSP is required to incur expenditure for the roll-out prior to the start of the next regulatory control period, the current Rules would permit a DNSP to submit a cost pass through application under clause 6.6.1 to recover this expenditure. The most relevant pass through event for the recovery of this expenditure would be a 'service standard event', rather than a 'regulatory change event'.[57]We consider that a mandated roll-out would meet the AER's current materiality threshold for a service standard event due to the potential scope of a roll-out.[58]

However, the cost pass through provisions in clause 6.6.1 of the Rules may not provide for the recovery of the net efficient costs of a mandated roll-out as the AER's criteria for assessing a DNSP's expenditure is not clearly specified. In particular, the AER would have no obligation to consider the efficient costs of a mandated roll-out or the impact of any potential off-setting cost savings associated with the roll-out on a DNSP's broader operations, when determining the amount that should be passed through. However, the AER would have the discretion to consider these factors if it considered

57 For further discussion on the distinction between a 'service standard event' and a 'regulatory change event' see: AAR, 2010, Advice in response to MCE Request for Advice on Cost Recovery for Mandated Smart Metering Infrastructure, pp. 15-16.

58 In recent distribution determinations the AER has noted that it will generally consider that a pass through event will have a material impact if the costs associated with the event would exceed 1 per cent of the smoothed forecast revenue specified in the final decision in the years of the regulatory control period that the costs are incurred. For example, see: AER, 2009, Final Decision: New South Wales Distribution Determination 2009-10 to 2013-14, April, p. 280.

it relevant to the making of its determination.[59] Therefore, it is uncertain as to whether an efficiency assessment would be conducted by the AER under the current cost pass through provisions.

The timeframes in the Rules for the cost pass through process also appear inadequate for a mandated roll-out. The 90 business day timeframe for DNSPs to submit an application for pass through following the occurrence of the pass through event is likely to be insufficient for DNSPs to estimate the costs of the roll-out with sufficient certainty, and it is likely that the AER would be required to provide DNSPs with a significant time extension to submit their applications.[60]

The AER's 60 business day timeframe for making a cost pass through determination is also likely to be insufficient, in light of the potential scope and complexity of a roll-out.[61] The AER is also unlikely to have sufficient time to consider fully the impact of any operational benefits associated with the roll-out. It may also be unable to undertake sufficient public consultation on the DNSP's application within that timeframe. Further, under the current Rules the AER has no ability to extend its decision making timeframe. As a result, where the AER has not made a decision within 60 business days of receiving a written application, it would be considered to have approved the pass through amount and the timing for its recovery, as specified in the DNSP's application.[62]

For these reasons, we consider that the cost pass through provisions would not accommodate the recovery of the net efficient costs of a mandated roll-out and that a new mid period cost recovery mechanism for mandated roll-outs is required. However, as discussed above, the more preferable cost recovery mechanism for mandated smart meter roll-outs would be for Ministers to align the timing of a Ministerial roll-out determination with the distribution determination process, so that DNSPs can recover mandated smart meter roll-out costs through the standard distribution determination process.

4.2 Recommended changes to the Rules

The Rules would be amended to require the AER to undertake an 'interim determination' within the regulatory control period, where a DNSP is required to incur costs associated with a mandated smart meter roll-out prior to the start of the next regulatory control period and the relevant distribution determination has not incorporated the costs of this roll-out.

Under this interim determination process:

- DNSPs would have six months to submit an 'interim regulatory proposal' to the AER, following the making of a Ministerial roll-out determination. This interim

59 See clause 6.6.1(j)(8) of the Rules.

60 See clauses 6.6.19(c) and (k) of the Rules.

61 See clause 6.6.1(e) of the Rules.

62 See clauses 6.6.1(e)(i) and (ii) of the Rules.

regulatory proposal would contain the DNSP's forecast expenditure for the mandated roll-out until the end of the current regulatory control period, and would include the estimated effect of any off-setting network operational benefits that the roll-out may provide;

- The AER would have a maximum of 12 months to publish its 'final interim determination' after receiving the DNSP's interim regulatory proposal. Within this 12 month period, the AER must also publish a draft interim determination and publicly consult on it for a minimum of six weeks;

- The AER's final interim determination would determine a DNSP's allowed revenue for the mandated roll-out for the remainder of the regulatory control period;

- The interim determination process would be undertaken by the AER in a similar way to the standard distribution determination process, if the costs of the mandated roll-out could have been incorporated in the standard distribution determination process. For instance, the AER would be required to assess whether the expenditure forecasts in a DNSP's interim regulatory proposal reasonably reflects the efficient and prudent costs of meeting its mandated obligations. This is similar to the operating expenditure criteria and the capital expenditure criteria in clauses 6.5.6(c) and 6.5.7(c) of the Rules;

- The AER would have the ability to re-open parts of the relevant distribution determination which it reasonably considers would be impacted by the mandated smart meter roll-out. For instance this may include: recalculating forecast allowed revenue to take into account any operational benefits associated with the roll-out; classifying new services that will be provided as part of the mandated roll-out or re-classifying services that were classified in the distribution determination; and re-examining the application of relevant incentive schemes. However, the AER would have no ability to re-calculate the weighted average cost of capital (WACC), and would be required to use the WACC that had been determined for the relevant distribution determination;

- The AER would be able to adjust forecast allowed revenue that had been approved as part of the relevant distribution determination, where it considers that this allowed revenue should be increased or decreased as a result of the mandated roll-out. But it could not claw back any unspent past allowed revenue in previous regulatory years of the regulatory control period;

- The revenue adjustment we have proposed in Chapter 3, to address any incentives DNSPs may have to delay a mandated roll-out, would be applied by the AER at the subsequent distribution determination process;

- The final interim determination would apply from the next regulatory year of the regulatory control period;

- The AER would not be required to undertake the interim determination process, where the AER would not be able to complete its final interim determination

within 2 months prior to the commencement of the final regulatory year of the regulatory control period. Rather, DNSPs would be required to recover the costs of the mandated roll-out through the distribution determination process for the next regulatory control period. Any costs that a DNSP may incur within the remainder of the regulatory control period would be assessed by the AER and the AER would be required to provide for allowed revenue for these costs, including any financing costs, where the AER considers that they are prudent and efficient. The AER would also be required to consider these costs under the standard distribution determination process;

- Where the AER is unable to complete an interim determination within the regulatory control period or incorporate the costs of the mandated roll-out within the distribution determination process for the next regulatory control period, the AER would be required to undertake an interim determination even if this interim determination would not be completed until the first regulatory year of the next regulatory control period. This interim determination would determine the allowed revenue for the mandated roll-out until the end of this next regulatory control period and would commence no later than the second regulatory year of this regulatory control period. The AER would be required to provide for any costs that a DNSP may incur in the period prior to the application of the interim determination, where the AER considers these costs are prudent and efficient. It is anticipated that this scenario may occur where a Ministerial roll-out determination is made in the last regulatory year of a regulatory control period.

The AER would be required to publish a guideline, following public consultation, outlining its approach to interim determinations for mandated smart meter roll-outs. This guideline would include detail on the information that DNSPs must include in their interim regulatory proposals and how the AER intends to undertake interim determinations.

4.3 Reasoning for our recommended changes to the Rules

The distribution determination process provides for the most effective and efficient process for the recovery of the net efficient costs of a mandated smart meter roll-out. Therefore, the timing of a Ministerial roll-out determination should be aligned with the start of the next distribution determination process so that a DNSP is only required to incur expenditure associated with the mandated roll-out at the start of the next regulatory control period. This would be the best possible outcome for the recovery of the net efficient costs of a mandated roll-out, and was broadly supported in submissions to the Draft Report.

However, as there is the possibility that the timing of a Ministerial roll-out determination would require DNSPs to incur expenditure prior to the start of the next regulatory control period, an alternative cost recovery mechanism is required to allow DNSPs to recover this expenditure. In the Draft Report, we recommended that where DNSPs incur expenditure for a mandated roll-out prior to the start of the next

regulatory control period, DNSPs should be required to defer cost recovery until the distribution determination process for the next regulatory control period.[63] During this process, the AER would conduct an ex-post review of the DNSP's incurred expenditure against the operating and capital expenditure criteria in the Rules. However, submissions to the Draft Report generally did not support this proposed ex-post review process.

DNSPs and the NSSC considered that an ex-post review process would: create funding uncertainty and regulatory risk; deter DNSPs from pursuing more costly investments that would offer benefits to consumers; and be complex and time consuming.[64]The AER also considered that an ex-post review would add substantial complexity to its assessment of roll-out costs.[65] Some DNSPs and the NSSC suggested that an amended 6 month cost pass through process or a limited re-opening of the distribution determination should be implemented instead.[66] The AER agreed that alternative options could include either amending the cost pass through provisions or developing a separate mechanism to deal specifically with mandated roll-outs, but noted that any alternative would need to provide the AER with sufficient time to review any proposal and would ideally include assessment criteria that mimics the operational and capital expenditure criteria used in distribution determinations.[67]

In this final advice, we have not retained our proposed ex-post review process. We consider that this approach may impose an unnecessary degree of regulatory risk and funding uncertainty on DNSPs which may impact on the efficiency and effectiveness of the roll-out. Rather, we have recommended that the AER be required to undertake an 'interim determination' process within the regulatory control period to determine the allowed revenue for the mandated roll-out until the end of the regulatory control period.

This interim determination process would be undertaken by the AER in a similar way to the distribution determination process, if the costs of the mandated roll-out could have been incorporated in the distribution determination process. The AER would be required to assess whether the expenditure forecasts in a DNSP's interim regulatory proposal reasonably reflects the efficient and prudent costs of meeting its mandated obligations. This would preserve incentives for efficiency and provide regulatory certainty to DNSPs regarding how their proposals would be assessed. It would also retain the current ex-ante approach to cost recovery that applies in Chapter 6 of the Rules, providing a common regulatory framework for all distribution investments. We considers that this interim determination could also be the subject of a merits review by

63 AEMC, 2010, Request for Advice on Cost Recovery for Mandated Smart Metering Infrastructure, *Draft Report,* 18 June, pp. 41-45.

64 See submissions on the Draft Report from: Energex, p. 5; EnergyAustralia, pp. 8-9; Citipower/Powercor, p. 4; ENA, pp. 11-13; Jemena, p.7; and the NSSC, p. 10.

65 AER, Submission on the Draft Report, pg. 5.

66 See submissions on the Draft Report from: Citipower/Powercor, p. 4; EnergyAustralia, p. 10 ; and the NSSC, p.11

67 AER, Submission on the Draft Report, pg. 5.

the Australian Competition Tribunal, in accordance with the current requirements in the NEL.[68]

In undertaking an interim determination, the AER would be able to re-open any parts of the relevant distribution determination which it reasonably considers would be impacted by the mandated roll-out. This would ensure that the AER has sufficient flexibility to consider the full impact of a mandated roll-out on the DNSP's operations. Further, the AER would not be required to determine an arbitrary boundary between mandated roll-out expenditure and non-mandated roll-out expenditure, where a DNSP has proposed expenditure on IT and communications assets in its interim regulatory proposal which may be used to provide other network services by the DNSP.

During the interim determination process, the AER would be able to increase or decrease forecast allowed revenue for the remainder of the regulatory control period, where it considers that the mandated roll-out would have an impact on the DNSP's forecast revenue in its distribution determination. As a result, the AER would be able to consider the impact of any operational cost savings on a DNSP's broader network operations that a mandated roll-out may provide. This would provide for the prompt pass through of efficiencies to consumers. However, the AER would not be able to re-examine or claw back any unspent allowed revenue which has been provided for in previous regulatory years in the regulatory control period (i.e. the AER would only be able to amend forecast allowed revenue in the remainder of the regulatory control period).

The AER would also have the ability to classify new services that may be provided as a result of the mandated roll-out or re-classify services that had been classified in the distribution determination process. However, as proposed in Chapter 3, the AER would have no discretion in classifying the core services in a Ministerial roll-out determination.

The AER would also have an opportunity to re-consider the application of any relevant incentive schemes which may be affected by the mandated roll-out. For instance, the AER may consider that mandated roll-out expenditure should be excluded from the EBSS, as there is a degree of uncertainty regarding the efficient costs of this expenditure; or the AER may consider that the Service Target Performance Incentive Scheme should include new performance measures which relate specifically to the mandated roll-out. This would provide the AER with the opportunity to apply the most appropriate regulatory framework to the mandated roll-out for the remainder of the regulatory control period.

To ensure that DNSPs have sufficient time to prepare their interim regulatory proposals, DNSPs would have six months following the making of a Ministerial roll-out determination to submit their proposal to the AER. The AER would then have a maximum of 12 months to publish their final interim determination, which would provide the AER with the opportunity to conduct a rigorous and comprehensive efficiency assessment. During this 12 month period, the AER must also publish a draft

68 See s. 71B(1) of the NEL and the definition of 'reviewable regulatory decision' in s. 71A of the NEL.

interim determination and consult on it for a minimum of six weeks, to allow stakeholders to comment and provide transparency to the determination process. The final interim determination would apply from the beginning of the next regulatory year of the current regulatory control period.

We anticipate that there is the possibility that the AER may be unable to complete its final interim determination within two months prior to the commencement of the final regulatory year of the regulatory control period. This may occur where a DNSP submits its interim regulatory proposal to the AER in the last 26 months of the regulatory control period.[69] In these circumstances, the AER should not be required to undertake the interim determination process within the current regulatory control period, as the interim determination could not be applied in that period. Rather, it is recommended that the AER be required to determine the allowed revenue for the mandated roll-out through the distribution determination process for the next regulatory control period.

As part of its regulatory proposal for the next regulatory control period, the DNSP would also be able to include any costs, including any financing costs, it would incur prior to the next regulatory control period, which would allow DNSPs to recover these costs and limit the possibility of potential delays to the roll-out. The AER would be required to approve these costs, including any financing costs, if it considers that they are prudent and efficient. This amendment to the Rules would also apply to any mandated roll-out costs that a DNSP may incur prior to the next regulatory control period under the standard distribution determination process.

Where the AER is unable to complete an interim determination within the regulatory control period or incorporate the costs of the mandated roll-out within the distribution determination process for the next regulatory control period, the AER would be required to undertake an interim determination even if this interim determination would not be completed until part way into the first regulatory year of the next regulatory control period. However, the AER would be required to complete this interim determination by the end of the ninth month of the first regulatory year, to allow the interim determination to commence from the beginning of the second regulatory year. This interim determination would determine the allowed revenue for the mandated roll-out until the end of this next regulatory control period. We consider that this has the potential to occur where a Ministerial roll-out determination is made fairly late in the regulatory control period (e.g. in the final year of the regulatory control period). This arrangement would ensure that all possible Ministerial roll-out

69 This has the potential to occur in the last 26 months of the regulatory control period as the AER would have a maximum of 12 months to publish its final interim determination after receiving a DNSP's interim regulatory proposal. Further, the AER's final interim determination would need to be completed at least 2 months prior to the final regulatory year of the regulatory control period to allow that final interim determination to apply from the beginning of the final regulatory year (i.e. the final interim determination would need to be published at least 14 months prior to the end of the regulatory control period). Therefore, where a DNSP submits its interim regulatory proposal to the AER in the last 26 months of a regulatory control period, the AER would not be able to complete its final interim determination within 2 months prior to the commencement of the final regulatory year of the regulatory control period.

determinations can be accommodated in the cost recovery framework for mandated SMI.

5 Mid period cost recovery for mandated smart meter pilots and trials

In this Chapter we outline our final advice in regards to mid period cost recovery for mandated smart meter pilots and trials; cost recovery during the 'dead zone; and mid period cost recovery for ancillary services. As discussed in Chapter 4, we have recommended that mandated smart meter roll-outs should not be assessed under the cost pass through provisions and that a separate mid period cost recovery arrangement should apply to mandated roll-outs.

5.1 Mid period cost recovery for mandated smart meter pilots and trials

This section outlines our advice on the adequacy of the cost pass through provisions to provide for the recovery of the efficient costs of mandated smart meter pilots and trials, including any associated retailer fees that are incurred.

5.1.1 Summary of our assessment of the Rules

In considering how the existing cost pass through provisions would be applied to mandated smart meter pilots and trials, we have assessed whether DNSPs would have a legal ability to seek cost pass through and if the cost pass through process would provide for the recovery of efficient costs.

We consider that DNSPs would only have the ability to seek cost pass through for mandated pilots and trials, where the mandated pilots and trials are able to fall under a pre-existing classification of a service, which is subject to the cost pass through provisions. If the trial or pilot did not fall within a pre-existing classification contained in the AER's distribution determination, then these services would be unregulated and would not be subject to the cost recovery arrangements in Chapter 6 of the Rules.[70]

As discussed in Chapter 3, we have proposed an amendment to the Rules which would specify that mandated smart meter pilot and trial services would be classified as standard control services. This amendment would ensure that DNSPs can seek cost recovery under the cost pass through provisions where a Ministerial pilot determination is made, as the cost pass through provisions in clause 6.6.1 of the Rules automatically apply to standard control services. Where a mandated pilot or trial is classified as a standard control service, we consider that DNSPs would be able to seek cost pass through under a 'service standard event'.[71]

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70 AAR, 2010, Advice in response to MCE Request for Advice on Cost Recovery for Mandated Smart Metering Infrastructure, pp. 9-10.

71 As a Ministerial pilot determination would be made under the NEL and would alter the scope of the direct control services provided by a DNSP within a regulatory control period, we consider that a Ministerial pilot determination would need the definition of a 'service standard event' in Chapter 10 of the Rules.

However, DNSPs would only be able to seek cost pass through under a service standard event, if the costs of undertaking the pilot or trial met the relevant materiality threshold for a service standard event. As the materiality threshold for pass through events is not specified in the Rules, the AER has the flexibility to determine the appropriate threshold for pass through events.

In recent distribution determinations, the AER has indicated that it will generally consider a pass through event as material if the costs of the event exceed 1% of the smoothed forecast revenue specified in a final distribution determination in the years of the regulatory control period that the costs are incurred.[72] For some distribution determinations, the AER has also nominated a specific 'smart meter event', which has a lower materiality threshold than the general materiality threshold of 1% of smoothed forecast revenue.[73]

However, the AER has indicated that it now considers that the costs of both prescribed pass through events in the Rules (e.g. a service standard event) and nominated pass through events in distribution determinations, must meet its definition of 'material' (i.e. 1% of smoothed forecast revenue) in order to be passed through.[74] As a result, the AER does not consider that it has the flexibility to specify a different materiality threshold for nominated pass through events, to the general materiality threshold it has determined for prescribed pass through events.[75] We consider that there is a risk that some mandated pilot and trials may not meet the AER's general materiality threshold of 1% of smoothed forecast revenue.[76] Therefore, for a lower materiality threshold to apply to mandated smart meter pilots and trials, an amendment to the Rules would be required.

With regard to whether the cost pass through process would provide for the recovery of efficient costs, we have a number of concerns. The existing 90 business day timeframe for DNSPs to submit an application for cost pass through is likely to be appropriate for mandated smart meter pilots and trials, as the scope and complexity of the pilots and trials would be limited.[77] Further, the AER is required to extend the timeframe for DNSPs to submit an application, where it considers that the difficulty of assessing or quantifying the effect of the pass through event justifies the extension.[78] The AER has 60 business days to make a cost pass through determination after receiving an application, and in most circumstances this timeframe is likely to be

72 For instance see: AER, 2009, Final Decision: New South Wales Distribution Determination 2009-10 to 2013-14, April, p. 280.

73 For instance see: AER, 2010, Final Decision: Queensland Distribution Determination 2010-11 to 2014-15, 6 May, p. 298.

74 AER, Submission on the Draft Report, pp. 7-8.

75 AER, Submission on the Draft Report, pp. 7-8

76 For example, SMI trials to be undertaken by EnergyAustralia between 2009 and 2011 were estimated to cost a total of $16m in its regulatory proposal for the 2009-10 to 2013-14 regulatory control period. In contrast, 1% of the smoothed revenue requirement for EnergyAustralia for 2009-10 would be equivalent to $12.3m and in 2010-11 it would equal $13.8m.

77 Clause 6.6.1(c) of the Rules.

78 Clause 6.6.1(k) of the Rules.

sufficient for pilots and trials.[79] However, as the AER has no ability to extend this timeframe, where there is a lack of reliable information on the costs of undertaking comparable pilots or trials or the AER is required to undertake further analysis or consultation, there is a risk that 60 business days may be insufficient for the AER to make its cost pass through determination.

Further, in making a cost pass through determination, the AER has no obligation under the current Rules to consider the efficiency of the pass through amount proposed by the DNSP. Although, the AER has the discretion to undertake an efficiency assessment if it considers it relevant.[80] The AER is also required to take into account the NEO in making a cost pass through determination.[81] It is likely that the AER would undertake an efficiency assessment as it is a matter of good regulatory practice. However, greater prescription regarding the criteria the AER must apply in making a cost pass through determination may be warranted to provide greater regulatory certainty to DNSPs.

Under the current cost pass through provisions, DNSPs would also be able to seek the recovery of any third party costs it incurs in undertaking a mandated pilot or trial, including any retailer costs. However, DNSPs would be required to demonstrate that it had or would incur the third party costs solely as a consequence of the Ministerial determination being made and that these costs had not been incorporated in an existing distribution determination.[82] This is the current approach to the assessment of any third party costs and is also considered appropriate for a mandated smart meter pilot, as it would ensure that DNSPs may only seek cost pass through for any necessary and prudent costs.

5.1.2 Recommended changes to the Rules

The cost pass through provisions would be amended specifically in regards to mandated smart meter pilots and trials to:

- Specify that the materiality threshold for mandated smart meter pilots and trials is equivalent to the AER's administrative costs of assessing a pass through application;
- Allow the AER to extend its time period for making a cost pass through determination for mandated smart meter pilots and trials to a maximum of six months by publishing a notice, where it considers that the difficulty of assessing or quantifying the effect of the Ministerial pilot determination justifies the extension; and
- Require the AER, when making a cost pass through determination for mandated smart meter pilots and trials, to consider the costs that an efficient and prudent DNSP in the circumstances of the relevant DNSP would require.

79 Clause 6.6.1(e) of the Rules.

80 See clause 6.6.1(j)(8) of the Rules.

81 See s. 16(1)(a) of the NEL.

82 Clause 6.6.1(j)(5) and 6.6.1(j)(7) of the Rules.

5.1.3 Reasoning for our recommended changes to the Rules

Specification of the materiality threshold for mandated smart meter pilots and trials

In the Draft Report, we recommended that the AER could specify a lower materiality threshold for mandated smart meter pilots and trials by nominating a specific 'smart meter event' in its distribution determinations. In its submission to the Draft Report, the AER has considered that it does not have the discretion in the Rules to specify a different materiality threshold for mandated pilots and trials to the general materiality threshold of 1% of smoothed forecast revenue that it has determined for prescribed pass through events in the Rules.[83] EnergyAustralia considered that the AER's application of different materiality considerations in different jurisdictions has lead to regulatory uncertainty, while Ergon Energy raised concerns about how the materiality threshold is applied.[84]

We agree that there has been some inconsistency in relation to the AER's materiality threshold for mandated smart meter pilots and trials, and that this has created a degree of regulatory uncertainty for DNSPs. To address this, we have proposed an amendment to the Rules to specify that the materiality threshold for mandated smart meter pilots and trials should be equivalent to the AER's administrative costs of assessing a pass through application. This threshold would apply to each year in which the costs of the mandated pilot or trial are incurred. This is the same threshold that the AER has determined should apply in NSW, ACT, Qld and SA in its recent distribution determinations for 'smart meter events'.[85] Therefore, our amendment seeks to codify in the Rules the regulatory decisions that have been made by the AER in its distribution determinations. This amendment would provide greater regulatory certainty for DNSPs regarding their ability to recover the costs of mandated pilots and trials, and would also ensure that there is a consistent materiality threshold for mandated pilots and trials across jurisdictions.

Allowing the AER to extend its timeframe for making a cost pass through determination

Our second proposed amendment to the cost pass through provisions would allow the AER to extend its time period for making a cost pass through determination to up to 6 months, where it considers that the difficulty of assessing or quantifying the effect of the Ministerial determination justifies the extension. The AER and ENA supported this amendment .[86] EnergyAustralia accepted that the AER may need more than 60 business days to assess efficient costs, but raised concerns that a time extension may

83 AER, Submission on the Draft Report, pp. 7-8.

84 See submissions on the Draft Report from: EnergyAustralia, pp. 11-12; Ergon Energy, p. 6.

85 See: AER, 2009, Final Decision: New South Wales Distribution Determination 2009-10 to 2013-14, April, p. 280; AER, 2009, Final Decision: Australian Capital Territory Distribution Determination 2009-10 to 2013-14, April, p. 130; AER, 2010, Final Decision: Queensland Distribution Determination 2010-11 to 2014-15, 6 May, p. 298; AER, 2010, Final Decision: South Australia Distribution Determination 2010-11 to 2014-15, 6 May, p. 224.

86 See submissions on the Draft Report from: AER, p. 8; ENA, p. 14.

lead to greater regulatory uncertainty.[87] Citipower/Powercor considered that the current timeframes are sufficient.[88]

We have recommended this amendment as the AER currently has no ability to extend its time period for making a cost pass through determination for mandated smart meter pilots and trials. In most cases, the AER's current 60 business day timeframe is likely to be sufficient, but as we have also recommended that the AER be required to conduct an efficiency assessment on the proposed pass through amount, there is a possibility that additional time may be required to assess larger or more complex pilots and trials. This amendment would ensure that the AER is able to assess the DNSP's proposed expenditure with sufficient time and rigour, which is likely to provide for more efficient outcomes and promote well informed and appropriate regulatory processes. The proposed amendment would also facilitate the AER in conducting public consultations on cost pass through applications, thereby promoting transparency.

Requiring the AER to consider the efficiency of the proposed pass through amount

We have also proposed an amendment to require the AER to consider the costs that an efficient and prudent DNSP would require when it makes a cost pass through determination for mandated smart meter pilots and trials. This amendment was supported by the AER, who suggested that it should be extended to all pass through events.[89] EnergyAustralia and Citipower/Powercor considered that the current pass through arrangements are sufficient, while ENA suggested that an efficiency assessment is not appropriate for mandated smart meter pilots and trials as DNSPs have a limited ability to control this expenditure.[90]Both the NSSC and Origin Energy noted that the cost pass through provisions need to provide certainty to retailers regarding cost recovery, if they are to participate in mandated pilots and trials.[91]

We have recommended this amendment to require the AER to undertake an efficiency assessment, as it would promote the efficient management of costs by DNSPs and the efficient provision of services. It would also provide incentives for DNSPs to effectively identify and manage the risks of mandated pilots and trials, as DNSPs would be required to demonstrate that their costs are efficient and prudent when seeking cost recovery. As the AER would also be required to consider the specific circumstances of the DNSP, we consider that the potential for DNSPs to have a more limited ability to control their costs, compared to normal commercial network operations, would be taken into account by the AER. This amendment would also provide greater consistency between the cost pass through process and the distribution determination process. Further, it would remove the current lack of clarity regarding how the AER

87 EnergyAustralia, Submission on the Draft Report, p. 12.

88 Citipower/Powercor, Submission on the Draft Report, p. 5.

89 AER, Submission on the Draft Report, pp. 8-9.

90 See submissions on the Draft Report from: EnergyAustralia, p. 12; Citipower/Powercor, p. 5; ENA, pp. 14-15.

91 See submissions on the Draft Report from: NSSC, p. 13; Origin Energy, p. 4.

assesses applications and would therefore provide greater certainty on the treatment of third party costs.

5.2 Cost recovery during the dead zone

This section outlines our advice on cost recovery for mandated smart meter pilots and trials under the cost pass through provisions during the 'dead zone'.

5.2.1 Summary of our assessment of the Rules

We consider that a cost recovery risk occurs where a Ministerial pilot determination is made in the last 13 months of a regulatory control period, but a DNSP does not occur costs associated with that determination until the next regulatory control period. This time period has been labeled as a 'dead zone' and has been identified by DNSPs as a common cost recovery risk under the current Rules. Where a Ministerial pilot determination is made in this period, a DNSP may be unable to seek cost recovery under either the cost pass through provisions or the distribution determination process.

A DNSP may be unable to seek cost recovery under the cost pass through provisions during the dead zone, as DNSPs may only seek cost recovery for costs incurred in the same regulatory control period as the pass through event.[92]Therefore, where the pass through event and the incurring of costs occur in separate regulatory control periods, a DNSP would not be able to seek cost pass through under the current Rules.

If a Ministerial pilot determination is made during the dead zone, a DNSP may also be unable to seek cost recovery under the distribution determination process, as the DNSP would have already submitted its regulatory proposal for the forthcoming regulatory control period to the AER, as DNSPs are required to submit proposals 13 months prior to the next regulatory control period. Following the submission of this proposal, there are limited opportunities for DNSPs to submit proposals for additional forecast capital and operating expenditure for the next regulatory control period.[93]

5.2.2 Recommended changes to the Rules

A general amendment to the cost pass through provisions would be made to allow DNSPs to seek cost recovery for pass through events in the following regulatory control period, when a pass through event occurs in the last 13 months of one regulatory control period, but the costs are incurred in the following regulatory control period. This amendment to the Rules would apply to all pass through events in

92 See the definition of an 'eligible pass through event' in Chapter 10 of the Rules.

93 For instance, DNSPs could submit proposals for additional expenditure in a submission to the AER's draft distribution determination. Under clause 6.10.3(b) of the Rules, a DNSP could also submit a revised regulatory proposal following the publication of the AER's draft distribution determination, but may only make revisions to address matters raised by the draft distribution determination or the AER's reasoning in the draft distribution determination.

Chapter 6 of the Rules (i.e. to both positive change events and negative change events) and not only to mandated smart meter pilots and trials.

An amendment specifically for mandated smart meter pilots and trials would also be made to allow DNSPs to include the costs of mandated smart meter pilots and trials in their revised regulatory proposal to the AER, even where the AER has not referred to the mandated smart meter pilot or trial within its draft distribution determination.

5.2.3 Reasoning for our recommended changes to the Rules

There is a clear cost recovery risk under the current Rules where a Ministerial pilot determination is made in the last 13 months of a regulatory control period, but costs associated with that determination are not incurred until the next regulatory control period. This problem arises due to the timing of the Ministerial pilot determination and the issue could be avoided if the Ministerial determination is aligned with the distribution determination process.

In submissions to the Draft Report, DNSPs generally considered that there was merit in addressing the dead zone issue for all pass through events in Chapter 6 of the Rules.[94] However, the NSSC and Energex stated that the dead zone issue should only be addressed for mandated pilots and trials as more general amendments are beyond the scope of the Review. [95]

As this is a common problem to all pass through events, we consider that there is considerable merit in addressing this issue for all pass through events in Chapter 6 of the Rules. Our proposed amendment to allow DNSPs to seek cost pass through is a simple and proportionate response to the cost recovery risk we have identified. This cost recovery risk has also been previously identified by DNSPs and our amendment is broadly supported by industry. Further, as our proposed amendment would apply to all cost pass through events in Chapter 6 of the Rules, it would also provide for consistency in the treatment of regulated distribution investments.

We have also proposed an amendment specifically for mandated smart meter pilots and trials, which would allow DNSPs to incorporate the costs of a mandated pilot or trial within their revised regulatory proposal during the distribution determination process, even where the AER's draft distribution determination has not referred to the pilot or trial. This would allow DNSPs to seek cost recovery under the distribution determination process, where a Ministerial pilot determination is made after the AER has published its draft distribution determination. As mandated pilots and trials would be relatively small in scope, we consider that the AER would have sufficient time to consider the costs of a pilot or trial in the period between receiving a revised regulatory proposal and the publication of its final distribution determination. This would also reduce the need for mandated pilot and trial costs to be recovered by DNSPs through a separate cost pass through process, where a Ministerial pilot determination is made in

94 See submissions on the Draft Report from: Jemena, p. 4; Citipower/Powercor, p. 5; ENA, p. 14; Ergon Energy, p. 6; EnergyAustralia, p. 13.

95 See submissions on the Draft Report from: NSSC, p. 6; Energex, p. 5.

the last regulatory year of a regulatory control period. This would reduce regulatory costs for both DNSPs and the AER.

5.3 Mid period cost recovery for ancillary services

This section outlines our advice on the recovery of efficient costs under the cost pass through process for ancillary ('non-core') smart metering services, where these services are classified as alternative control services.

5.3.1 Summary of our assessment of the Rules

As discussed in Chapter 3, we have proposed amendments to the Rules which would specify that the 'core services' in a Ministerial determination would be classified as standard control services.[96] Therefore, the AER would have no discretion in classifying these services.

However, the AER would retain discretion in classifying ancillary services which may be provided by DNSPs using their mandated SMI. These services would be classified under the current process for service classification in Rule 6.2 of the Chapter 6 Rules. As discussed in Chapter 2, these ancillary services or 'non core services' may include services that a DNSP is mandated to provide under a Ministerial smart meter determination or services that a DNSP voluntarily provides using its mandated SMI. In some cases, these services may be unregulated, where the AER considers that there is sufficient competition in the market for these services. In other cases, these services may be classified as a standard control service or an alternative control service.

Where these ancillary services are classified as standard control services, the cost pass through provisions in clause 6.6.1 of the Rules would automatically apply. However, where ancillary services are classified as an alternative control service, the AER would have discretion in determining whether the cost pass through provisions would be applied to these services. If the AER determines that cost pass through provisions should apply, it may determine to apply the provisions in clause 6.6.1 of the Rules or alternative cost pass through arrangements. On the other hand, there is also the potential that the AER may decide not to apply any cost pass through provisions to these services.

As a result, there is a cost recovery risk under the current Rules where a DNSP is required to seek cost pass through for an ancillary smart metering service, which is classified as an alternative control service. Under our proposed amendments in Chapters 3 and 4, this cost recovery risk would not exist for the current distribution determinations.[97] However, a cost recovery risk could materialise in future regulatory

96 As proposed in Chapter 3, these 'core services' would include the following services that a DNSP is mandated to provide under a Ministerial determination: smart meter pilot and trial services; smart meter provision and installation; smart meter data provision; and the recovery of the costs of stranded metering assets

97 As discussed in Chapter 3, mandated smart meter pilot and trial services would be classified as standard control services, which would allow DNSPs to seek cost recovery under the cost pass

control periods, as the AER would retain discretion over whether the cost pass through provisions would apply to ancillary smart metering services which are classified as alternative control services.

5.3.2 Recommended changes to the Rules

The AER would be required to consider the need for adequate pass through arrangements for mandated ancillary smart metering services which may be provided by DNSPs using mandated SMI, when deciding on the appropriate control mechanisms for alternative control services in making a distribution determination.

5.3.3 Reasoning for our recommended changes to the Rules

We consider that in practice the cost recovery risk associated with an alternative control service classification is small as the AER is required to provide DNSPs with a reasonable opportunity to recover their efficient costs in setting the control mechanism for alternative control services.[98] However, despite this limited risk, there is merit in amending the Rules to place an obligation on the AER to consider the appropriate pass through arrangements for mandated ancillary smart metering services which are classified as alternative control services, when making its distribution determinations.

In submissions to the Draft Report, Citipower/Powercor agreed that there was a cost recovery risk where SMI services are classified as alternative control services, while the NSSC and Energex considered that the principles in the Rules for standard control services should apply where smart metering services are classified as alternative control services.[99] Integral supported our proposed amendment to require the AER to consider the appropriate pass through arrangements for alternative control services.[100]

Our proposed amendment would provide greater certainty for DNSPs regarding their opportunities for cost recovery for ancillary smart metering services that DNSPs are mandated to provide under a Ministerial determination. This amendment would only apply to mandated ancillary smart metering services rather than all ancillary smart metering services, as DNSPs would have an obligation to provide mandated ancillary smart metering services under a Ministerial determination. Therefore, it is considered that DNSPs should have greater regulatory certainty in relation to cost recovery for these services. We have determined to maintain the AER's current discretion over the control mechanism for alternative control services rather than requiring the AER to adopt the pass through arrangements for standard control services, as this would allow the AER to develop the most appropriate and effective control mechanism for each mandated ancillary smart metering service. Further, this amendment would not create

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through provisions in clause 6.6.1 of the Rules. Under our proposed interim determination process discussed in Chapter 4, the AER would have an opportunity to classify any ancillary services that may be provided with or as part of a mandated smart meter roll-out.

98 See the NEL Revenue and Pricing Principles.

99 See submissions on the Draft Report from: Citipower/Powercor, p. 5; NSSC, p. 16; Energex, p. 6.

100 Integral Energy, Submission on the Draft Report, p. 5.

an onerous regulatory burden on the AER, as it seeks to codify the existing requirements in the NEL to allow DNSPs a reasonable opportunity to recover their efficient costs.

6 Tariff issues associated with mandated SMI

This Chapter sets out our final advice on the three questions raised by the MCE on how the costs of the mandated SMI roll-out should be translated into distribution service tariffs for retailers (who then decide how to pass such tariffs onto customers).[101] It includes our advice on:

- the unbundling of tariffs for smart metering services from DUOS charges;
- the efficient allocation of the costs of mandated SMI; and
- the mechanisms to smooth the tariff impact of a mandated smart meter roll-out.

With respect to the arrangements for setting tariffs for mandated SMI services, we have found that the current Rules would not best promote the national electricity objective. The current approach, consisting of having high level principles in the Rules with the discretion for DNSPs to develop their own tariffs is unlikely to maximise efficiency consistent with the MCE policy principles for mandated SMI. The current Rules could permit a wide range of possible tariffs and the DNSP may have an incentive to set tariffs for mandated SMI in a manner which acts as a barrier to future competition. Further, under the current Rules, the AER has a limited amount of time during the pricing approval process to assess a DNSP's proposed annual tariffs.

We have put forward proposed amendments to assess the three aspects raised in the terms of reference for the MCE's consideration. With respect to how to allocate the costs of mandated SMI across different distribution tariffs, we stress that the policy is dependent upon whether contestability occurs in the future plus the arrangements for that contestability. It will also be influenced by the range of ancillary commercial services which arise from the SMI. We have developed our recommendations to reflect that initially the services will be provided under a mandated monopoly position with the prospect of moving to a supplier led model, with contestability for SMI services.

In practice this requires a framework under which DNSPs are required to develop charges for smart meters and associated services using clearly objective and transparent principles which promote a set of tariffs which relate to the incremental cost of providing each service. The remaining unallocated or common costs must then be allocated in a manner which both reflects customers' interests and does not act as a barrier to future contestability.

This chapter discusses possible methodologies and develops recommendations which could promote such an outcome given what we know today. We recommend that as the MCE develops its policy and arrangements for the future contestability of smart metering services, it reviews our recommendations to ensure that they remain appropriate in light of the policy for contestability.

101 Expenditure for a mandated smart meter pilot is not likely to have a material effect on network charges and should be recovered through the relevant DUOS charge.

6.1 General Assessment of policy for SMI tariffs

The costs associated with mandated SMI can be divided into five broad categories:

1. Unit capital cost of the smart meter

2. Installation costs

3. IT systems/communication interface/back office support

4. On going operating costs (primarily data communication costs)

5. The stranded costs of replacing existing accumulation meters.

The policy for setting of tariffs for recovering SMI costs will determine both who pays for the costs and also when. Therefore it affects the distribution of charges across the customer base and also the profile of charges over time.

As part of this Review, the MCE has asked for advice on three questions relating to how the costs of mandated SMI should be translated into tariffs for customers. These issues are:

- Is it appropriate to unbundle the tariffs for smart metering services from DUOS charges;

- What is the efficient allocation of the costs of mandated SMI; and

- What are current mechanisms available under the Rules to smooth the tariff impact of a mandated smart meter roll-out.

There are clear inter-dependencies across these three areas. In order to develop a coherent and consistent set of recommendations, it was essential to consider what should be the optimal approach to determining the set of tariffs for mandated SMI services. This section summarises the constraints we faced when developing our advice.

The range of potential services encompasses many products not just the meter installation. This could include remote connect/disconnect services; remote load control services; smart metering data services; and supply capacity limiting services. A key consideration in assessing efficient tariff outcomes is the prospect of competition in the services that may arise from mandated SMI. The MCE has stated that it remains open to the introduction of contestable smart metering services beyond the mandated exclusivity period, as technology and retail competition matures to support this, and has called for regulatory and operational arrangements in the national framework to allow for this.[102] Therefore it is important that the Rules foster the development of such services and do not create any barriers to the potential for effective competition in

102 MCE, 2008, Smart Meter Decision Paper, 13 June, p. 7

future smart metering services. We have developed our advice consistent with these objectives.

The range of possible services which could be open to competition and the arrangements for how such contestability would operate have yet to be developed. For example, at this time, decisions on restoration or exit fees and the type of smart metering services that may need to continue to be regulated may be required. This makes it hard to identify what exactly would be a barrier to contestability.

It is commonly considered that it is better to recover the bulk, if not all, the costs of SMI before the start of the contestability, in order to promote competition through having lower switching fees when customers are required to 'buy out' their current provider in order to switch suppliers. While there is merit in this approach, there are three other factors to consider.

Firstly, it is not clear whether all the SMI costs will be allocated to a tariff class for services which are suitable for competition. It does not seem to be economically efficient nor sensible to have contestability in the communications interface/IT support systems. There should be one common system with appropriate protocols for the managing and sharing of the data between competitors. Given that, it may be sensible to separate these costs from the other core service costs which are more likely to be open to competition (e.g., meter provision). Hence it should not negatively affect competition if such costs are not recovered before the start of contestability.

Secondly, the approach of recovering costs before contestability should not lead to the early replacement of assets before the end of their useful economic life. Ideally, the costs of SMI should be spread over the useful economic life to prevent inefficient early replacement. There is likely to be some overlap between the useful economic lives of assets and the start of contestability. What the depreciated value of SMI assets should be at the start of contestability and how that remaining value should be recovered during contestability needs to be addressed.

Thirdly, if all the costs are recovered before customers start to benefit from the services then some customers will contribute to the costs and may not receive any benefit from the service (e.g. people who emigrate), while other customers may contribute little to the costs but receive many of the benefits. These issues of inter-generational equity suggest that as far as possible costs should be recovered from those customers who will benefit from the services.

It is difficult to fully consider these three factors without more analysis and discussion on the arrangements for contestability in mandated SMI services. For example, a retailer led model of contestability may in practice mean that switching costs are lower because retailers make arrangements to facilitate transfer of assets at the point of customer transfer.

Another consideration in deciding how to allocate mandated SMI costs is the ability to distinguish between costs directly incurred due to the mandated roll-out and other costs of the DNSPs. This issue was raised in the updated Victorian Cost Benefit

Analysis, especially in relation to network management IT costs. It will be essential for contestability for tariffs to be based on the individual costs of providing the service.

Network costs can either be allocated directly to a defined individual consumer (or group of customers) through a separate charge or allocated across all network customers through a common use of system charge. A consideration in assessing the appropriate tariffs for mandated smart metering services is the possibility that the scope of a mandated roll-out may be limited to a subgroup of the general customer base. Therefore, there is a question of whether customers should contribute to the roll-out costs, if they have not received a smart meter.

The decision on the coverage of the smart meter roll-out will be decided by the jurisdictional Minister when making the mandated roll-out determination. Therefore we have developed our advice having regard to the possibility that only a sub-set of residential customers may have received a smart meter. Plus in the event that the scope of roll-out does not cover all customers in a jurisdiction, consideration of how tariffs for SMI services should interact with non-SMI metering charges will be needed.

We recognise that given these unknown parameters there is a danger of making amendments to the Rules which turn out to create inefficient pricing signals or create perverse outcomes in the long term. However given that, we do also recognise that the current uncertainty in relation to how costs would be recovered may impact on the willingness of DNSPs to participate in mandated roll-outs.

6.2 Unbundling tariffs for smart metering services

In Chapter 3, we explained our recommendation for how mandated SMI services should be classified. We have proposed that the activities which are integral to a Ministerial smart meter determination (the core services) should be classified as standard control services, while other ancillary (non-core) services which are provided by DNSPs using mandated SMI should be classified under the existing arrangements in the Rules. Hence the AER would decide the appropriate classification of such ancillary services in accordance with the existing principles in Rule 6.2 of the Rules. Given this proposed arrangement for service classification, this section now outlines our advice on how it is appropriate to unbundle tariffs for mandated smart metering services from general network charges.

6.2.1 Summary of our assessment of the Rules

Where ancillary smart metering services are classified as alternative control services, the current Rules should result in a separate smart metering charge for each type of service provided.[103] However, it is unclear whether the Rules would promote unbundling if mandated smart metering services are classified as standard control services, as DNSPs have discretion in determining their tariffs so long as they are

103 Under clause 6.18.3(c) of the Rules, DNSPs are required to have separate tariffs for alternative control services and standard control services.

consistent with the pricing principles in clause 6.18.5 of the Rules. It would appear that bundled charges could be consistent with these principles. Further, a DNSP may have an incentive not to unbundle charges, in order to create a barrier to future contestability or to affect competition in auxiliary commercial services associated with SMI.

In principle, we consider that some of the costs of a mandated roll-out should be unbundled from DUOS charges. The proportion would depend upon the method applied for the efficient allocation of costs (discussed in section 4.2).

A separate charge for mandated smart metering services would support the transition to future contestability. It would also provide increased transparency regarding the costs of a mandated roll-out for the AER and consumers. For the AER, unbundled charges may improve the regulatory scrutiny of services which are being provided at the interface between regulated and competitive activities. For consumers, unbundled charges may stimulate interest in time of use (TOU) tariffs which may encourage customers to maximise the potential benefits of a roll-out.[104] We consider that these benefits would outweigh any disadvantages associated with unbundling, such as increased administrative costs for DNSPs.

Where possible, unbundling should occur at the start of the roll-out, as there are broader benefits associated with unbundling beyond the promotion of future competition. Unbundling at the start of the roll-out would also ensure that potential entrants have sufficient information to determine whether to enter the market following the end of the exclusivity period, and lead to a more efficient take-up of services during the exclusivity period. We note that the retail businesses have argued for unbundling of smart metering services during the course of this Review.

However, it is difficult to be prescriptive in terms of what assets and services should be unbundled from DUOS charges, as the MCE is yet to make a decision on future contestability. There is also uncertainty as to what would be the actual range of additional functionality services that DNSPs will be required to provide – as this will be a decision by the relevant minister - compared to the potential functionality currently being developed by the NSSC.

Therefore given our assessment of the Rules, we consider that amendments would be necessary to achieve tariff unbundling for mandated smart metering services. However for mandated smart meter services which we have referred to as "non-core" we consider that the current Rules should be sufficient. We note that the AER would have the ability to classify such services as alternative control services and also given the likely diverse nature of such ancillary services, the current Rules would promote separate charges where appropriate.

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104 We recognise that further policy initiatives may be needed to support the realisation of customer benefits and that retailers would determine whether the unbundled smart meter charge would be displayed on a customer's bill. However, we consider that our advice to the MCE should not create any additional barriers to customers maximising the potential benefits of a mandated roll-out. Also, the current absence of clear pricing signals to the end use customers is not a sufficient reason not to advocate for the unbundling of mandated smart metering services.

6.2.2 Recommended changes to the Rules

To facilitate the unbundling of smart metering services from DUOS charges, the Rules should be amended to require that:

- there is a separate unbundled charge for the meter provision and installation service
- there is a separate unbundled charge for meter data provision
- for non-core services, classification is done in accordance with the existing Rules.

The other core services, of replacing existing meters and pilots, will be permitted to be recovered through the DUOS charge and therefore would not be unbundled. Figure 6.1 shows these recommendations related to service classification.

Figure 6.1 Mandated Smart Metering Services by tariff structure

	Core services				Non-core services
Activities	**Smart meter provision and installation**	**Meter data provision**	**Recovery of stranded meter costs**	**Mandated smart meter pilot and trial services**	**Ancillary services** - May be mandated under a Ministerial determination or voluntarily provided by DNSPs using their mandated SMI (e.g. supply capacity limiting services, remote connect/disconnect services etc)
Service classification	Standard control service - specified in the Rules. No AER discretion over service classification.	Standard control service - specified in the Rules. No AER discretion over service classification.	Standard control service - specified in the Rules. No AER discretion over service classification.	Standard control service - specified in the Rules. No AER discretion over service classification.	AER maintains current discretion to classify these services in accordance with Rule 6.2 in the current Rules.
Tariffs	Separate tariff, which is unbundled from DUOS.	Separate tariff, which is unbundled from DUOS.	Tariffs remain in DUOS.	Tariffs remain in DUOS.	Service classification will determine how tariffs will be calculated. Where services are classified as standard control or alternative control services, tariffs will be determined in accordance with the existing pricing principles in clause 6.18.5 of the Rules.

6.2.3 Reasoning for our recommended changes to the Rules

Unbundling the tariffs of the two key services arising from a mandated roll-out - meter provision and data provision - from DUOS charges would provide a range of economic benefits, including the promotion of future contestability in smart metering services and more efficient decisions about the take-up of the services during any exclusivity period. As these services are to be classified as standard control services it is necessary for the Rules to prescribe that such services have a separate unbundled charge.

The NSSC considered that the principles for the allocation of costs for smart metering, and for unbundling smart metering services should be the same as those currently applying for other network investment.[105] Integral Energy argued that the Commission should not be recommending unbundling until the MCE has conducted its review into the case for SMI contestability.[106] Other network businesses raised concerns on the administrative complexity and the costs caused from unbundling. However Origin supported unbundling of SMI costs from general use of system charges.[107]Noting the network businesses concerns, the Commission continues to consider that there are positive economic efficiency benefits from unbundling of SMI costs and that such unbundling should occur from the start of the roll-out as it provides transparent signals to both customers and prospective competitors.

In relation to non-core services, our proposed amendment seeks to facilitate unbundling by the AER where it is considered appropriate. We do not consider the Rules should be prescribed at this level of service as it would add complexity and implementation costs at this stage of the development of SMI services. Hence the AER would not be required to unbundle all the service tariffs associated with a mandated roll-out. However, in determining whether to unbundle, the AER would be required to take into account the SMI pricing principles, which are discussed in section 4.2. It would be possible for bundled charges to be consistent with these principles, for instance, where there is uncertainty regarding future contestability or where there is sufficient difficulty in separately identifying and allocating SMI costs. The AER would be required to make a decision as to whether unbundling should occur in the next regulatory control period in its Framework and Approach Paper at the beginning of the distribution determination process. This would provide regulatory certainty to DNSPs and would allow the AER to make a decision on unbundling in sufficient time and through a public consultation process.

Under our amendments, the AER would not be required to classify the non-core services as alternative control services to achieve unbundling, which would allow the AER to retain its current discretion to determine the most appropriate service classification for each smart metering service. This would ensure that the Rules are robust enough to accommodate all potential Ministerial determinations.

6.3 Efficient allocation of the costs of mandated SMI

This section addresses whether the Rules would provide for the efficient allocation of the costs of a mandated smart meter roll out across the different distribution service tariffs levied on retailers. There are two aspects which need to be assessed. Firstly, how should the costs be apportioned between the individual charges assigned to a residential customer which has (or will have) a smart meter and the total residential customer base of the DNSP[108]; and secondly, should costs be recovered from retailers

105 NSSC, Submission to Draft Report, pg. 17

106 Integral Energy, Submission to Draft Report pg.10.

107 Origin Energy, Submission to Draft Report, pg.5.

108 Through distribution use of system charges.

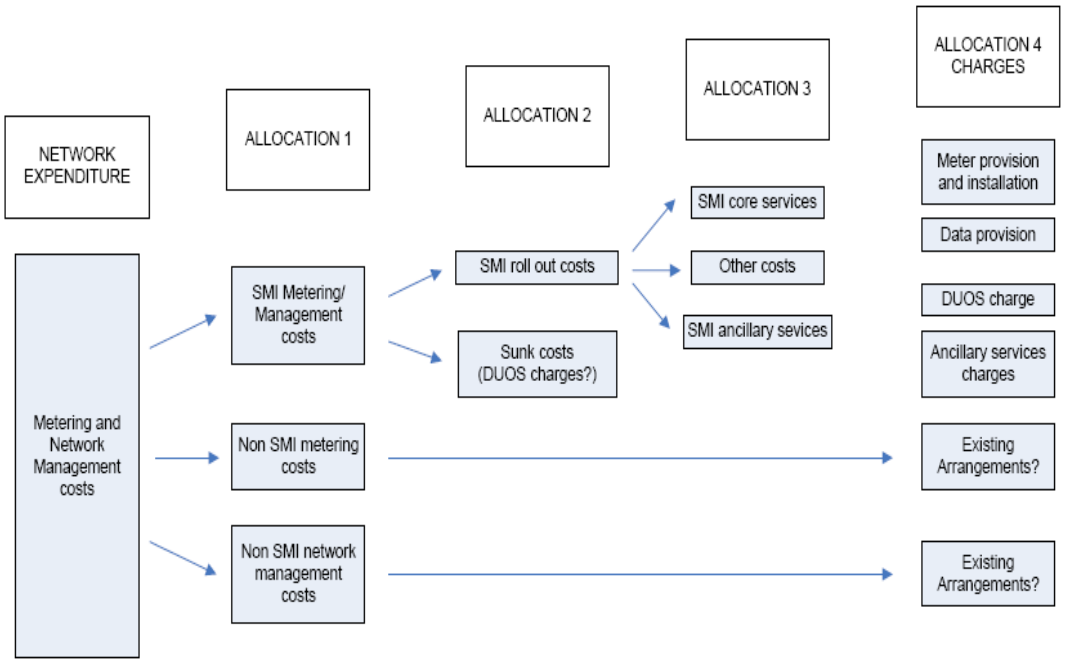
via a fixed charge or a variable charge and should this charge should be the same for all customer types.

Allocating mandated SMI expenditure to tariff classes would not be a straightforward exercise. There are three key questions to be addressed:

- What is the total pool of costs that need to be recovered?
- What is the total range of services for which charges could be levied to recover the costs?
- How to allocate the total pool of costs to the services?

Figure 6.2 shows the various stages and decisions required.

Figure 6.2 Process for allocating SMI expenditure to SMI charges



6.3.1 Summary of our assessment of the Rules

Under the Rules, costs are allocated to tariff classes and tariff elements by DNSPs in accordance with defined pricing principles in clause 6.18.5 of the Rules, and the AER may only amend a DNSPs tariffs if the tariffs do not comply with these pricing principles. These pricing principles contain general efficiency criteria based on the 'causer pays' principle, which requires customers to pay the relevant costs of services they have requested. As these principles are set at a high level, a range of possible tariffs, between the stand alone cost and the avoidable cost of the roll-out, would comply with the Rules and each DNSP has the discretion to determine which of these possible tariffs should apply.

However, the causer pays principle may not result in the efficient allocation of costs for a mandated smart meter roll-out, as a roll-out would occur as a result of a Ministerial determination rather than as a result of a customer request or by customer agreement. In addition, the range of discretion provided to the DNSP in setting network tariffs may not be appropriate for mandated smart metering services given the potential for future contestability and the incentive for the DNSPs to apportion a small share of common or joint costs to activities that are perceived as being likely to face the strongest competitive pressures as a means to deter future competitors.

An alternative methodology to allocate the costs of a mandated roll-out would be to apply the 'beneficiary pays' principle, which would result in allocating roll-out costs to retailers in relation to where the benefits of the SMI are captured. As a mandated roll-out would provide network operational benefits which would accrue to network users more generally, a proportion of the roll-out costs should be allocated across the general customer base irrespective of whether all of that customer base has a smart meter.

Therefore this approach may be more economically efficient as it would prevent retailers whose customers do not have a smart meter being subsidised via lower DUOS charges by those who do.

The key stages of the allocation process will be moving from allocation 2 to the set of charges under allocation 4, as shown in Figure 6.2. The difficulty of this process will also depend upon how granular the level of charges must be set at. Given the two broad methodologies of either causer pays or beneficiary pays, we assessed five broad options for allocating mandated SMI expenditure:[109]

1. Allocation to separate unbundled SMI charges in accordance with the current principles in the Rules (i.e., causer pays principle).

2. Allocation to separate SMI charges using more detailed prescription on how each charge is calculated based upon allocating costs to the various mandated SMI services.

3. Allocation to both separate unbundled SMI charges and DUOS charges based upon application of beneficiary pays principle.

4. Allocation to both separate unbundled SMI charges and DUOS charges in accordance with an objective prescribed method based on the nature of the costs and level of contestability in the level of relevant service. For example:

    - the unbundled tariffs for meter and data provisions should reflect the costs of such services that are variable to the individual service (i.e. cost of meter); and

109 The option of allocating all costs to DUOS is not raised given our advice to have unbundled SMI charges.

- the remaining costs, which are mainly the fixed IT systems, communications, back-office support expenditure, should be allocated to the DUOS charges.

5. A hybrid approach of using option 2 for the non-core services and option 3 for the core services.

In principle, the method which would best facilitate competition would be to apply a bottom-up approach where costs are allocated based on costs that can be directly attributed to the provision of the service. This would leave a share of total costs which cannot be directly allocated. Such common costs should be allocated in a way which least distorts the competitive market.

Our advice is that the most efficient method to allocate the costs of a mandated SMI roll-out across the different tariffs levied on retailers is applying option 5 as follows:

- the tariffs for the non-core services should reflect the incremental cost of providing those services;

- the unbundled tariffs for meter provision and data provisions should reflect such a share of the SMI costs based upon the beneficiary pays approach; and

- the remaining costs are allocated to DUOS charges.

In principle, we consider that the costs of core mandated smart metering services should be allocated between the separate unbundled charges and the DUOS charges, depending on the ratio of network operational cost savings to the total benefits of the mandated SMI. Hence, the separate unbundled charge should reflect the proportion of benefits which could be captured or assigned to individual customers who have an installed and functioning smart meters.

Given the nature of mandated roll-out, we consider that it important that every participant which benefits from the mandated infrastructure should make a contribution to recover the costs. However in the event of a commercial roll-out, it would be more important that customers face tariffs that reflect the total cost of providing the service so that the customer would make an efficient choice.

The Commission has not made any assumptions on where the bulk of the benefits would arise from SMI and therefore notes that this ratio could vary substantially. Instead, what is important is that the Rules facilitate the ability for the costs of mandated SMI to be charged consistent with an efficient allocation of costs, whatever that allocation may be. However, the practical application of the beneficiary pays principle may be difficult as the costs associated with the mandated roll-out would need to be separated out from the costs of a DNSP's broader operations. However this will be a pre-requisite for competition to develop. If the SMI costs are not separated out then there is limited basis for a competitor to enter.

There may also be difficulties in determining the value and the allocation of the benefits of the roll-out, particularly as the roll-out progresses and more customers

receive meters. However the proposed annual reporting requirements (explained in Chapter 3) will assist in applying this principle.

An alternative to this approach would be to allocate all of the fixed costs to DUOS charges and the variable costs to the unbundled smart metering charge (i.e., cost of meter provision and installation). Such an allocation rule may not have a detrimental effect on contestability given that it is unlikely that there would be competition in providing such infrastructure. Instead there should be one common system with appropriate protocols for the managing and sharing of the data between different suppliers of SMI related services.

As most of the costs of a mandated roll-out would involve fixed costs that would not vary with consumption, on efficiency grounds, the costs associated with a roll-out should be recovered as a fixed charge. This was supported by stakeholders in their submissions to the Draft Report. However amendments to the Rules are necessary to achieve this.

In relation to whether the tariff should be the same for all customers, clause 6.18.4 would promote the same charge for customers assigned to the same tariff classes. One of the factors which determine how customers should be assigned to each tariff class is whether remotely read interval metering has been installed at the customer's premise as a result of a regulatory obligation.[110] It seems that this clause would promote standardised charges, subject to the nature of connection and extent of the usage of the customers. Although a standardised charge would not result in the most efficient allocation of costs as the costs and benefits of a roll-out may vary across customers, a standardised charge may be the most practical way to recover costs. Therefore, we recommend that the current Rules provide the AER with sufficient guidance to determine how to segregate customers into different tariff classes for mandated smart metering services.

Another dimension to the allocation of mandated SMI costs is the timing of charges, and when should customers start to contribute to the cost recovery. The Rules do not provide much guidance on this matter. It seems it will depend on how tariff classes for each service are classified.

In the Draft Report, we considered that where a customer has not yet received an installed and functioning smart meter, these customers should not be required to contribute to the share of costs allocated to the unbundled smart metering charges. A number of stakeholders argued against this point on the grounds that it would not be practical to do so.

6.3.2 Recommended changes to the Rules

To address the risk that the Rules may not promote the efficient allocation of the costs of a mandated smart meter roll-out, the Rules would be amended to:

110 Clause 6.18.4 (a)(1)(iii) of the Rules.

- Provide greater prescription regarding the setting of tariffs for smart meter metering services, by inserting 'SMI pricing principles' into the Rules; and

- Require DNSPs to take into account the SMI pricing principles when proposing tariffs for mandated smart meter roll-outs. The AER would have the ability to require amendments to a DNSP's proposed tariffs, if it considers that the DNSP's tariffs are not consistent with the SMI pricing principles.

The SMI pricing principles would be as follows:

- the costs of providing mandated smart metering services should be recovered through a fixed tariff

- a proportion of costs should be allocated to those customers who benefit from the mandated smart metering services, based on the share of benefits those customers receive compared to the benefits that all customers receive. The AER could inform the DNSP of the appropriate proportion to apply for the forthcoming regulatory control period in its distribution determination;

- a proportion of the costs should be allocated to the general DUOS tariffs, based on the share of benefits all customers receive compared to the benefits that are specific to customers with mandated smart meters. The AER shall inform the DNSP of the appropriate proportion to apply for the forthcoming regulatory control period in its distribution determination;

- the DNSP shall not be remunerated twice for the same cost through different tariffs;

- should promote future contestability in smart metering services;

- should be easily comprehensible; and

- must be determined with regard to the transaction costs of calculating the tariff.

Further detailed prescription on these principles would be provided by the AER through a supporting guideline. Such additional guidance may be crucial in promoting contestability.

We also recommend that any of the unbundled mandated smart metering charge should not be levied on retailers before a customer has an installed and functioning smart meter.

In relation to non-core services, the SMI pricing principles would not apply. Hence AER would not be required to calculate the relative proportion of benefits for each service in order to apply a beneficiary pays principle. Instead the AER should decide upon the proportion of total mandated SMI costs which can be attributable to those services under the existing cost allocation Rules. The DNSP would then allocate this proportion of SMI costs amongst the non-core services in accordance with the existing principles in clause 6.18.5 of the Rules and the AER's decision on service classification. The remaining proportion of total SMI costs would be allocated out between the DUOS

charge and the core services (which are unbundled), in accordance with the beneficiary pays principle.

This is the hybrid approach of allocation costs to separate SMI charges using more detailed prescription on how each charge is calculated for the non-core services and allocating costs to both separate unbundled SMI charges and DUOS for the core services in accordance with applying a beneficiary pays approach. If it is considered that a beneficiary pays approach is too difficult or too uncertain to apply in practice we note that there is some merit in applying the alternative of option 4 approach. This would allocate costs to both separate unbundled SMI charges and DUOS charges in accordance with an objectively prescribed method based upon the nature of the costs and level of contestability in the level of relevant service. That is, all fixed costs for IT and communication systems are levied on retailers through the DUOS charge.

6.3.3 Reasoning for our recommended changes to the Rules

To provide for the efficient allocation of the costs of a mandated smart meter roll-out, we have proposed that DNSPs be subject to additional prescription in proposing tariffs for mandated smart meter roll-outs. Under our proposed SMI pricing principles, DNSPs would be required to propose tariffs consistent with a set of detailed principles and result in a fixed charge rather than a charge that varies with consumption.

In principle, we consider that the allocation of costs for the core services should reflect the beneficiary pays principle for the reasons set out below. However there may be a risk that allocating costs using this principle may undermine future competition in such services, if it results in a cross-subsidy which only the DNSP benefits from. In theory, this could be addressed through ensuring the allocation ratio remains constant but in practice this may be difficult.

Given this, there is merit in developing option 4 as a credible alternative. This will require further analysis and discussion on the appropriate prescribed allocation methodology.[111] One possible method could be to prescribe that the IT systems/communication interface costs are recovered through the DUOS charge with the meter provision and installation costs recovered through an unbundled separate charge. There should also be a separate charge for the data provision reflecting the incremental costs of providing that service.

We note that this additional prescription would result in an inconsistency between the pricing framework for mandated roll-outs and other network services, and that there may be practical difficulties in developing tariffs under a beneficiary pays principle. However, we consider that additional prescription is required to ensure that tariffs reflect the nature of mandated smart meter roll-outs and promote efficient behaviour by customers. Further, our proposed amendments would provide for a proportionate change to the Rules as tariffs must be determined with regard to the transaction costs of calculating the tariffs and the current propose-respond model would be maintained.

111 It may require detailed prescription in supporting guidelines on how the allocation methodology should be applied by the DNSPs.

As a result, the AER would only be able to modify a DNSP's tariffs, where it can demonstrate that the proposed tariffs do not reflect the SMI pricing principles.

A number of the submissions questioned whether the beneficiary pays principle would work in practice. The AER considered that the determination of the total operational benefits associated with a SMI rollout, and the apportionment of these benefits to individual consumers would be a complex exercise given the difficultly in estimating some of the benefits associated with a SMI rollout, such as the quantum of deferred network investment. It noted that difficulty in quantifying indirect benefits associated with the rollout would mean that the proportion of the SMI costs allocated to consumers would not always be aligned with the application of the beneficiary pays principle. The AER questioned whether the economic benefits of setting charges on this basis in these circumstances would outweigh the administrative costs of applying this principle.

As the beneficiary pays principle would allocate some SMI costs into DUOS, the AER also raised the concern that the principle may be inconsistent with the need to set cost reflective prices for the services to encourage the potential for contestability. To address these concerns we have exempted the non-core services from the beneficiary pays principle. We accept the AER's comment on the need to encourage competition in non-core ancillary services, as the DNSP would not have exclusivity over such services during the mandated period. Hence the allocation of mandated SMI costs attributable to these services would be done in accordance with the existing pricing principles in clause 6.18.5 of the Rules.[112] This may result in core mandated smart metering services being charged in accordance with the beneficiary pays principle and the non-core services being priced in accordance with the existing principles. We do not consider that this would be an inefficient outcome, but note that it is important that the AER is able to apply regulatory scrutiny to how a DNSP develops its charges for non-core services to protect against a DNSP allocating the costs in a manner which places it at an unfair competitive advantage.[113]

One issue with respect to non-core services is that although costs may be incurred in providing additional functionality to the SMI, the Minister may not have decided to activate some of the functionalities. As such costs could not be applied to be recovered through the separate service charge, they would have to be recovered through another avenue, possibly the DUOS charge.

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112 The revenue expected to be recovered from any such tariff class is required to be between the avoidable cost of not serving the customers in that tariff class and the stand alone cost of serving those customers under clause 6.18.5(a) of the Rules. In addition, the tariff must take into account the long run marginal cost for the relevant service and must be determined having regard to whether the relevant customers are able or likely to respond to price signals under clauses 6.18.5(b)(1) and (2)(ii) of the Rules. Tariffs must also be determined having regard to the associated transaction costs and whether customers are able or likely to respond to price signals. In regards to the recovery of fixed costs, the DNSP must adjust its tariffs with minimum distortion to efficient patterns of consumption.

113 This issue may need to assessed further under the Rule change process. This may result in amendments to the current cost allocation provisions in the Rules.

We do not accept the views expressed in submissions that the beneficiary pays principle would be too difficult to apply in practice. We note that there is likely to be sufficient information on the range of the benefits from SMI including both the information used by the Minister in making the determination and also the information provided to the AER under the proposed annual reporting requirement. This information should enable the AER to make a reasonable estimate on the proportion of network operational cost savings that are comprised of the total SMI benefits. However, we have also amended the proposal to place the obligation on the AER to decide on the apportionment of the costs using the beneficiary pays principle as part of its distribution determination. As the beneficiary pays principle would require time and proper consideration it should not be undertaken each year by DNSPs and assessed by the AER in the annual tariff approval process.

The Victorian Updated Cost Benefit Analysis provided figures which are sufficiently detailed to support an application of a beneficiary pays principle.[114] A worked example is provided below.

Cost Estimates ($m) 2008-2028 Present Value		
	Low case	**High case**
AMI Roll-out	1124	1527
AMI Program additional costs	143	241
2006-2009 Sunk Cost of non AMI infrastructure	297	297
Total	1564	2062

Benefits Estimates ($m) 2008-2028 Present Value		
	Low case	**High case**
Distributor operations	1,879 (75.7%)	3225 (49.5%)
Retailer operations	47 (1.9%)	139 (2.1%)
Customer demand response and HAN operation	556 (22.4%)	3110 (47.8%)
Total	2481	6504

Applying these figures to our proposed advice would result in the following tariffs:

- The AMI program additional costs incorporate the metering functionalities to enhance the range of services available to customers. Making the simple assumption that this covers all non-core service costs, then $143m - $241m of

114 Oakley Greenwood 2010, "Benefits and Costs of the Victorian AMI Program". Available on http://new.dpi.vic.gov.au/smart-meters/program-background/victorian-ami-program

costs will be allocated to non-core services and subsequently allocated to each service in accordance with the existing Rules.

- For core services, the AMI roll-outs covers the costs of meter provision and installation, IT/communications and on-going operational expenditure. Making the assumption that distributor operations cost savings benefit all the general customer base and therefore in accordance with the beneficiary pays principle should be allocated to the DUOS charge, this means that between $850m (low case) to $765.7 (high case) should be allocated to DUOS charges. This results in between $274m (low case) to $761m (high case) being allocated to the unbundled meter provision and data provision charges. A method is needed to separate this amount between these two charges. We suggest that is done on a ratio of allocated costs of both services.

- The $297m sunk costs would continue to be recovered in accordance with their original economic life in DUOS charges (see section 6.3.2).

- This means that between $1,147m (75 per cent) in the low case to $1,063m (52 per cent) in the high case of smart metering costs would be allocated to the DUOS charge.

This exercise shows that a beneficiary pays approach could work in practice. However it also highlights the wide spectrum of changes possible under this approach depending on what estimates and assumptions are used. Therefore, for such an approach to work, it will be essential that a clear objective procedure is developed to govern how to allocate costs based upon the beneficiary pays concept. Such a procedure should be common to all jurisdictions.

A number of submissions disagreed with the proposal that the unbundled charge should be only be levied once the meter is installed and operational.[115] Origin argued that it would not be practical to apply charges only when the SMI is installed and operating at individual premises and would lead to significant administrative costs for retailers. It argued that as mandated SMI will be done on a exclusive basis, all customers within the region should be subject to cost recovery, whether or not a smart meter has been installed.

There is potential benefit in aligning the charging of the separate tariffs with the installation and functioning of the smart meter. As a number of benefits associated with SMI are dependent upon customers' decisions, aligning the charging may best trigger the desired change in customer behaviour.

However a potential disadvantage with this approach, is that it decreases the customer base to recover those costs allocated to those charges. This could result in substantially high charges especially in the early years of the roll-out which could damage customer

115 This does not mean that the DNSPs cannot start to recover any costs until a meter has been installed. Under our recommendations, the DNSP would be able to pass through a proportion of the costs through DUOS charges, depending upon the network operational cost savings to total SMI benefits ratio.

support for the roll-out. Another potential disadvantage is that it could negatively affect the financing of the mandated roll-out through extending the time between expenditure and charging.

However these effects would not happen if the upfront fixed costs were not allocated from such charges. We consider that this is likely to happen under the beneficiary pays approach, for example using the low case scenario calculations for the updated Victorian cost benefit analysis would result in 75 per cent of the costs being allocated to DUOS. It would not be case if the alternative option 4 allocation method was applied instead. Also the extent of any charges will be influenced or the decision regarding back-ending depreciation (see next section).

Consistent with the efficient allocation of costs, we continue to consider that it would be appropriate for individual mandated smart metering charges to be levied on retailers only once the customer has an installed and functioning smart meter. Without an operational smart meter, customers would be unable to capture the potential benefits of the meter.

Also it does not mean that the DNSPs cannot start to recover any costs until a meter has been installed. Under our recommendations, the DNSP would be able to pass through a proportion of the costs through DUOS charges, depending upon the network operational cost savings to total SMI benefits ratio. In addition, we have recommended that the separate unbundled charges may only begin to be levied from the next quarterly billing period after the smart meter has been installed. This will help to minimise the administrative costs of this recommendation and addresses the view raised by stakeholder on the practical application of this rule.

6.4 Tariff smoothing

This section outlines our advice on whether the Chapter 6 Rules would allow the AER to require DNSPs to smooth the tariff impact of a smart meter roll-out decision and if not, what amendments should be made to permit tariff smoothing.

6.4.1 Summary of our assessment of the Rules

One of the key characteristics of a mandated smart meter roll-out is that the costs incurred in rolling out the meters and associated communications occur up-front, whilst the benefits (including the network operational benefits) would only begin to be realised once a significant proportion of the roll-out is complete. This difference in the timing profile of costs and benefits could lead to a significant up-front spike in tariffs which then gradually declines as cost savings start to be realised. The MCE has indicated that the AER should consider mechanisms to smooth the tariff impact of a smart meter roll-out decision[116]and have asked for advice on the current mechanisms in the Rules available to the regulator to achieve this.

116 MCE, 2008, *Smart Meter Decision Paper*, p. 8.

The initial price impact of a mandated roll-out on consumers could be significant.[117] Our assessment of the Rules has found that the treatment of depreciation for the stranded metering infrastructure would contribute to the magnitude of this initial tariff increase but that the regulator would have insufficient ability to smooth out the impact on customer's tariffs.

Under clause 6.5.5(b)(1) of the Rules, DNSPs could be required to accelerate the depreciation of meters which are stranded as a consequence of a mandated roll-out, as DNSPs are required to depreciate assets using a profile which reflects the economic life of the asset. As the economic life of existing meters would be in effect zero following a mandated roll-out, DNSPs can seek to recover the costs of these stranded meters under an accelerated depreciation profile.

The accelerated depreciation of these assets could have a significant impact on consumer tariffs and would be contrary to the MCE's policy objective of minimising the tariff impact of a mandated roll-out on customers.[118]

Under the current Rules, the AER has the ability to smooth tariffs within a regulatory control period, but its ability to smooth tariffs between regulatory control periods is questionable.

The AER is able to smooth tariffs within a regulatory control period through the profile of X factors under clause 6.5.9 of the Rules. The AER is not explicitly required under the Rules to consider the tariff impact on customers when determining the value of X factors. However, in practice, the AER has actively considered tariff smoothing in determining the appropriate X factors, and has used its discretion to smooth tariffs over the regulatory control period.

Smoothing tariffs between regulatory control periods could occur through the use of depreciation profiles, by requiring DNSPs to recover a greater proportion of their costs at the end of the economic lives of the SMI assets (i.e. by 'back-ending depreciation'). However, it is unlikely that the current Rules would allow the AER to use depreciation to smooth the tariff impact of a mandated roll-out, as the AER may only modify the depreciation profiles proposed by DNSPs where they do not conform to the requirements in clause 6.5.5(b) of the Rules.

Under these requirements, the AER would be required to demonstrate that a back-ended depreciation profile reflected the nature of the SMI asset over its economic life. It may be possible to develop an argument that the use of IT and communication

117 Based on figures for the Victorian AMI roll-out, the potential price impact from a mandated roll-out of smart meters, could be in the order of 5-10% of the average customer's retail bill in the first full year of the roll-out AER, 2009, Final Determination: Victorian advanced metering infrastructure review: 2009-11 AMI budget and charges applications, October 2009 and AER Decision, Advanced Metering Infrastructure 2011 revised charges, October 2010.

118 We understand that for the Victorian roll-out, any post 2006 expenditure on non SMI metering is treated as accelerated depreciation. This treatment of existing meters contributed roughly between 6% to 12% of the total annual AMI tariffs charged by the Victorian DNSPs in 2009, and 2.5% to 6% of the annual tariffs charged in 2010.. See the Victorian AMI final decision charges models available from the AER website.

interface systems will depend upon the profile of the roll-out and hence that the use of these assets would be strongly correlated with the timing of the benefits of the roll-out. If so, then straight line depreciation would be an inappropriate profile for these assets. Rather, the nature of these assets would mean that they should be depreciated on a declining profile, such that their value gradually declines at the start of the roll-out and then declines more quickly over the asset life. This argument would not be appropriate for the costs of providing and installing the smart meter as the use of the meter would be constant over the economic life and therefore straight line depreciation is more appropriate.

We recognise that it may be difficult for the AER to apply such an argument to demonstrate that a back ended deprecation profile was appropriate for the IT and communication costs of SMI, especially where a DNSP has not proposed such a profile. Therefore, if the MCE wishes to better facilitate the smoothing of the tariff impact of SMI, it may want to consider making explicit amendments to better enable the AER to smooth the tariff impact from mandated roll-outs over multiple regulatory control periods.

6.4.2 Recommended changes to the Rules

To smooth the tariff impact of a mandated smart meter roll-out on consumers, the Rules would be amended to:

- Prevent recovery of the stranded costs of existing accumulation meters through accelerated depreciation following a mandated smart meter roll-out. Instead, DNSPs would be required to continue to recover the costs of these meters through DUOS charges based on their current asset lives; and

- Require the AER to have regard to the need to minimise the initial tariff impact of a mandated smart meter roll-out, when determining the appropriate X factor for the forthcoming regulatory control period.

While we do not put forward any recommendation, we also provide for the MCE's consideration, potential amendments which would provide the AER with the ability to modify a DNSPs proposed depreciation schedule for SMI assets. Under this amendment, the AER would be required to take into account defined criteria in the Rules when determining whether to modify a DNSPs depreciation schedule. We note that there are significant issues with providing the AER with such an ability.

6.4.3 Reasoning for our recommended changes to the Rules

We consider that the tariff impact on consumers from the accelerated deprecation of existing meters following a mandated roll-out could be significant. To decrease the up-front tariff impact of a mandated roll-out on consumers, we have proposed an amendment to prevent the recovery of the costs of existing meters through accelerated depreciation.

In addition, the draft Rules will ensure that the costs of existing meters (plus associated infrastructure) would continue to be recovered after the meter has been taken out of service. This is because the proposal to classify the replacement of existing meters as a standard control service would remove the possibility of removing such assets from the RAB under Schedule S6.2.1 (e)(7) of the Rules.[119] As DNSPs would be required to recover the costs of the existing meters through DUOS charges based on their current determined asset lives, our proposed amendment should not place DNSPs at a competitive disadvantage once contestability is introduced.

The submissions to the Draft Report supported this proposal. Integral Energy stated that recovering the residual value of the existing meters over the previously forecast remaining lives is not inconsistent with the broader regulatory framework, as long the previously accepted lives are preserved and that the regulatory WACC remains appropriate.[120]

We have also proposed an amendment to the Rules to place an explicit obligation on the AER to consider tariff smoothing when determining the profile of X factors in making a distribution determination. As this change would codify the existing practice of the AER, it would not result in a disproportionate change to the Rules. We agreed with the NSSC's suggestion that this amendment should be limited to smart metering in order to not have wider application to other network expenditure and have drafted the Rule accordingly.[121] We note that stakeholders did not disagree with this proposal. CitiPower and Powercor were supportive of including guidance on the use of the X-fact to smooth out recovery of SMI charges, as long as the outcome is revenue neutral.[122]

Possible amendments to facilitate tariff smoothing over multiple regulatory periods

The Draft Report included a proposal to allow the AER to back-end depreciation for SMI assets to assist in smoothing the potential cost impacts. However, as this would be a fundamental change to the current framework, which is based on the presumption that the DNSP should appropriately select the depreciation profile, the proposal limited the AER's ability to only require the depreciation of SMI assets to be back ended to where there was positive economic benefit from doing so. In addition, we noted that given the short economic life for fixed cost SMI assets (approximately 7 years for IT systems and 15 years for smart meters) there may be limited benefits in changing the profile of cost recovery for such assets. Our recommendation regarding stranded accumulation meters may also smooth the price impact of a roll-out to the point where additional smoothing is not needed.

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119 This addresses EnergyAustralia's concern that the Rules must ensure that any legacy infrastructure disposed to accommodate SMI is capable of being recovered into the future. EnergyAustralia, Submission to Draft Report, pg. 18.

120 Integral Energy, Submission to Draft Report, pg. 9.

121 NSSC, Submission to Draft Report, pg. 17.

122 Citipower/Powercor, Joint submission to the Draft Report, pg. 6.

The network businesses raised a range of concerns on this proposal and considered that the approach should be avoided. They thought that it would only defer and complicate issues of cost recovery. A number noted that manipulating the depreciation profile to defer cost recovery would negatively impact the future contestability of smart metering services through higher switching fees. Energex argued that the introduction of differing depreciation treatments for assets creates increased administrative complexity to data management and operation of their revenue and pricing methodologies.[123] Ergon Energy also noted that back ending depreciation would be a reversal of the current treatment where DNSPs depreciate assets in accordance with Accounting Standards.[124]

Integral Energy argued that the proposal does not recognise the way in which the AER's Post Tax Revenue Model results in back end loading of cash-flows through the model's approach to calculating inflation and regulatory depreciation.[125] The AER stated that while it acknowledges the potential economic reasons to justify deferred depreciation profiles, there are practical difficulties and potential gaming opportunities associated with back-ended depreciation profiles. The AER also advised that the Commission should consider including a level of prescription on how the back-ended depreciation should be profiled with the timing of benefits.

We note the concerns raised by stakeholders on the proposal to facilitate back ending depreciation of SMI assets. In addition, we recognise that there are two other potential disadvantages. Back-ending depreciation could also increase the negative impact of any technology risk associated with SMI, as it defers cost recovery into the future.

Another potential disadvantage is the impact on the cash-flows of the DNSPs. Extending the time between expenditure and the recovery of costs could require increases in the businesses' working capital allowance and lead to higher financing costs. The impact of this will depend upon the total value of the businesses capital expenditure program and also the financial market conditions. These will influence the ability of the businesses to attract the necessary investment to undertake the roll-out.

However, we also note the potential merit in minimising the initial tariff impact on customers given the difference in the timing between the up-front costs and benefits associated with SMI.

Also the current regulatory framework sets a forecast revenue allowance which the business is incentivised to out perform against and achieve further cost savings. This approach will encourage the DNSP to maximise the potential operational benefits of SMI. However, as a result of this approach, the value of benefits which are passed through to customers would be higher in subsequent regulatory control periods

123 Energex, Submission to Draft Report, pg. 6.

124 Ergon Energy, Submission to Draft Report, pg. 7.

125 Integral Energy state that by offsetting increments from applying CPI to the RAB against depreciation cash flows, the AER has instituted a cash flow profile which is designed (amongst other things to provide smoother intergenerational pricing. Integral Energy, Submission to Draft Report, pg. 10.

compared to the first control regulatory period. This would occur as the incentives provided under the first period would encourage the business to achieve and reveal additional efficiencies. This impact on the profile of benefits may justify deferring a proportion of the up-front costs of a roll-out into subsequent regulatory control periods to better align the timing of costs to benefits and achieve tariff smoothing.

As the MCE has already stated that the AER should consider mechanisms to smooth the tariff impact, we have developed a proposed amendment to the Rules which would better enable the AER to redistribute the profile of SMI cost recovery.

We recommend that such an amendment should be limited to only the communication and IT costs since a) a declining depreciation profile could only be consistent with the nature of such assets and b) deferral of cost recovery for such assets should not result in a barrier to any later introduction of contestability because, as noted earlier, we question whether the costs of which should be part of any contestable service tariff.

In addition, there needs to be:

(a) regard to the application of other mechanisms, in relation to treatment of accumulation meter costs and the AER's decision on the X factor (as proposed in section 6.3.2.), which can assist in smoothing the tariff impact before deciding on whether to back end depreciation; and

(b) there needs to be appropriate criteria that the AER must consider when deciding whether to apply back ended depreciation. In doing so, the AER would need to consider the impact on future competition in smart metering services and potential concerns about inter-generational equity if there is a mismatch between when benefits are enjoyed by customers and the customers who pay the costs.

To achieve this we are proposing the following criteria:

- the ability to back-end depreciation would only allow the profile of depreciation to change and would not allow cost recovery to extend past the economic life of the asset;
- the SMI assets that can be subject to any back-end depreciation include the supporting fixed IT costs and not the unit capital costs of smart meters
- the profile of depreciation should reflect the estimated timing profile of benefits
- The AER must:
  - have regard to the application of other mechanisms which could assist in smoothing the tariff impact of mandated SMI
  - consider how back-ending depreciation would impact on the potential for future contestability in SMI services
  - explain in its distribution determination why it considers back-ending depreciation would be beneficial to customers.

This criteria will help to minimise the impact of changing the depreciation schedule on future contestability and would also lessen the uncertainty that DNSPs may have on how the AER could apply this ability. However we also note that uncertainty in relation to how costs would be recovered by DNSPs following the introduction of future contestability needs be further considered, as it may impact on the willingness of DNSPs to participate in mandated roll-outs.

We also want to stress that irrespective of whether this amendment is made, it is important that there is adequate customer education and awareness on the likely tariff impacts over the course of the mandated roll-out. This will help foster customer understanding and support for the mandated roll-out.

7 Implementation of our final advice

The MCE will consider our final advice and draft Rules and decide on the appropriate design for the cost recovery arrangements for mandated SMI. If the MCE determines that changes to the Rules should be made, proposed Rules would then need to be considered through a standard Rule change process by the Commission.

Cost recovery under any new arrangements should present minimal implementation issues, if the introduction of the new arrangements is effected as described below.

Our proposed changes to specify the service classification of the 'core services' in a Ministerial smart meter determination should take effect from the time the Rules are made, to ensure that DNSPs in NSW, Qld and SA can seek cost recovery if a Ministerial determination is made in the current regulatory control period. For the proposed interim determination process for mandated smart meter roll-outs, we also recommend that this process commences with the commencement of the Rules in order to provide adequate cost recovery arrangements if a Ministerial roll-out determination is made before the start of the next regulatory control period. The other changes we have proposed to the distribution determination process and pricing arrangements, outlined in Chapters 3 and 6, should not be applied until the next distribution determination process. This would ensure that our proposed changes can be implemented at the commencement of a distribution determination process. The AER would then be able to consult on how changes to the distribution determination process may apply through its Framework and Approach Paper.

For NSW and ACT DNSPs, the next distribution determination process will commence in June 2012 for the start of the next regulatory control period on 1 July 2014. For SA and Qld DNSPs, the next distribution determination process will commence one year later, in June 2013. The completion of any Rule change process by the Commission by mid 2011 would provide ample time for any new arrangements to be applied for the commencement of the distribution determination processes for NSW and ACT DNSPs in mid 2012.

Our proposed changes to the cost pass through provisions in clause 6.6.1 of the Rules, as outlined in Chapter 5, should take effect from the time the Rules are made. These proposed changes are mechanical in nature and should not have a significant impact on how the cost pass through process is undertaken.

Legal advice has been sought on potential issues of retrospectivity that may arise in regards to cost recovery for DNSPs which may be in the process of undertaking mandated smart meter roll-outs and pilots, when any Rule changes are made.[126] The impact of any changes to Chapter 6 of the Rules will depend on the specific circumstances of each DNSP. However, any changes to the Rules regarding cost recovery for mandated SMI should not present any retrospectivity issues for DNSPs.

126 See AAR, 2010, Advice in Response to MCE Request for Advice on Cost Recovery for Mandated Smart Metering Infrastructure, 18 June, pp. 31-32.

Under our proposed Rule amendments, the AER would be required to develop guidelines on its approach to interim determinations for mandated smart meter roll-outs and the information requirements for the annual provision of information on mandated smart meter roll-outs, pilots and trials. To ensure that the AER has adequate time to develop and consult on these guidelines, we consider that the AER should be provided with six months to publish these guidelines following the making of the Rules. This could in theory result in the interim determination being applied before any guidelines are in place. However, we do not consider that this is a sufficient reason to delay the interim determination process because of the importance of ensuring the recovery of net efficient costs and also given the level of prescription on how the interim determination process would be applied in the proposed Rules.

Currently our proposed amendments are not applicable to Victoria (except the information reporting provision as discussed in Chapter 3), as the existing legislative arrangements for the AMI roll-out, including those relating to the recovery of the costs of the AMI roll-out, will continue to be applied.[127] There is a question as to whether Victoria may want to transition to the national arrangements, possibly in respect only to the tariff arrangements at later date. The Rule change process would provide an opportunity to further consider this matter and how any transition would take place.

127 However, in preparing our draft advice we have had regard to the design of the Victorian arrangements and the reasons behind this approach. We have also used the experience gained in undertaking the Victorian roll-out in developing our final advice.

Abbreviations

AER	Australian Energy Regulator
AMI	Advanced metering infrastructure
DNSPs	Distribution network service providers
DUOS	Distribution use of system
EBSS	Efficiency Benefit Sharing Scheme
ENA	Energy Networks Association
MCE's	Ministerial Council on Energy's
NEL	National Electricity Law
NEO	National Electricity Objective
NSSC	National Stakeholder Steering Committee on Smart Meters
RAB	Regulatory asset base
Rules	National Electricity Rules
SMI	Smart metering infrastructure
TOU	Time of use
WACC	Weighted average cost of capital

A MCE's Request for Advice

MCE
Ministerial Council on Energy

CHAIR
The Hon Martin Ferguson AM MP
Minister for Resources and Energy
Telephone: (02) 6277 7930 Facsimile: (02) 6273 0434

Min ID:B09/2403

Dr John Tamblyn
Chairman
Australian Energy market Commission
PO Box A2449
SYDNEY SOUTH NSW 1215

Dear Dr Tamblyn, John

ADVICE ON WHETHER THE ECONOMIC REGULATION OF DISTRIBUTION SERVICES CONTAINED IN CHAPTER 6 OF THE NATIONAL ELECTRICITY RULES EFFICIENTLY ACCOMMODATES COST RECOVERY FOR MANDATED SMART METERING INFRASTRUCTURE

In a recent out of session decision, the Ministerial Council on Energy (MCE) agreed that I write to you to request that the Australian Energy Market Commission provide advice to the MCE on whether Chapter 6 of the National Electricity Rules efficiently accommodates cost recovery for smart metering infrastructure mandated by Ministerial Determination as contemplated in the *National Electricity (South Australia) (Smart Meters) Amendment Act 2009.*

The detailed Request for Advice, including a requirement to publish a Statement of Approach, is attached. We look forward to receiving your advice by no later than end August 2010.

Yours sincerely

Martin Ferguson

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MINISTERIAL COUNCIL ON ENERGY REQUEST TO THE AUSTRALIAN ENERGY MARKET COMMISSION FOR ADVICE ON WHETHER CHAPTER 6 OF THE NATIONAL ELECTRICITY RULES EFFICIENTLY ACCOMMODATES COST RECOVERY FOR MANDATED SMART METERING INFRASTRUCTURE

Pursuant to Section 6(b) AUSTRALIAN ENERGY MARKET COMMISSION ESTABLISHMENT ACT 2004 (SA)

REQUEST FOR ADVICE

BACKGROUND

1. On 13 June 2008 the Ministerial Council on Energy (MCE) issued a Statement of Policy Principles (the Statement of Policy Principles) in relation to the mandated roll-out of smart meters. The Statement of Policy Principles contains the following principles:

   1.1. To promote competitive retail markets and maximise the benefits of a large scale accelerated roll-out of smart meters to residential and other small customers, there should be a national minimum functionality supported by a national regulatory framework for smart meters.

   1.2. To maximise the net benefits of a mandated roll-out of smart meters in a timely manner and capture the operational benefits for distribution network service providers, distribution network service providers will be legislatively obliged to roll out smart meters to some or all residential and other small customers in those jurisdictions where a mandated roll-out will take place.

   1.3. A distribution network service provider who is obliged to roll out smart meters should have exclusivity over meter provision and responsibility for related metering data provision in respect of the customers covered by the mandate during the period in which the distribution network service provider must complete that mandate.

   1.4. The regulatory framework for distribution network tariffs, consistent with the revenue and pricing principles, should ensure that distribution network service providers:

      1.4.1. are able to recover in a transparent manner the costs directly resulting from meeting the mandated service standards for smart meters and the costs of their existing investment which has been stranded by any mandatory roll out; and

      1.4.2. promptly pass on cost efficiencies resulting from the installation of smart meters to tariff classes affected by the costs of a smart meter roll-out.

2. Further to the Statement of Policy Principles, following two rounds of public consultation the MCE presented the *National Electricity (South Australia) (Smart Meters) Amendment Bill 2009* to the South Australian parliament which passed on 29 October 2009. The *National Electricity (South Australia) (Smart Meters) Amendment Act 2009* (the Smart Meter Act) facilitates and supports mandated trials, pilots and roll-outs of smart meters in participating jurisdictions. As set out in the second reading speech, a Ministerial smart metering determination will have the effect of changing the regulatory obligations on the distribution business, triggering a mechanism for recovery of efficient direct costs in accordance with the National Electricity Rules (the Rules). Ministers also recognised the importance of promptly passing on cost efficiencies resulting from smart metering to customers affected by the costs of a roll-out. This Request for Advice is to ascertain whether the interaction of the Rules with the Law could be improved to more efficiently accommodate Ministerial smart metering determinations.

3. The Smart Meter Act and the Statement of Policy Principles were developed to implement the MCE decision of June 2008 to place an obligation on distribution businesses to roll out smart meters where a jurisdictional implementation date has been set and to facilitate distribution businesses recovering the efficient direct costs of providing the mandated infrastructure and services.

4. The Smart Meter Act also supports the timely implementation of pilots with the objective of confirming smart metering costs and benefits in jurisdictions where these remain uncertain, facilitating distribution business recovery of efficient costs in delivering these pilots.

5. Pursuant to s6(b) of the *Australian Energy Market Commission Establishment Act 2004 (SA)* the MCE may request the Australian Energy Market Commission (AEMC) to provide advice.

6. Participating jurisdictions under the National Electricity Law (NEL) have agreed to the following Request for Advice by the AEMC.

REQUEST

7. In November 2009, MCE agreed to request the AEMC to provide advice to MCE on whether the existing economic regulation applying to distribution services set out in Chapter 6 of the National Electricity Rules (the Rules) most efficiently accommodates the recovery of the efficient costs of smart metering activities mandated by a Ministerial Determination. This advice and any proposed Rule changes (the Advice) is to have regard to:

   - the National Electricity Objective;
   - the MCE Statement of Policy Principles;
   - the Smart Meter Act at Attachment A and draft initial rule at Attachment B; and
   - the June 2008 MCE Smart Meters Decision Paper.

   The Advice is to be prepared in accordance with the following requirements.

Issues to be addressed

Provision for recovery of efficient costs of smart meter roll-outs and pilots

8. The AEMC should consider whether the current Rules most efficiently accommodate the recovery of efficient distributor costs associated with meeting their obligations under a Ministerial pilot metering determination (which may include direct load control) or a Ministerial smart meter roll-out determination, via the distribution determination process and the cost pass through provisions in clause 6.6.1 of the Rules.

   Specific issues to consider include:

   8.1. The interaction of the obligations imposed on distribution network service providers under sections 118B and 118D of the proposed NEL amendments with the revenue and pricing principles in the NEL and the operating expenditure objectives and capital expenditure objectives in clauses 6.5.6(a) and 6.5.7(a) of the Rules;

   8.2. The interaction of the obligations imposed on distribution network service providers under sections 118B and 118D of the proposed NEL amendments and the definition of 'regulatory change event' for the purposes of the cost pass through provisions in clause 6.6.1 of the Rules;

   8.3. Whether the provisions of Chapter 6 of the Rules allow a distributor to enter into a contract (or other arrangement) with a retailer for the provision of retail services used in smart meter and direct load control pilots or trials and then allow the distributor to recover the associated fees charged by the retailer;

   8.4. The implications for cost recovery of services being categorised as alternative control services rather than standard control services, and whether any modifications to the Rules are required to ensure recovery of efficient costs and whether it is appropriate to unbundle metering services from distribution use of system charges;

   8.5. The implications for the recovery of efficient costs of implementing a future Ministerial pilot metering determination which may include direct load control and/or a Ministerial smart meter rollout determination for distribution price determinations that have already been made by the AER prior to the NEL amendments, including whether the costs of alternative control services can be recovered under the cost pass through mechanism if this was not anticipated in the determination;

Obligation and ability to take into account network benefits

9. The AEMC should consider:
   9.1. Whether there is an obligation under the NEL and the Rules for the AER to take into account 'reasonably achievable network operational benefits' in determining efficient costs;
   9.2. Whether the Rules provide the ability for the AER to take into account 'reasonably achievable network operational benefits' either during the distribution determination process or in making a pass through determination or both, and to request information sufficient for this purpose;
   9.3. Whether the framework provides for the efficient allocation of costs of a smart meter roll-out, which may include apportioning costs against something other than a standardised cost per customer.

Cost pass through provisions under clause 6.6.1

10. In respect of the cost pass through determination process under clause 6.6.1 of the Rules the AEMC should consider:
   10.1. Whether there is sufficient flexibility provided under the Rules for the AER to determine an appropriate materiality threshold for the pass through of distributor costs associated with a Ministerial pilot metering determination;
   10.2. Whether the timeframes in the current Rules for pass through applications and determinations are appropriate, in the context of a Ministerial pilot metering determination and/or a Ministerial smart meter rollout determination.

Incentives under the regulatory regime

11. It would be appropriate for the AEMC to consider:
   11.1. Whether an efficiency benefit sharing scheme as provided for under clause 6.5.8 of the Rules is appropriate for an accelerated roll-out of smart meters, given the MCE decision that the efficiencies gained from a roll-out are to be passed on to customers 'promptly';
   11.2. Whether the current incentive mechanisms incorporated in the Rules are sufficient to maximise the competitive purchase of meters and metering services; and
   11.3. Whether Chapter 6 of the Rules provides appropriate incentives for a distribution network service provider to manage technology risks for the long-term benefit of consumers without a re-examination of the Weighted Average Cost of Capital (WACC), which is outside the scope of this review. The risks to be managed include premature failure of a new technology.

Mechanisms to smooth impacts on tariffs over time

12. In light of MCE's June 2008 decision that the regulator should consider mechanisms to smooth any impact on tariffs over time, the AEMC should consider:
   12.1. Whether clause 6.5.5 of the Rules in relation to depreciation requires modification, to allow the AER to require a distributor to modify its proposed depreciation schedules in order to smooth the tariff impact of a smart meter roll-out decision, (this includes the depreciation of existing accumulation meter assets that are being replaced before the end of their economic life);
   12.2. The need to minimise potential price impacts on customers caused by paying for the Smart Metering Infrastructure (SMI) roll-out before benefits are realised;

12.3. Whether the framework allows the AER to obtain the necessary information to ensure benefits are being realised within a reasonable timeframe.

Assumptions

13. In developing the Advice requested above, the AEMC is to assume that:

13.1. the provisions described in the transitional Rule have commenced;

13.2. Rules, standards and the National Electricity Market technical procedures describing technical specifications, performance requirements, amendments to functions, service standards and national minimum functionality in respect of SMI have been made; and

13.3. no further Rule changes for jurisdictional derogations in relation to delivery of smart meter trial, pilot and roll-out programs will be made.

Consultation

14. The AEMC must prepare and publish on its website a draft Statement of Approach by no later than 20 December 2009. The AEMC must invite public comment on the draft Statement of Approach. The AEMC must consider comments on the draft Statement of Approach in preparing the final Statement of Approach for publication.

15. The AEMC must prepare and publish draft Advice on the issues outlined in the Request for Advice, and invite public comment on the draft Advice. The AEMC must consider comments on the draft Advice in preparing the final Advice on issues outlined in the Request for Advice.

Recommendations

16. The Advice should make recommendations on any changes to the Rules necessary to ensure the recovery of the efficient costs of mandated smart metering infrastructure and have regard to the prompt pass through of benefits to consumers, where this is in their long term interest.

Management of confidential information

17. The AEMC must manage confidential information provided in accordance with the requirements of section 24 of the AEMC Establishment Act 2004 and section 108 of the NEL.

Date by which advice is due

18. The AEMC must provide a copy of the final Advice to the MCE by end August 2010. The AEMC must also publish a copy of the final Advice on its website no later than two weeks after providing the Advice to MCE.

A

No 54 of 2009 assented to 5.11.2009

South Australia

National Electricity (South Australia) (Smart Meters) Amendment Act 2009

An Act to amend the *National Electricity (South Australia) Act 1996.*

Contents

The Parliament of South Australia enacts as follows:

Part 1—Preliminary

1—Short title

This Act may be cited as the *National Electricity (South Australia) (Smart Meters) Amendment Act 2009*.

2—Commencement

(1) This Act will come into operation on a day to be fixed by proclamation.

(2) Section 7(5) of the *Acts Interpretation Act 1915* does not apply to this Act or to a provision of this Act.

3—Amendment provisions

In this Act, a provision in Part 2 amends the *National Electricity Law* set out in the Schedule to the *National Electricity (South Australia) Act 1996*.

Part 2—Amendment of *National Electricity Law*

Division 1—Smart meter amendments

4—Amendment of section 2—Definitions

(1) Section 2, definition of ***additional Minister initiated Rules***—delete "or section 90B" and substitute:

, section 90B or section 90C

(2) Section 2—after the definition of ***Ministerial Gazette notice*** insert:

Ministerial pilot metering determination means a determination made under section 118B;

Ministerial smart metering determination means—

(a) a Ministerial smart meter rollout determination; or

(b) a Ministerial pilot metering determination;

Ministerial smart meter rollout determination means a determination made under section 118D;

(3) Section 2—after the definition of ***shared transmission service*** insert:

smart meter amendments means the amendments to this Law made by section 5 of the *National Electricity (South Australia) (Smart Meters) Amendment Act 2009* of South Australia;

5—Insertion of Part 8A

After Part 8 insert:

Part 8A—Smart metering services

Division 1—Interpretation

118A—Definitions

In this Part—

relevant customer means a person who consumes electricity through a supply point connected to a distribution system owned, operated or controlled by a regulated distribution system operator to which a Ministerial smart metering determination applies;

required smart metering infrastructure means smart metering infrastructure that is specified under the Rules to be required smart metering infrastructure;

smart meter assessment means an assessment of the costs and benefits, or operational performance, or both, of different smart metering infrastructure and other related technologies, including devices designed to enable direct load control;

smart metering infrastructure means infrastructure (and associated systems) associated with the installation and operation of remotely read electricity metering and communications, including interval meters designed to transmit data to, and receive data from, a remote locality;

smart metering services means services provided by means of required smart metering infrastructure that are specified as smart metering services under the Rules;

smart meter trials means trials of smart metering infrastructure and other related technologies, including devices designed to enable direct load control.

Division 2—Ministerial pilot metering determinations

118B—Ministerial pilot metering determinations

(1) A Minister of a participating jurisdiction may make a determination that requires a regulated distribution system operator that earns most of its revenue from the provision of electricity network services provided by means of a distribution system situated partly or wholly in that participating jurisdiction to conduct smart meter trials or undertake a smart meter assessment (or both).

(2) In making a Ministerial pilot metering determination, the Minister must have regard to—

(a) the national electricity objective; and

(b) any comments or submissions made to the Minister as part of the consultation conducted under section 118C.

(3) A Ministerial pilot metering determination must specify the regulated distribution system operator, or the class of regulated distribution system operator to which the determination applies (the ***relevant operator or relevant operators***).

(4) Without limiting subsection (1), a Ministerial pilot metering determination may—

(a) specify minimum standards of performance and service that must be met or investigated by the relevant operator or relevant operators in conducting smart meter trials;

(b) specify the nature and timing of the smart meter trials;

(c) in relation to information derived from a smart meter trial or a smart meter assessment, require the relevant operator or relevant operators to—

(i) subject to any conditions specified in the determination, provide that information to a person specified in the determination; or

(ii) make such information publicly available.

(5) A requirement of the kind referred to in subsection (4)(c) may require information that relates to a person—

(a) be provided to another person; or

(b) be made publicly available.

(6) However, a requirement referred to in subsection (4)(c) must not require the relevant operator to make the information publicly available in a manner that identifies the person to whom the information relates unless the relevant operator has the written consent of the person to do so.

(7) Subsection (6) does not apply to information that is in the public domain.

118C—Consultation with interested persons required before making Ministerial pilot metering determination

Before making a Ministerial pilot metering determination, the Minister must consult with a person or body that the Minister considers has an interest in the determination.

Division 3—Ministerial smart meter rollout determinations

118D—Ministerial smart meter rollout determinations

(1) A Minister of a participating jurisdiction may make a determination about the provision of smart metering services by a regulated distribution system operator that earns most of its revenue from the provision of electricity network services provided by means of a distribution system situated partly or wholly in that participating jurisdiction.

(2) In making a Ministerial smart meter rollout determination, the Minister must have regard to—

(a) the national electricity objective; and

(b) any submissions made to the Minister as part of the consultation conducted under section 118E.

(3) A Ministerial smart meter rollout determination must not be inconsistent with the Rules.

(4) A Ministerial smart meter rollout determination must—

(a) specify the regulated distribution system operator, or the class of regulated distribution system operator to which the determination applies (the ***relevant operator or relevant operators***); and

(b) specify any of the following or a combination of any of the following in relation to which the relevant operator or relevant operators must provide smart metering services:

(i) the minimum number of relevant customers;

(ii) the class of relevant customers;

(iii) the minimum number of supply points; and

(c) specify the date on which the determination expires.

(5) Without limiting subsection (1), a Ministerial smart meter rollout determination may specify—

(a) the date or dates by which, and the location at which, smart metering services, or different classes of smart metering services, must be provided;

(b) the date or dates by which required smart metering infrastructure, or different classes of smart metering infrastructure, become operational.

(6) A Ministerial smart meter rollout determination has effect according to its tenor despite anything to the contrary in any agreement or contract.

118E—Public consultation required before making Ministerial smart meter rollout metering determination

Before making a Ministerial smart meter rollout metering determination, the Minister must consult with the public about the determination.

Division 4—Provisions applicable to Ministerial smart metering determinations

118F—Compliance with Ministerial smart metering determinations

(1) A regulated distribution system operator must comply with a Ministerial smart metering determination that applies to the operator.

(2) A regulated distribution system operator incurs, by complying with a Ministerial pilot metering determination, no liability for breach of contract, breach of confidence or any other civil wrong.

118G—Minister of participating jurisdiction must consult with other participating jurisdiction Ministers

A Minister of a participating jurisdiction must consult with the Ministers of the other participating jurisdictions before making a Ministerial smart metering determination.

118H—Content of Ministerial smart metering determinations

A Ministerial smart metering determination—

(a) may be of general or limited application;

(b) may differ according to differences in time, place and circumstances.

118I—Publication and giving of Ministerial smart metering determinations

As soon as practicable after a Ministerial smart metering determination is made the determination—

(a) must be published in the South Australian Government Gazette; and

(b) must be given to—

(i) every regulated distribution system operator to which it applies; and

(ii) the AER; and

(iii) the AEMC.

118J—When Ministerial smart metering determinations take effect

A Ministerial smart metering determination has effect on and after the day specified in the determination for the period specified in the determination.

118K—AEMC must publish Ministerial smart metering determination it receives on its website

The AEMC must publish a Ministerial smart metering determination on its website as soon as practicable after receiving it.

Division 2—Other related amendments

6—Insertion of section 90C

After section 90B insert:

90C—South Australian Minister to make initial Rules related to smart meters

(1) The Minister in right of the Crown of South Australia administering Part 2 of the *National Electricity (South Australia) Act 1996* of South Australia (the ***South Australian Minister***) may make Rules for or with respect to either or both of the following subjects:

(a) the smart meter amendments;

(b) any other subject contemplated by, or consequential on, the smart meter amendments.

(2) Rules may only be made under subsection (1) on the recommendation of the MCE.

(3) Section 34(3) applies to Rules made under subsection (1) in the same way as it applies to Rules made by the AEMC.

(4) As soon as practicable after making Rules under subsection (1), the South Australian Minister must—

(a) publish in the South Australian Government Gazette notice of the making of the Rules stating the date of commencement of the Rules or, if different Rules commence at different times, the various dates of commencement; and

(b) make the Rules publicly available.

(5) Once the first Rules have been made under subsection (1), no further Rules can be made under that subsection.

B

RECEIVED
26 NOV 2009

Print/Photocopy supplied to :.....

Department : .....

On : .....

By : .....

Confidential Draft prepared by the Office of Chief Parliamentary Counsel Victoria

National Electricity Amendment (Ministerial Smart Meter Roll Out Determinations) Transitional Rule 2009

TABLE OF PROVISIONS

Print/Photocopy supplied to :.....

Department : .....

On : .....

By : .....

Sixth Draft
10/08/2009

National Electricity Amendment (Ministerial Smart Meter Roll Out Determinations) Transitional Rule 2009

1 Title

This Rule is the *National Electricity Amendment (Ministerial Smart Meter Roll Out Determinations) Transitional Rule 2009.*

2 Commencement

This Rule commences operation on [ ].

3 Amendment of National Electricity Rules

The National Electricity Rules are amended as set out in Schedule 1.

SCHEDULE 1

[1] New Rule 11.28—Ministerial Smart Meter Roll Out Determinations

After Rule 11.27 insert:

11.28 Ministerial Smart Meter Roll Out Determinations

11.28.1 Definitions

In this rule 11.28:

relevant commencement date, for a relevant *metering installation*, means the day on which the Ministerial smart meter roll out determination that applies to the relevant *metering installation* takes effect.

relevant *metering installation* has the meaning given by rule 11.28.2.

specified amount means the amount assigned to variable "y" in Schedule 3 of the *metrology procedure* in relation to a participating jurisdiction.

supply point means a supply point—

(1) that is a *connection point* connected to the distribution system of a regulated distribution system operator; and

(2) through which the regulated distribution system operator is required to provide smart metering services in accordance with a Ministerial smart meter roll out determination.

volume consumption means the volume of *energy* consumed by a customer through the relevant supply point calculated in accordance with Schedule 2 of the *metrology procedure*.

11.28.2 Meaning of relevant *metering installation*

(a) For the purpose of this rule, a **relevant *metering installation*** is a *metering installation* for a supply point in respect of which the volume consumption of the customer is less than the specified amount.

(b) For the purpose of this rule, a **relevant *metering installation*** does not include:

(1) a *metering installation* installed for a supply point before the relevant commencement date in respect of which a *Market Participant* is the *responsible person*; or

(2) a *metering installation* referred in paragraph (a) that is installed for the supply point referred to in that paragraph on and after the relevant commencement date in accordance with the ordinary replacement cycle of that *Market Participant*; or

(3) a *metering installation* located at a *high voltage connection point*.

11.28.3 Period of application of rule to relevant metering installations

This rule 11.28:

(a) applies to a relevant *metering installation* on the day the Ministerial smart meter roll out determination that applies to the relevant *metering installation* takes effect; and

(b) ceases to apply to a relevant *metering installation* on the day the Ministerial smart meter roll out determination that applies to the relevant *metering installation* ceases to have effect.

11.28.4 Designation of responsible person

Despite clauses 7.2.2 and 7.2.3, the *responsible person* for a relevant *metering installation* is the regulated distribution system operator to whom the Ministerial smart meter roll out determination (that applies to that relevant *metering installation*) applies.

11.28.5 Agency data collection systems and agency metering databases

(a) If *AEMO* uses:

(1) *agency data collection systems* under clause 7.3.5(c); or

(2) *agency metering databases* to form part of the *metering database* under clause 7.9.1(b),

in respect of *metering data* from a relevant *metering installation*, the person engaged by *AEMO* under clause 7.9.1(b1) to provide the *agency data collection systems* and the *agency metering databases* must be selected by the *responsible person* for the relevant *metering installation*.

(b) Paragraph (a) applies despite anything to the contrary contained in any contractual or other arrangement between a *Market Participant* and *AEMO*.

11.28.6 Remote acquisition of data by the responsible person

For the purposes of clause 7.9.2(a):

(a) the *responsible person* for a relevant *metering installation* (and not *AEMO*) is responsible for the *remote acquisition* of *metering data* from a relevant *metering installation*;

(b) *AEMO* is responsible for storing the *metering data* referred to in paragraph (a) as *settlements ready data* in the *metering database*; and

(c) the *responsible person* for a relevant *metering installation* must provide the *metering data* remotely acquired under paragraph (a) to *AEMO*.

ENDNOTES

B The Commission's approach to developing its advice

In developing our final advice, we have assessed how the current Chapter 6 Rules would be applied to cost recovery associated with a mandated smart meter roll-out compared to a mandated smart meter pilot or trial, which may include direct load control. We have also analysed what is possible under the current legal framework of the Rules and the NEL. A copy of the legal advice that was provided to us by AAR in preparing our draft advice was published with our Draft Report.[128]This legal advice provides comprehensive detail on the way that the Chapter 6 Rules and the NEL would be applied to DNSPs seeking cost recovery for SMI which is mandated by a Ministerial determination.

In considering how the Rules and the NEL would be applied in practice, we have also assessed the potential differences between mandated SMI and other distribution investments. The potential issues that may arise from a mandated smart meter roll-out or pilot under the scenarios for assessment outlined in the Final Statement of Approach were also considered, along with submissions we have received during the Review.

In developing our final advice, we have sought to identify the areas where the current Rules are able to accommodate the recovery of the efficient costs of mandated SMI for both roll-outs and pilots. Where we consider that the Rules are unable to accommodate the recovery of efficient costs, we have assessed alternatives and proposed amendments to the Rules using the decision making criteria for the Review.

B.1 Differences between mandated SMI and other distribution network investments

In considering the appropriateness of the current Chapter 6 Rules, we have considered how investments required for mandated smart meter roll-outs and pilots, including trials of direct load control, may differ from other kinds of distribution network investments. We consider that the key differences between mandated SMI and other distribution network investments include:

- **Shift in the role of decision maker** - A mandated smart meter roll-out or pilot is not the usual decision making format for the majority of network services and investments. Under a mandated roll-out or pilot of SMI, a Ministerial determination will set out the parameters of the required investment including the timing of when a mandated smart meter roll-out or pilot will occur, the services that DNSPs must provide and the minimum functionality requirements of the smart meters they must install. In contrast, in regards to other network investments, the DNSP is the initiator and primary decision maker of investment proposals. This shift in responsibility for determining how and when a roll-out or pilot of SMI is undertaken may impact on a DNSP's incentives in carrying out its obligations under a Ministerial determination.

128 AAR, 2010, Advice in Response to MCE Request for Advice on Cost Recovery for Mandated Smart Metering Infrastructure, 18 June.

- **Exclusivity over the provision of services** - Under a mandated roll-out of SMI, DNSPs will be the exclusive providers of SMI during the mandated period. This situation will differ from the current arrangements for the provision of smart meters, as metering services are contestable. Exclusivity over smart metering services may impact on the timing, risks and ability for DNSPs to recover their costs in undertaking a mandated smart meter roll-out. The exclusivity period may also impact on the incentives on DNSPs in selecting technologies to meet their obligations.

- **Uncertainty about costs and benefits** - As SMI technology is relatively new and yet to be rolled out on a mass scale in Australia, there is the potential for considerable uncertainty about the efficient costs and benefits associated with SMI investments. This is in contrast to more traditional distribution network investments, where there is a relatively high degree of certainty from both DNSPs and the regulator about potential costs and benefits, which has been developed through experience and acquired information. Uncertainty about the efficient costs and benefits of SMI may present difficulties for the regulator in determining an appropriate level and profile of recoverable net expenditure.

- **Scope and scale of investment**- The potential scope and scale of a mass mandated smart meter roll-out also differs from the scope and scale of other distribution network investments which are usually undertaken by DNSPs. For example, a smart meter roll-out across NSW would involve installing smart meters for approximately 5.2 million customers, while a roll-out across Qld would involve approximately 3.3. million customers.

In considering these differences between a mandated accelerated provision of SMI and other distribution network investments, we have remained mindful of the need to maintain an appropriate balance between prescription in the Rules in relation to specific issues such as mandated SMI, and the need to maintain a more generic Rules framework, which provides appropriate guidance and discretion to both DNSPs and the AER.

B.2 Decision making criteria for the Review

In our Final Statement of Approach we outlined the decision making criteria we will use to guide our approach and the development of our recommendations to the MCE. These criteria were refined following stakeholder submissions on our Draft Statement of Approach and were developed with regard to the NEO, the MCE's Statement of Policy Principles on Smart Meters, the NEL Revenue and Pricing Principles, and the requirements in the MCE's Request for Advice. The following decision making criteria have been used in the development of our final advice:

1. **Promotion of the efficient management of costs and provision of services**

   The regulatory framework should promote the efficient provision of smart metering services and the efficient operation of SMI. The Rules need to provide incentives for DNSPs to minimise costs in deciding upon the design, purchase

and implementation of equipment and software to meet their obligations under Ministerial determinations. The regulatory framework must promote efficient investment by DNSPs in mandated SMI and reduce the risks of over and under investment. The regulatory framework should also provide DNSPs with a reasonable opportunity to recover their efficient costs in meeting a Ministerial determination.

2. **Appropriate allocation of risk, having regard to what DNSPs can control**

   There are a number of risks associated with mandated investment in SMI, including the risk of costs being higher than forecast and the technological risks associated with making a substantial long term investment. The regulatory framework needs to promote the effective identification and management of such risks, both between different parties and between different administrative processes, to deliver the best outcomes for customers.

3. **Support potential benefits being realised in practice**

   The benefits of smart metering can be divided into two main categories: operational benefits and demand response benefits. The regulatory framework needs to ensure that the regulator is able to consider these benefits in making its determinations, and that benefits are realised to the maximum extent possible and promptly passed through to customers, to ensure their long term interests are supported.

4. **Promotion of transparent, well informed and appropriate regulatory processes**

   The regulatory process for determining the efficient costs and benefits associated with mandated SMI should be transparent and open, with the opportunity for stakeholder input. The regulatory framework should also ensure that the regulator has sufficient time and information to make its determinations.

5. **Robust to the necessary range of possible applications**

   The Rules for mandated SMI should be robust enough to accommodate all potential Ministerial determinations and the potential for future contestability in smart metering services. The regulatory framework should also be consistent with the principles of good regulatory design and practice, in order to promote the stability and predictability of the framework, and to ensure that the framework is proportionate.

6. **Consistency in treatment across different types of regulated distribution investments**

   A common framework for economic regulation should be applied to all distribution investments which are used in the provision of regulated services, to promote consistent and effective regulation and regulatory certainty. Any deviation in treatment, specifically in relation to mandated SMI, would have to be justified as being in the long term interests of consumers.

B.3 Scenarios for assessment

In our Final Statement of Approach, we outlined the scenarios that we intended to use to test our assessment of the issues which may arise from a smart meter roll-out or pilot Ministerial determination and to understand the potential implications of alternative cost recovery mechanisms. The following scenarios have been used to test the robustness of our final advice:

- The timing of the Ministerial determination;
- The length of the mandated period;
- The uncertainty of anticipated costs and benefits; and
- The future contestability of metering services.

B.3.1 The timing of the Ministerial determination

This variable relates to when the Ministerial determination is made in relation to the periodic distribution regulation determination process. We considered two possibilities:

- the timing of the Ministerial determination is such that it allows the roll-out or pilot to be incorporated within the periodic distribution determination process conducted by the AER; or
- the timing of the Ministerial determination is such that incorporation of the impact of the roll-out or pilot within the distribution determination process is not practicable, creating a requirement for cost recovery to be pursued via other available mechanisms, such as the cost pass through provisions.

B.3.2 The length of the mandated period

This variable relates to whether or not a mandated roll-out extends from one regulatory control period to another. We considered a scenario in which a mandated roll-out is initiated during one regulatory control period and extends into subsequent regulatory control periods. The costs during the first period will require cost recovery to be initiated under a separate mechanism (such as a pass through provision), but the costs in subsequent regulatory control periods could be accounted for through the distribution determination process. For all scenarios, benefits will be considered to occur following the roll-out, and to extend beyond the end of the regulatory control period in which costs are incurred.

B.3.3 The uncertainty of anticipated costs and benefits

The third variable relates to the question of whether a reliable and detailed project specification will be available at the time that the Ministerial determination is made. We considered two possibilities:

- A scenario in which costs and benefits at the time of the Ministerial determination are relatively firm, or are considered to be subject to substantial uncertainty; and

- A scenario in which, as the roll-out proceeds, costs and benefits are revealed to be either as anticipated, or substantially more or substantially less.

Where the estimates of potential costs and benefits are subject to a higher level of uncertainty, are contentious or are disputed by the DNSP, the task of judging the appropriate timing and level of off-setting cost savings will be made more difficult for the regulator.

B.3.4 The future contestability of metering services.

This final variable relates to whether smart metering services will become contestable following the end of the mandated exclusivity period for DNSPs. In assessing the future contestability of smart metering services, we have considered the types of services that may be provided using mandated SMI. This has the potential to encompass a range of services, including but not limited to: remote connection/disconnection services; remote load control services; smart metering data services; and supply capacity limiting services.[129]In considering the future contestability of metering services, we have assessed scenarios which allowed for:

- The contestability of residential and other small customer smart metering services following the end of the mandated exclusivity period specified in a Ministerial determination; and

- The continuation of DNSPs as the exclusive providers of smart metering services.

129 The NSSC commented on the range of possible services that may be provided using mandated SMI in their submission to the Draft Statement of Approach. See NSSC, Submission on the Draft Statement of Approach, pp. 12-15.

C Summary of submissions on the Draft Report

This Appendix contains a summary of the issues raised by stakeholders in submissions to our Draft Report[130] and the Commission's response to each of these issues. In preparing our Final Report, we have taken account of these issues and our considerations have been discussed throughout the report.

A total of 10 submission were received on the Draft Report from the following organisations:

- AER
- Citipower/Powercor
- Energex
- EnergyAustralia
- ENA
- Ergon Energy
- Integral Energy
- Jemena
- NSSC
- Origin Energy

130 AEMC, 2010, Request for Advice on Cost Recovery for Mandated Smart Metering Infrastructure, *Draft Report*, 18 June.

Table C.1 Summary of issues raised in submissions on the Draft Report

Draft Report recommendations	Issues raised in submissions	Commission response
Cost recovery under the distribution determination process		
DNSPs have an incentive under the current Rules to delay the timing of mandated roll-outs. To counter-act this incentive the Rules should be amended to provide for an explicit revenue adjustment at the time of the next distribution determination.	Energex considered that DNSPs should not be unduly penalised by this revenue adjustment and that it should not apply to commercially provided smart meter roll-outs.[131] EnergyAustralia did not support this proposed revenue adjustment as it considered that it places too much discretion with the AER and does not acknowledge that DNSPs may incur higher costs where there is a roll-out delay that is beyond the DNSP's control.[132] ENA suggested that the revenue adjustment should provide regulatory certainty to DNSPs, be symmetrical, and consistent with the NEL Revenue and Pricing Principles.[133] Integral Energy and Jemena agreed in principle with the proposed revenue adjustment, but Integral considered that the AER should be required to consider the individual circumstances of each DNSP.[134]	We have retained our Draft Report recommendation to require the AER to make an explicit revenue adjustment at the next distribution determination process to: • remove any additional revenue earned by a DNSP where it has rolled out smart meter and/or associated infrastructure slower than forecast in its previous distribution determination; and • compensate a DNSP for costs above allowed revenues where a DNSP has rolled out smart meters and/or associated infrastructure faster than forecast in the previous distribution determination. This revenue adjustment would be symmetrical as it would address situations where a DNSP's roll-out is slower and faster than forecast. It would only be applied to mandated roll-outs. DNSPs would be revenue neutral as a result of this amendment as it would be based on differences

131 Energex, Submission on the Draft Report, pg. 3.

132 EnergyAustralia, Submission on the Draft Report, pg. 6.

133 ENA, Submission on the Draft Report, pg. 5.

134 See submissions on the Draft Report from: Energex, pg. 3; EnergyAustralia, pg.6; ENA, pg. 5;Integral Energy, pg. 3; Jemena, pg. 4.

Draft Report recommendations	Issues raised in submissions	Commission response
		between the forecast and actual timing of when costs for the roll-out are incurred. As a result, DNSPs would be able to recover at least their efficient costs under this revenue adjustment, in accordance with the NEL Revenue and Pricing Principles. Where DNSPs have specific individual circumstances which may affect how a roll-out may be implemented, these individual circumstances would be reflected in the AER's forecast costs for the roll-out.
Where there is uncertainty around the costs and benefits of SMI when a distribution determination is made, the current process may not promote the recovery of the efficient costs of mandated roll-outs. To address this risk, the AER should be provided with the discretion to apply one of the following mechanisms in making a distribution determination: • Rolling forward the RAB on the basis of forecast depreciation rather than actual depreciation for short lived SMI assets; or • A cost sharing mechanism.	DNSPs and the NSSC generally did not support the proposed mechanism relating to the roll-forward of the RAB, as it would weaken incentives for efficiency and create greater investment uncertainty, financing risk and complexity.[135] The AER and the NSSC indicated a preference for the proposed cost sharing mechanism as it provides greater flexibility, while the ENA suggested that DNSPs should have the ability to choose which mechanism is applied to them.[136] EnergyAustralia and Integral Energy did not support either of the mechanisms.[137] There was general agreement between stakeholders that these mechanisms should only be applied to mandated	We have not retained our Draft Report recommendation to allow the AER to implement additional regulatory mechanisms where uncertainty remains in relation to the efficient costs and benefits of mandated SMI. Rather, we consider that the incentives for short lived assets in the Chapter 6 Rules may need to be addressed as part of a broader review of the framework for the economic regulation of distribution networks.

135 See submissions on the Draft Report from: Citipower/Powercor, pg. 2; ENA, pp. 7-8; Energex, pp. 2, 4; EnergyAustralia, pp. 6-7 ; Jemena, pp. 3-6; NSSC, pp. 7-9.

136 See submissions on the Draft Report from: AER, pg. 3; NSSC, pg. 9; ENA, pg. 7.

137 See submissions on the Draft Report from: EnergyAustralia, pp. 6-7; Integral Energy, pp. 3-4.

Draft Report recommendations	Issues raised in submissions	Commission response
	SMI and not to distribution investments more generally, as this would be beyond the scope of the MCE's terms of reference.[138]	
To ensure that the AER has access to relevant information to assist it in making distribution determinations, DNSPs should be required to provide annual information to the AER on the costs and network operational benefits of any mandated smart meter roll-outs, pilots or trials they are undertaking.	DNSPs raised concerns about the scope of this reporting requirement and considered that it was unnecessary as the AER's NEL information gathering powers are sufficient.[139] The ENA also suggested that the reporting requirement should be time limited, least cost, procedurally balanced, and purpose focused.[140] Energex raised concerns about confidentiality issues and the need for published information to be fully representative.[141] The NSSC and Origin noted that DNSPs should only be required to report on benefits which accrue to the DNSP. However, Origin suggested that annual reporting may have general educational benefits, confirm the cost-benefit assumptions that underpinned the network investment, and facilitate future determinations.[142]	We have not retained our Draft Report recommendation to require DNSPs to provide annual information to the AER on the actual costs and network operational benefits of any mandated smart meter roll-out, pilots or trials they are undertaking. A specific reporting requirement in the Rules is preferred over a reliance on the AER's existing information gathering powers in the NEL, as it would provide certainty and clarity to DNSPs regarding this new requirement and reduce the risk of delays in the provision of information. DNSPs would only be required to report the costs and network operational benefits that accrue directly to the DNSP. The AER would have the discretion to not apply this reporting requirement where it considers that the required information is being provided under alternative reporting requirements, to reduce the

138 See submissions on the Draft Report from: Origin Energy, pg. 3; Jemena, pg. 4; Citipower/Powercor, pg. 2; Energex, pg 4; EnergyAustralia, pp. 6-7; ENA, pg. 1; Ergon Energy, pg. 2.

139 See submissions on the Draft Report from: Origin Energy, pg. 3; Jemena, pg. 4; Citipower/Powercor, pg. 2; Energex, pg 4; EnergyAustralia, pp. 6-7; ENA, pg. 1; Ergon Energy, pg. 2.

140 ENA, Submission on the Draft Report, pg. 10.

141 Energex, Submission on the Draft Report, pg. 4.

142 See submissions on the Draft Report from: NSSC, pp. 7-8; Origin Energy, pg. 3

Draft Report recommendations	Issues raised in submissions	Commission response
	The AER supported the proposed reporting requirement, but highlighted that it would need access to third party information where DNSPs have contracted out their obligations.[143]	likelihood of overlapping reporting requirements. As the Rules can only bind Registered Participants, this reporting requirement may not allow the AER to seek information from third parties who may be contracted by a DNSP to meet their obligations in a Ministerial determination. However, where the AER considers further information is required from third parties who are not Registered Participants, the AER would be able to use their information gathering powers under Section 28 of the NEL.
Mid period cost recovery for mandated smart meter roll-outs		
Where a Ministerial roll-out determination is made within a regulatory control period and has triggered expenditure which is not incorporated within a distribution determination, the AER's decision on the allowed level of expenditure should be deferred until the next distribution determination process. At this time the AER would perform an ex-post review of the efficiency of the incurred expenditure.	DNSPs and the NSSC considered that an ex-post review process would: create funding uncertainty and regulatory risk; deter DNSPs from pursuing more costly investments that would offer benefits to consumers; and be complex and time consuming.[144] Some DNSPs and the NSSC suggested that an amended 6 month cost pass through process or a limited re-opening of the distribution determination should be implemented instead.[145] The AER agreed that alternative options could include either amending the cost pass through provisions or developing a separate mechanism to deal specifically with mandated roll-outs, but noted that any alternative would	We have not retained the proposed ex-post review process in our final advice, as it is considered that this process may impose an unnecessary degree of regulatory risk and funding uncertainty on DNSPs which may impact on the efficiency and effectiveness of the roll-out. Rather, it is recommended that where a Ministerial roll-out determination is made within a regulatory control period, the AER should be required to make an 'interim determination' to determine the allowed revenue for that roll-out until the end of the regulatory control period. This interim determination process would use similar

143 AER, Submission on the Draft Report, pg. 4.

144 See submissions on the Draft Report from: Energex, p. 5; EnergyAustralia, pp. 8-9; Citipower/Powercor, p. 4; ENA, pp. 11-13; Jemena, p.7; and the NSSC, p. 10.

145 See submissions on the Draft Report from: Citipower/Powercor, p. 4; EnergyAustralia, p. 10 ; and the NSSC, p.11

146 AER, Submission on the Draft Report, pg. 5.

Draft Report recommendations	Issues raised in submissions	Commission response
	need to provide the AER with sufficient time to review any proposal and would ideally include assessment criteria that mimics the operational and capital expenditure criteria used in distribution determinations.[146]	criteria and be in a similar form to the distribution determination process.
Mid period cost recovery for mandated smart meter pilots and trials		
The Rules provide the AER with sufficient flexibility to determine an appropriate materiality threshold for mandated smart meter pilots and trials.	The AER has suggested that it does not have the discretion in the Rules to specify a different materiality threshold for mandated pilots and trials to the general materiality threshold of 1% of smoothed forecast revenue that it has determined for prescribed pass through events in the Rules.[147] EnergyAustralia considered that the AER's application of different materiality considerations in different jurisdictions has lead to regulatory uncertainty, while Ergon Energy raised concerns about how the materiality threshold is applied.[148]	We have recommended an amendment to the Rules to specify that the materiality threshold for mandated smart meter pilots and trials is equivalent to the AER's administrative costs of assessing a pass through application. This is the same threshold that the AER has determined should apply in NSW, ACT, Qld and SA in its recent distribution determinations for 'smart meter events'. Therefore, our amendment seeks to codify in the Rules the regulatory decisions that have been made by the AER in its distribution determinations. This amendment would also provide greater regulatory certainty and consistency for DNSPs regarding their ability to recover the costs of mandated pilots and trials.
The Rules should be amended to require the AER to indicate how it will classify mandated pilots and trials when making a distribution determination.	The AER notes that this amendment may not be workable for its current distribution determinations, as it has not classified smart meter pilots and trials or remotely read smart meter services.[149]Integral Energy also highlighted	We have recommended that mandated smart meter pilot and trial services should be classified as standard control services. Therefore, DNSPs would be able to seek cost pass through for mandated smart meter pilots and trials under clause 6.6.1 of the

147 AER, Submission on the Draft Report, pp. 7-8

148 See submissions on the Draft Report from: EnergyAustralia; pp. 11-12; Ergon Energy, p. 6.

149 AER, Submission on the Draft Report, pg. 6.

Draft Report recommendations	Issues raised in submissions	Commission response
	this cost recovery risk for NSW DNSPs in the current regulatory control period, as the AER has not classified types 1-4 metering services in its current distribution determinations.[150] ENA supported this amendment as it would remove uncertainty for DNSPs and consumers.[151]	Rules even where a Ministerial pilot determination is made in the current regulatory control period. As a result, the cost recovery risk we identified in our Draft Report where a Ministerial pilot determination is made within a regulatory control period and the AER has not considered the classification of these services would no longer exist. As a result, we have not retained this recommendation in our final advice.
The cost pass through provisions in clause 6.6.1 of the Rules should be amended specifically for mandated pilots and trials to: • Allow the AER to extend its time period for making a cost pass through determination for mandated pilots and trials to a maximum of 6 months; and • Require the AER in making a cost pass through determination for a mandated pilot or trial to consider the costs that an efficient and prudent DNSP in the circumstances of the	In relation to our draft recommendation on the timeframes for the AER to make a cost pass through determination, The AER and ENA supported this amendment.[152] EnergyAustralia accepted that the AER may need more than 60 business days to assess efficient costs, but raised concerns that a time extension may lead to greater regulatory uncertainty.[153]Citipower/Powercor considered that the current timeframes are sufficient.[154] In relation to our draft recommendation to require the AER to conduct an efficiency assessment in making a cost pass through determination, this amendment was supported by the AER who suggested that it should be extended to all pass through events.[155] EnergyAustralia and	We have retained our Draft Report recommendations to amend the cost pass through provisions for mandated pilots and trials to: • Allow the AER to extend its time period for making a cost pass through determination for mandated pilots and trials to a maximum of 6 months; and • Require the AER in making a cost pass through determination for a mandated pilot or trial to consider the costs that an efficient and prudent DNSP in the circumstances of the relevant DNSP would require. We have recommended these amendments, as the

150 Integral Energy, Submission on the Draft Report, pg. 1.

151 ENA, Submission on the Draft Report, pg. 14.

152 See submissions on the Draft Report from: AER, p. 8; ENA, p. 14.

153 EnergyAustralia, Submission to the Draft Report, p. 12.

154 Citipower/Powercor, Submission on the Draft Report, p. 5.

155 AER, Submission on the Draft Report, pp. 8-9

Draft Report recommendations	Issues raised in submissions	Commission response
relevant DNSP would require.	Citipower/Powercor considered that the current pass through arrangements are sufficient, while ENA suggested that an efficiency assessment is not appropriate for mandated smart meter pilots and trials as DNSPs have a limited ability to control this expenditure.[156] Both the NSSC and Origin Energy raised concerns regarding the need for certainty in relation to the recovery of retailer costs under the cost pass through process.[157]	AER currently has no ability to extend its time period for making a cost pass through determination for mandated smart meter pilots and trials. In most cases, the AER's current 60 business day timeframe is likely to be sufficient, but as we have also recommended that the AER be required to conduct an efficiency assessment on the proposed pass through amount, there is a possibility that additional time may be required by the AER to assess larger or more complex pilots and trials. An efficiency assessment by the AER would promote the efficient management of costs by DNSPs and the efficient provision of services. Requiring the AER to conduct this assessment would also remove the current lack of clarity regarding how the AER assesses applications and would therefore provide greater certainty on the treatment of third party costs.
A general amendment to the cost pass through provisions should be made to allow DNSPs to seek cost recovery where a pass through event occurs during the 'dead zone'.	DNSPs generally considered that there was merit in addressing the dead zone issue for all pass through events in Chapter 6 of the Rules.[158] However, the NSSC and Energex stated that the dead zone issue should only be addressed for mandated pilots and trials as more general amendments are beyond the scope of the Review.[159]	We have recommended a general amendment to the cost pass through provisions to allow DNSPs to seek cost recovery where a pass through event occurs during the 'dead zone'. This amendment would apply to all pass through events in Chapter 6 of the Rules, as this is a common cost recovery risk to all pass through events that has been previously identified by DNSPs. Our proposed amendment is a simple and

156 See submissions on the Draft Report from: EnergyAustralia, p. 12; Citipower/Powercor, p. 5; ENA, pp. 14-15.

157 See submissions on the Draft Report from: NSSC, p. 13; Origin Energy, p. 4.

158 See submissions on the Draft Report from: Jemena, p. 4; Citipower/Powercor, p.5; ENA, p. 14; Ergon Energy, p. 6; EnergyAustralia, p. 13.

159 See submissions on the Draft Report from: NSSC, p.6; Energex, p.5.

Draft Report recommendations	Issues raised in submissions	Commission response
		proportionate response to this cost recovery risk. An amendment is also proposed specifically for mandated smart meter pilots and trials, to allow DNSPs to include their forecast costs for mandated pilots and trials in their revised regulatory proposal during the distribution determination process, even where the AER has not specifically referred to the pilot or trial in its draft distribution determination.
Cost recovery for mandated smart metering services which are classified as alternative control services		
The current distribution determination process has the potential to provide for the recovery of the efficient costs of mandated smart metering services which are classified as alternative control services, as the AER is required to have regard to the NEL Revenue and Pricing Principles and NEO when determining the revenue requirement for alternative control services. Modifications to the Rules are not required.	The AER, Ergon Energy and Integral Energy considered that no further modifications to the Rules were required, where mandated smart metering services are classified as alternative control services.[160] The NSSC suggested that where mandated smart metering services are classified as alternative control services, the AER should be required to apply the principles for standard control services in the Chapter 6 Rules, as the AER's discretion in relation to alternative control services is inappropriate for the significant size of mandated roll-out investments.[161] EnergyAustralia considered that a Ministerial imposed obligation to roll-out SMI should be considered primarily as a standard control service.[162]	We have recommended an amendment to the Rules to require the AER to classify the core services in a Ministerial determination as standard control services. Core services include the following services that a DNSP is mandated to provide under a Ministerial smart meter determination: smart meter provision and installation; recovery of stranded meters costs; meter data provision; and smart meter pilot and trial services. We considered that greater prescription regarding the service classification of these core services was required to ensure that DNSPs have certainty regarding their opportunities for cost recovery and how these services would be regulated. The AER would retain its current distribution to

160 See submissions on the Draft Report from: AER, p. 9; Ergon Energy, p. 6; Integral Energy, p. 7.

161 NSSC, Submission on the Draft Report, p. 12.

162 EnergyAustralia, Submission on the Draft Report, pp. 11, 14.

Draft Report recommendations	Issues raised in submissions	Commission response
		classify non-core smart metering services. Where these services are classified as alternative control services, it is considered that the current distribution determination process has the potential to provide for the recovery of net efficient costs. Therefore, no further changes to the distribution determination process are recommended.
The Rules should be amended to require the AER to consider the need for adequate cost pass through arrangements for mandated smart metering services arising from a Ministerial pilot determination, when deciding on the appropriate control mechanisms for alternative control services.	Citipower/Powercor agreed that there was a cost recovery risk where SMI services are classified as alternative control services.[163] The NSSC and Energex considered that the principles in the Rules for standard control services should apply where smart metering services are classified as alternative control services.[164] Integral supported our proposed amendment to require the AER to consider the appropriate pass through arrangements for alternative control services.[165]	As discussed above, under our final advice, we have recommended that mandated smart meter pilot and trial services be classified as standard control services. Therefore, there would be no cost recovery risk for mandated smart meter pilot and trial services as DNSPs would be able to seek cost pass through under clause 6.6.1 of the Rules. The AER would retain its current discretion to classify 'non-core' smart metering services. Therefore, we have recommended that where the AER classifies non-core smart metering services which are mandated under a Ministerial smart meter determination as alternative control services, the AER should consider the appropriate pass through arrangements for these services in making a distribution determination. This would ensure that DNSPs have an opportunity to seek cost pass through for these services.

163 Citipower/Powercor, Submission on the Draft Report, p. 5

164 See submissions on the Draft Report from: NSSC, p. 16; Energex, p. 6.

165 Integral Energy, Submission on the Draft Report, p.5.

Draft Report recommendations	Issues raised in submissions	Commission response
Incentives under the current regulatory regime		
It is appropriate to apply the EBSS to the operational benefits of a mandated smart meter roll-out. However, the AER should retain its current discretion to determine whether the EBSS should be applied to expenditure associated with a mandated smart meter roll-out, where there is significant uncertainty in relation to that expenditure.	Energex and Integral Energy suggested that mandated roll-out costs should be excluded from the EBSS as these costs are not controllable by DNSPs.[166]	No changes to the current EBSS are recommended. The AER would maintain its current discretion to exempt expenditure from the EBSS, as it preserves the ability of the AER to determine the most appropriate form of regulation that should apply to mandated SMI.
The current incentives in the Rules are appropriate for the competitive purchase of meters and metering services under the distribution determination process.	Ergon Energy and EnergyAustralia generally agreed with this recommendation.[167] The NSSC noted that some of the benefits of a mandated roll-out may increase service levels rather than reduce costs and other benefits may flow directly to consumers rather than delivering a benefit to the DNSP.[168]	We have not recommended that any further changes be made to the Rules to provide for the competitive purchase of meters and metering services, as the incentives in the current Rules are considered sufficient. We note that incentives to increase service levels could be addressed by the AER through changes to the Service Target Performance Incentive Scheme. Further, investments which provide benefits to consumers rather than to DNSPs could still be approved by the AER under the current distribution determination process where the AER considers that such investments are prudent and efficient.
The incentives in the Rules are	EnergyAustralia has raised concerns that aspects of the	We agree that the MCE and NSSC processes will

166 See submissions on the Draft Report from: Energex, p. 6; Integral Energy, p. 7.

167 See submissions on the Draft Report from: Ergon Energy, p. 6; EnergyAustralia, p.15.

168 NSSC, Submission to the Draft Report, p. 16.

Draft Report recommendations	Issues raised in submissions	Commission response
appropriate for the management of technology risks by DNSPs, as many of these risks will be addressed by the MCE and NSSC processes which will result in obligations on the DNSP.	regulatory regime were established without more risky technologies being considered, but accepts that the magnitude of technology risk can only be properly determined once MCE and NSSC processes are more progressed.[169] Origin Energy highlighted that there should be incentives on DNSPs to optimise investment decisions, such as their choice of communications technology, as it may affect future contestability.[170]	affect the magnitude of the technology risks of a mandated roll-out, particularly as the MCE is yet to make a decision on the future contestability of smart metering services. As these processes are still in progress, we do not consider that it would be prudent to make any further changes to the Rules to provide incentives for the management of technology risks.
Tariff issues associated with mandated SMI		
To address the risk that the Rules may not promote the efficient allocation of the costs of a mandated smart meter roll-out, the Rules should be amended to provide greater prescription regarding the setting of tariffs for smart meter metering services, by inserting an set of 'SMI pricing principles' into the Rules which are based on a beneficiary pays principle. DNSPs would be required to take into account the SMI pricing principles when proposing tariffs for	A number of DNSPs and the NSSC did not consider that any further changes to the current pricing principles in the Rules were required.[171] The AER considered that the determination of the total operational benefits associated with a SMI rollout, and the apportionment of these benefits to individual consumers would be a complex exercise given the difficultly in estimating some of the benefits associated with a SMI rollout, such as the quantum of deferred network investment. The AER questioned whether the economic benefits of setting charges on this basis in this	The Commission continues to support the application of the beneficiary pays principle to determine the efficient allocation of mandated SMI costs. However, AER would not be required to use the beneficiary pays principle to determine the allocation of costs for consumers for non-core services. Rather, the AER would be allowed to base the allocation of costs for non-core services on the existing pricing principles in clause 6.18.5 of the Rules. We have retained our Draft Report recommendation to only allow DNSPs to charge consumers an unbundled charge, where individual consumers have

169 EnergyAustralia, Submission to the Draft Report, p. 15.

170 Origin Energy, Submission to the Draft Report, p. 4.

171 See submissions on the Draft Report from: EnergyAustralia, pg. 18; Integral Energy, pg. 10; Energex, pg. 6; Ergon Energy, pg. 7; NSSC, pg. 17.

Draft Report recommendations	Issues raised in submissions	Commission response
smart meter services. DNSPs would only be able to charge individuals unbundled charges when they have received an installed and functioning smart meter.	circumstance would outweigh the administrative costs of applying this principle.[172] Origin argued that it would not be practical to apply charges only when the SMI is installed and operating at individual premises and would lead to significant administrative costs for retailers.[173]	received an installed and functioning smart meter. To reduce the administrative costs for retailers, DNSPs would be able to charge consumers from the next quarter after consumers have received this installed and functioning smart meter. DNSPs would also be required to recover the costs of a mandated roll-out through a fixed charge, as the costs of a mandated roll-out would involve fixed costs that would not vary with consumption.
The Rules should be amended to require the AER to make its decision on whether smart metering services should be unbundled from DUOS charges in its Framework and Approach Paper during the distribution determination process. The AER would be required to make this decision after taking into account the SMI pricing principles.	A number of DNSPs and the NSSC did not consider that Rules on unbundling should be made in light of the current uncertainty in regards to the future contestability of smart metering services.[174] The AER considered that as it already has the flexibility to unbundle SMI tariffs by classifying them as alternative control services, no further changes to the Rules are required.[175]	We have determined to require the AER to unbundle smart meter provision and installation and meter data provision services from DUOS, to provide consumers and potential new entrants with greater transparency regarding the costs of mandated smart meter roll-outs. Therefore, the AER would have no discretion in relation to whether these are unbundled from DUOS. The other core services, of recovering stranded meter costs and mandated pilots and trials, will be permitted to be recovered through the DUOS charge and therefore would not be unbundled.
The Rules should be amended to prevent DNSPs from recovering the stranded costs of existing accumulation meters through accelerated depreciation	Integral Energy stated that recovering the residual value of the existing meters over the previously forecast remaining lives is not inconsistent with the broader regulatory framework, as long the previously accepted lives being	We have retained our Draft Report recommendation to require DNSPs to continue to recover the costs of stranded meters through DUOS charges based on their current asset lives

172 AER, Submission to Draft Report, pg. 9.

173 Origin Energy, Submission to Draft Report, pg. 2.

174 See submissions on the Draft Report from: EnergyAustralia, pg. 19; Integral Energy, pg. 10; Energex, pg. 6; Ergon Energy, pg. 7; NSSC, pg. 17.

175 AER, Submission on the Draft Report, pg.9.

Draft Report recommendations	Issues raised in submissions	Commission response
following a mandated smart meter roll-out. Instead, DNSPs would be required to continue to recover the costs of these meters through DUOS charges based on their current asset lives.	preserved and that the regulatory WACC remains appropriate.[176]	
The Rules should be amended to require the AER to have regard to the need to minimise the initial tariff impact of a mandated smart meter roll-out, when determining the appropriate X factor for the forthcoming regulatory control period.	CitiPower/ Powercor were supportive of including guidance on the use of the X-factor to smooth out the recovery of SMI charges, as long as the outcome is revenue neutral.[177] The NSSC's suggested that this amendment should be limited to smart metering in order to not have wider application to other network expenditure.[178]	We have retained our Draft Report recommendation to require the AER to have regard to the need to minimise the initial tariff impact of a mandated roll-out when determining the appropriate X factor. As this change would codify the existing practice of the AER, it would not result in a disproportionate change to the Rules. This amendment would only be applied to mandated roll-outs and not more generally to other network expenditure.
The Rules should be amended to provide the AER with the ability to modify a DNSP's proposed depreciation schedule for smart metering assets in order to smooth the tariff impact of a mandated roll-out.	Energex argued that the introduction of differing depreciation treatments for assets creates increased administrative complexity to data management and the operation of their revenue and pricing methodologies.[179] Ergon Energy also noted that back ending depreciation would be a reversal of the current treatment where the DNSPs depreciates assets in accordance with the Accounting Standards.[180] Integral Energy argued that the proposal does not recognise the way in which the AER's	We recognise the significant issues with such an amendment. While we do not make any recommendations on this. we provide for the MCE's consideration, a potential amendment which would provide the AER with the ability to modify a DNSPs proposed depreciation schedule for SMI assets. Under this amendment, the AER would be required to take into account defined criteria in the Rules when determining whether to modify a DNSPs depreciation schedule.

176 Integral Energy, Submission to Draft Report, pg. 9.

177 Citipower/Powercor, Joint submission to the Draft Report, pg. 6.

178 NSSC, Submission to Draft Report, pg. 17.

179 Energex, Submission to Draft Report, pg. 6

180 Ergon Energy, Submission to Draft Report, pg. 7.

Draft Report recommendations	Issues raised in submissions	Commission response
	Post Tax Revenue Model results in back end loading of cashflows through the model's approach to calculating inflation and regulatory depreciation.[181] The AER stated that while it acknowledges the potential economic reasons to justify deferred depreciation profiles, there are practical difficulties and potential gaming opportunities associated with back-ended depreciation profiles.[182]	

181 Integral Energy, Submission to Draft Report, pg. 10.

182 AER, Submission to Draft Report, pg. 10.

D Summary of recommendations against the items in the MCE's Request for Advice

This Appendix provides a summary of the Commission's recommendations, as contained in Chapters 3 to 6 of this Final Report, against the items in the MCE's Request for Advice. Our proposed changes to the Rules are explained in detail in the Rule change request and draft Rules, which were published with this report.

Summary of recommendations against the items in the MCE's Request for Advice

MCE Request for Advice Item	Commission's recommendations
Provision for recovery of efficient costs of smart meter roll-outs and pilots	
8.1. The interaction of the obligations imposed on distribution network service providers under sections 118B and 118D of the proposed NEL amendments with the revenue and pricing principles in the NEL and the operating expenditure objectives and capital expenditure objectives in clauses 6.5.6(a) and 6.5.7(a) of the Rules	The obligations imposed on DNSPs to undertake a smart meter pilot or trial (section 118B of the NEL) and roll-out smart meters (section 118D of the NEL) interact with the NEL Revenue and Pricing Principles and the operating and capital expenditure objectives in the Rules to: • Require a DNSP to include its forecast operating and capital expenditure in its regulatory proposal to meet its mandated obligations under sections 118B and 118D of the NEL; • Require the AER to accept a DNSP's forecast expenditure if it is satisfied that it reasonably reflects the operating and capital expenditure criteria in clauses 6.5.6(c) and 6.5.7(c) of the Rules; and • Require the AER to take into account the NEL Revenue and Pricing Principles when making a distribution determination. Under these Principles, the AER must provide a DNSP with a reasonable opportunity to recover at least its efficient costs of meeting its mandated obligations. The current requirements in the NEL and the Rules have the potential to accommodate the recovery of the efficient costs, net of reasonably achievable network operational benefits, of mandated smart meter roll-outs and pilots through the distribution determination process. There are no inconsistencies between the NEL Revenue and Pricing Principles and the capital expenditure objectives and the operating expenditure objectives in the Rules.

MCE Request for Advice Item	Commission's recommendations
	No changes to the Rules recommended However, in practice the recovery of the net efficient costs of mandated smart meter roll-outs may not occur under the current Rules where there is sufficient uncertainty about the timing and quantum of expenditure. We recommend amending the Rules to introduce a revenue adjustment to ensure that DNSPs remain revenue neutral to differences between the actual and forecast timing of a mandated roll-out. We also recommend that the Rules be amended to provide for a new reporting requirement on DNSPs to address potential uncertainty regarding the efficient costs of mandated SMI, which is discussed in regards to item 9.2.
8.2. The interaction of the obligations imposed on distribution network service providers under sections 118B and 118D of the proposed NEL amendments and the definition of 'regulatory change event' for the purposes of the cost pass through provisions in clause 6.6.1 of the Rules	DNSPs would be able to seek cost pass through for mandated smart meter roll-outs and pilots under clause 6.6.1 of the Rules under a 'service standard event'. However, DNSPs would only be able to recover their costs under a 'service standard event', if their costs met the relevant materiality threshold determined by the AER for that event. Our assessment of whether the AER has sufficient flexibility to determine an appropriate materiality threshold for mandated smart meter pilots is in item 10.1. As it is considered that mandated smart meter roll-outs and pilots would meet the definition of a service standard event, it is unlikely that DNSPs could seek cost pass through under a regulatory change event as a regulatory change event is defined as a regulatory obligation or requirement that falls under no other category of pass through event However, as discussed in regards to item 10.2, the Commission has recommended that the cost pass through provisions should not apply to mandated smart meter roll-outs and should only apply to mandated smart meter pilots and trials. Where the costs for a mandated smart meter roll-out are incurred within a regulatory control period, it is proposed that DNSPs would seek cost recovery under a new interim determination process. **No changes to the Rules recommended**
8.3. Whether the provisions of Chapter 6 of the Rules allow a distributor to enter into a contract (or other arrangement) with a retailer for the provision of retail services used in smart meter and direct load control pilots or trials and then allow the distributor to recover	The provisions in Chapter 6 of the Rules relating to the distribution determination process and the cost pass through process would allow a DNSP to enter into a contract with a retailer and recover the associated fees charged by the retailer. Under the distribution determination process, the DNSP would be required to demonstrate that these retailer services were necessary for it to comply with its regulatory obligations under a Ministerial smart metering

MCE Request for Advice Item	Commission's recommendations
the associated fees charged by the retailer	determination, in accordance with the operating expenditure objectives in clause 6.5.6(a) of the Rules. The retailer fees would be assessed by the AER in relation to the operating expenditure criteria in clause 6.5.6(c) of the Rules and the AER would be required to accept the proposed retailer fees if it is satisfied that the fees reasonably reflect the operating expenditure criteria. Under clause 6.5.6(e)(9), the AER would also be required to consider whether the proposed retailer fees were referable to arrangements that reflected arm's length terms in determining whether it is satisfied that the retailer fees meet the operating expenditure criteria. Under the cost pass through process, DNSPs would only be able to seek pass through if the Ministerial smart metering determination met the requirements of a pass through event in Chapter 10 of the Rules or an additional pass through event that had been approved by the AER in a relevant distribution determination. The AER would be required to determine the appropriate pass through amount, which may include any retailer fees which are necessary for the DNSP to fulfill its mandated obligations. Under the Commission's proposed changes to the cost pass through provisions discussed in regards to item 9.1, the AER would also be required to consider the costs that an efficient and prudent DNSP in the circumstances of the relevant DNSP would require when making a cost pass through determination. **No changes to the Rules recommended**
8.4. The implications for cost recovery of services being categorised as alternative control services rather than standard control services, and whether any modifications to the Rules are required to ensure recovery of efficient costs and whether it is appropriate to unbundle metering services from distribution use of system charges	***The implications for cost recovery of services being categorised as alternative control services rather than standard control services*** We have recommended an amendment to the Rules to require the AER to classify the core services in a Ministerial smart meter determination as standard control services. Core services include the following services that a DNSP is mandated to provide under a Ministerial smart meter determination: smart meter provision and installation; recovery of stranded meter costs; meter data provision; and smart meter pilot and trial services. As a result, the AER would have no discretion in classifying these core services, but would maintain its current discretion in classifying non-core services. Under the distribution determination process, the AER would maintain its discretion to determine the appropriate form of control that should apply to non-core smart metering services which are classified as alternative control services. However, in determining the revenue requirement for alternative control services, the AER is required to take into account the NEL Revenue and Pricing Principles, which include providing DNSPs with a reasonable opportunity to recover at least their efficient costs. Therefore, no further changes to the distribution determination process are required to provide for the recovery of net efficient costs, where

MCE Request for Advice Item	Commission's recommendations
	non-core smart metering services are classified as alternative control services. There is no requirement in the Chapter 6 Rules for the AER to apply the cost pass through provisions in clause 6.6.1 of the Rules to alternative control services or any other mechanism which would allow DNSPs to seek an adjustment in revenue within a regulatory control period. Therefore, there is a risk to the recovery of the efficient costs of a Ministerial smart meter determination where non-core smart metering services are classified as alternative control services, the costs of a Ministerial smart meter determination have not been incorporated in a distribution determination, and the distribution determination contains no relevant cost pass through provisions. To reduce this cost recovery risk, we have proposed changes to the Rules which would require the AER in making a distribution determination to consider the need for adequate cost pass through arrangements for non-core smart metering services which are mandated under a Ministerial smart meter determination, if these services are classified as alternative control services. **Changes to the Rules recommended** ***Unbundling metering services from distribution use of system charges*** In principle, there are clear net economic benefits from unbundling the tariffs for smart metering services from DUOS charges. The current Rules may not result in unbundling, if smart metering services are classified as standard control services. Under the current Rules, the AER can only achieve unbundling if it classifies these services as alternative control services. To provide consumers and potential new entrants with greater transparency regarding the costs of mandated smart meter roll-outs, we have proposed an amendment to the Rules to require the AER to unbundle smart meter provision and installation and meter data provision services from DUOS charges. Therefore, the AER would have no discretion in relation to whether these services are unbundled from DUOS. Other core services of recovering the costs of stranded meters and mandated pilot and trial services would continue to be recovered from DUOS charges. **Changes to the Rules recommended**
8.5. The implications for the recovery of efficient costs of implementing a future Ministerial pilot metering determination which may include direct load control and/or a Ministerial smart meter rollout determination	As discussed in item 8.4, it is recommended that the core services in a Ministerial smart meter determination be classified as standard control services. Therefore, where a distribution determination have been made by the AER prior to the NEL amendments, DNSPs would be able to seek cost pass through under clause 6.6.1 of the Rules for mandated smart meter pilots under a 'service standard event', as the cost pass through

MCE Request for Advice Item	Commission's recommendations
for distribution price determinations that have already been made by the AER prior to the NEL amendments, including whether the costs of alternative control services can be recovered under the cost pass through mechanism if this was not anticipated in the determination	provisions automatically apply to standard control services. The costs of alternative control services cannot be recovered under the cost pass through provisions, unless the AER had determined to apply the cost pass through provisions (or an alternative cost pass through mechanism) to alternative control services in a relevant distribution determination. As discussed above in regards to item 8.4, the Commission has recommended changes to the Rules to require the AER to consider what cost pass through arrangements should apply to non-core services which are mandated under a Ministerial smart meter determination, if these services are classified as alternative control services. **Changes to the Rules recommended**
Obligation and ability to take into account network benefits	
9.1. Whether there is an obligation under the NEL and the Rules for the AER to take into account 'reasonably achievable network operational benefits' in determining efficient costs	Under the distribution determination process, we consider there is an obligation on the AER to take into account 'reasonably achievable network operational benefits' in determining whether it is satisfied that a DNSP's forecast expenditure reasonably reflects the operating and capital expenditure criteria. In determining whether a DNSP's forecast expenditure reflects the operating and expenditure criteria, the AER is required to have regard to the benchmark capital and operating expenditure that would be incurred by an efficient DNSP. In considering this benchmark expenditure, we consider that the AER would have an obligation to consider whether a DNSP's forecast expenditure reflected any 'reasonably achievable network operational benefits' associated with the mandated SMI, including any network operational benefits that would be achieved by an efficient DNSP. Under the cost pass through process, there is no specific obligation under the NEL or Rules on the AER to take into account of 'reasonably achievable network operational benefits' or the efficiency of the proposed pass through amount when making a cost pass through determination. However, the AER would have the discretion to consider 'reasonably achievable network operational benefits' if it considered it relevant to the making of its cost pass through determination. The Commission has recommended that the cost pass through provisions be amended to require the AER when making a cost pass through determination to consider the costs that an efficient and prudent DNSP in the circumstances of the relevant DNSP would require. **Changes to the Rules recommended**

MCE Request for Advice Item	Commission's recommendations
9.2. Whether the Rules provide the ability for the AER to take into account 'reasonably achievable network operational benefits' either during the distribution determination process or in making a pass through determination or both, and to request information sufficient for this purpose	The ability of the AER to consider network operational benefits during the distribution determination process and the cost pass through process will depend on the availability of reliable information about the potential benefits of SMI at the time the AER makes its determinations. Under the distribution determination process, the AER is able to obtain information on reasonably achievable network operational benefits through the DNSP's regulatory proposal, submissions it receives, any public information and any additional analysis which is undertaken by the AER. Under the cost pass through process, the information requirements for the DNSP's application are less detailed than the distribution determination process and consultation is at the discretion of the AER. If the AER considers that it requires additional information on 'reasonably achievable network operational benefits' to make its distribution determination or a cost pass through determination, under the NEL, the AER is able to: • serve a notice on a person to obtain information or documents; and/or • require a DNSP to provide it with information and/or prepare, maintain or keep specific information. However, to ensure that the AER has access to relevant information to assist it in estimating the efficient benchmark costs of a mandated smart meter roll-out or pilot in making a distribution determination, the Rules should be amended to require DNSPs in all jurisdictions, including Victoria, to provide annual information to the AER on the costs and network operational benefits of any mandated smart meter roll-outs, pilots or trials they are undertaking. The AER should be required to publish a guideline, following stakeholder consultation, which sets out the nature and format of information that DNSPs must provide. The AER would also be required to publish the information that it receives from DNSPs each year. **Changes to the Rules recommended**
9.3. Whether the framework provides for the efficient allocation of costs of a smart meter roll-out, which may include apportioning costs	Under the current Rules, DNSPs must comply with a number of high level principles when determining annual tariffs. As a range of possible tariffs are possible under these principles, this process may not provide for an efficient allocation of costs. We recommend that the Rules should be amended to provide for the efficient

MCE Request for Advice Item	Commission's recommendations
against something other than a standardised cost per customer	allocation of costs for the core services associated with mandated smart meter roll-outs by requiring the AER to allocate costs using the beneficiary pays principle. This is because some types of network operational benefits will accrue to all network customers and therefore a proportion of these costs should be recovered through the common DUOS charge. The tariffs for non-core services would be determined by the AER under the current pricing principles in clause 6.18.5 of the Rules. We have also proposed two additional amendments to provide for the efficient allocation the costs. The first amendment would only allow DNSPs to charge customers an unbundled smart metering charge from the next quarter after they have received an installed and functioning smart meter. The second amendment would require DNSPs to recover the costs of the roll-out through a fixed charge, as the costs of a mandated roll-out would involved fixed charges that would not vary with consumption. **Changes to the Rules recommended**
Cost pass through provisions under clause 6.6.1	
10.1. Whether there is sufficient flexibility provided under the Rules for the AER to determine an appropriate materiality threshold for the pass through of distributor costs associated with a Ministerial pilot metering determination	The Commission considers that a materiality threshold should apply to mandated smart meter pilots, to encourage the efficient management of costs by DNSPs and reduce the likelihood of DNSPs seeking cost pass through for minor cost increases. As a result, we consider that there is no reason as to why a materiality threshold should not apply to mandated smart meter pilots. As the materiality threshold for pass through events is not specified in the Chapter 6 Rules, the AER has discretion to determine the appropriate threshold for different pass through events. The AER has determined that a general materiality threshold of 1% of smoothed forecast revenue should be applied to pass through events in Chapter 6 of the Rules. To provide DNSPs with greater regulatory certainty regarding the materiality threshold of mandated pilots and trials and their opportunities for cost recovery, we have recommended an amendment to the Rules to specify that the materiality threshold for mandated smart meter pilots and trials should be equivalent to the AER's administrative costs of assessing a pass through application. This is the same threshold that the AER has determined should apply in recent distribution determinations for 'smart meter events'.

MCE Request for Advice Item	Commission's recommendations
	Changes to the Rules recommended
10.2. Whether the time frames in the current Rules for pass through applications and determinations are appropriate, in the context of a Ministerial pilot metering determination and/or a Ministerial smart meter rollout determination	The timeframes for DNSPs to submit a pass through application are considered sufficient for mandated smart meter pilots and trials, but are not considered sufficient for mandated smart meter roll-outs, because of the scope and complexity of roll-outs. The AER has 60 business days to make a cost pass through determination after receiving a pass through application and cannot extend this timeframe. We consider that this timeframe is likely to be sufficient for the AER to make a cost pass through determination for most mandated smart meter pilots and trials. However, it is recommended that the AER should be provided with the opportunity to extend its timeframe to a maximum of six months after receiving an application, if it considers that the difficulties of assessing or quantifying the effect of the relevant pass through event justifies the time extension. The timeframe for the AER to make a cost pass through determination is considered not sufficient for mandated smart meter roll-outs due to the potential scope and complexity of a roll-out. Further, as a smart meter roll-out is likely to provide for a number of operational benefits for the DNSP, it is likely to take a significant amount of time for the AER to consider the efficient costs of a smart meter roll-out. The most preferable approach to cost recovery for mandated smart meter roll-outs would be for the timing of a Ministerial roll-out determination to align with the timing of a distribution determination process, so that a DNSP is only required to undertake expenditure at the start of the next regulatory control period. To accommodate circumstances where this is not possible, we recommend that the Rules be amended so that the AER is required to undertake an interim determination process within a regulatory control period to determine the allowed revenue for the mandated roll-out for the remainder of the regulatory control period. Where a Ministerial pilot determination is made in the last 13 months of a regulatory control period but a DNSP only incurs costs in the next regulatory control period, DNSPs may be unable to seek cost recovery under either the cost pass through arrangements or the distribution determination process. A change to the Rules is proposed to ensure that DNSPs can seek cost recovery through the pass through provisions in these circumstances. This would apply generally to all pass through events in Chapter 6 of the Rules, rather than only to mandated smart meter pilots and trials. An amendment specifically for mandated smart meter pilots and trials is also recommended, to allow DNSPs to include the forecast expenditure for mandated pilots and trials in their revised regulatory proposal during the

MCE Request for Advice Item	Commission's recommendations
	distribution determination process, even where the AER has not referred to the pilot or trial in its draft distribution determination. **Changes to the Rules recommended**
Incentives under the regulatory regime	
11.1. Whether an efficiency benefit sharing scheme as provided for under clause 6.5.8 of the Rules is appropriate for an accelerated roll-out of smart meters, given the MCE decision that the efficiencies gained from a roll-out are to be passed on to customers 'promptly'	It is appropriate to apply the EBSS to the operational benefits of a mandated smart meter roll-out. However, the AER should retain its current discretion to determine whether the EBSS should be applied to expenditure associated with a smart meter roll-out, where there is significant uncertainty in relation to that expenditure. **No changes to the Rules recommended**
11.2. Whether the current incentive mechanisms incorporated in the Rules are sufficient to maximise the competitive purchase of meters and metering services	The Commission considers that the current incentives under the distribution determination process are sufficient to maximise the competitive purchase of meters and metering services, as the AER is able to substitute its own assessment of a DNSP's required forecast expenditure if it considers that the DNSP's proposed expenditure does not reflect the operating and capital expenditure criteria. Therefore, we have proposed no further changes to the Rules. **No changes to the Rules recommended**
11.3. Whether Chapter 6 of the Rules provides appropriate incentives for a distribution network service provider to manage technology risks for the long-term benefit of consumers without a re-examination of the Weighted Average Cost of Capital (WACC), which is outside the scope of this review. The risks to be managed include premature failure of a new technology	The current incentives in the Rules are appropriate for the management of technology risks by DNSPs, as many of these risks will be addressed by the MCE and NSSC processes. It is expected that the materiality of these risks are likely to be reduced prior to a mandated smart meter roll-out. However, there may be a need to revisit the appropriate incentives for mandated roll-outs after the NSSC's Rule change package has been finalised and the MCE has made a decision on the future contestability of smart metering services. **No changes to the Rules recommended**

MCE Request for Advice Item	Commission's recommendations
Mechanisms to smooth impacts on tariffs over time	
12.1. Whether clause 6.5.5 of the Rules in relation to depreciation requires modification, to allow the AER to require a distributor to modify its proposed depreciation schedules in order to smooth the tariff impact of a smart meter roll-out decision, (this includes the depreciation of existing accumulation meter assets that are being replaced before the end of their economic life)	It would be difficult under Clause 6.5.5 for the AER to require a DNSP to modify its proposed depreciation schedules to smooth the tariff impact of a smart meter roll-out decision. Under clause 6.5.5(b) of the Rules, DNSPs may be required to accelerate the depreciation of existing accumulation meters following a mandated smart meter roll-out, to reflect the premature end of the economic life of the accumulation meters. We note that the accelerated depreciation of these accumulation meters may lead to a price shock for consumers. It is recommended that the Rules be amended to prevent a DNSP from recovering the stranded costs of existing meters through accelerated depreciation. These meters should continue to be recovered through the DUOS charge based on their current asset lives. This amendment may assist in further smoothing the tariff impacts of SMI over the roll-out. An amendment which would enable the AER to change depreciation profiles in order to smooth the tariff impact of a mandated smart meter roll-out has been included for the MCE consideration. We note that there significant issues with such an ability. **Changes to the Rules recommended**
12.2. The need to minimise potential price impacts on customers caused by paying for the Smart Metering Infrastructure (SMI) roll-out before benefits are realised	The AER is currently able to minimise the price impacts on consumers within a regulatory control period by adjusting the X factor in making a distribution determination. However, tariff smoothing is not an explicit factor the AER must consider in determining the appropriate X factor. We advice that the Rules be amended to require the AER to have regard to the need to minimise the initial tariff impacts of recovering SMI costs when deciding upon the appropriate X factors for the regulatory control period. **Changes to the Rules recommended**
12.3 Whether the framework allows the AER to obtain the necessary information to ensure	Under the NEL and Rules, the AER has no specific obligation to monitor the progress of mandated smart meter roll-outs or pilots to ensure benefits are being realised within a reasonable timeframe. Therefore,

MCE Request for Advice Item	Commission's recommendations
benefits are being realised within a reasonable timeframe.	outside of a regulatory determination process (i.e. either a distribution determination process or a cost pass through process), the AER would not be able to use its existing NEL information gathering powers to seek information from DNSPs. We consider that there is the potential for some uncertainty regarding the level of efficient costs and network operational benefits of SMI to remain when the AER makes a regulatory determination for a mandated roll-out, pilot or trial. As outlined in item 9.2, to ensure that the AER has access to relevant information to assist it in estimating the efficient benchmark costs of a mandated smart meter roll-out, pilot or trial in making a regulatory determination, the Rules should be amended to require DNSPs in all jurisdictions to provide annual information to the AER on the costs and network operational benefits of any mandated smart meter roll-outs, pilots or trials they are undertaking. **Changes to the Rules recommended**