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Mr Warwick Anderson
General Manager
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

By email: NSWACTelectricity@aer.gov.au

Dear Mr Anderson

Submission on Issues Paper on ActewAGL's Regulatory Proposal for 2014-2019

Introduction

1. Vector Limited ("Vector") welcomes the opportunity to make this submission on the Australian Energy Regulator's ("AER") *Issues Paper, ActewAGL electricity distribution regulatory proposal, 2014-15 to 2018-19*, dated July 2014 ("the Issues Paper"). The regulatory proposal covers the transitional regulatory control period from 1 July 2014 to 30 June 2015 and subsequent regulatory control period from 1 July 2015 to 30 June 2019.

2. The Issues Paper identifies and describes the issues in ActewAGL's regulatory proposal the AER believes are likely to be important.

3. As the leading smart meter provider in New Zealand, Vector's interest in Australia is focused on the expansion of competition in metering services, including in the Australian Capital Territory ("ACT").

4. We believe that the transition to competitive metering arrangements is a critical aspect to achieving the National Electricity Objective and the Australian Government's efficiency and competition objectives for the National Electricity Market ("NEM"). As such, we expected the transition to a competitive metering market in the ACT to have been mentioned in the Issues Paper.

5. A key issue for Vector is the AER's proposal to impose exit fees for the replacement of legacy meters with smart meters. As indicated in our previous submissions to

the AER, we do not consider exit fees to be an appropriate mechanism to promote competition in the metering market and consumers' interest in the ACT.

6. This submission essentially reiterates the views we expressed in our most recent submission on the NSW distributors' regulatory proposals for 2014-2019, dated 8 August 2014. We again argue why we believe exit fees would not give the proposed reform the best chance of success, and identify alternative mechanisms for consideration by the AER, ActewAGL and other stakeholders.

7. No part of this submission is confidential and we are happy for it to be made publicly available.

8. Vector's contact person for this submission is:

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Expanding market competition

9. Vector supports the policy objective of expanding competition in metering services in the NEM, including in the ACT, which will be enabled by changes to the National Electricity Rules ("the Rules"). These changes are currently being considered by the Australian Energy Market Commission ("AEMC").

10. Vector has been consistent in its submissions to the AER and AEMC in supporting a market-led and retailer-led transition to smart metering in the NEM. Our experience in the New Zealand metering market has shown that it is possible to achieve consumer acceptance, positive business cases and a competitive smart metering market all at the same time.

11. Thus, we are concerned that the Issues Paper does not identify the transition to competitive metering arrangements as likely to be an important issue. While we note that type 5 and 6 metering services have already been classified as alternative control services for the 2009-2014 regulatory control period, this is the first time that ActewAGL, potential investors, consumers and other stakeholders in the ACT would have to undergo this process. And given that the Council of Australian Governments ("COAG") Energy Council "proposes to give the AER explicit responsibility to determine the costs associated with redundant metering, and the fee to be charged to recover these costs"[1], we believe this matter deserves some discussion or signalling of potential approaches to transition.

[1] AEMC 2014, *AEMC staff paper, Workshop 2: Network Regulatory Arrangements*, 1 August 2014, page 3

12. We discuss below why we do not consider the AER's proposal to impose exit fees for accumulation and manually read interval meters to be an appropriate mechanism for expanding competition in the ACT metering market. Exit fees do not have any basis (i.e. they do not meet regulatory principles) and do not promote competition.

13. We believe that transitions to new technologies are not costless but are in the long-term interest of consumers. We recognise that ActewAGL should be able to recover the costs of its efficient regulated investments that were approved by regulators ("residual meter charge"). However, we believe the recovery of these costs should be undertaken in a way that creates the lowest distortionary impact on investment and market entry incentives, and in a manner that would not harm consumers. And exit fees are not the way to achieve this.

14. In addition, we note that transitions to competitive arrangements in similar markets, which are identified below, did not involve exit fees.

15. The transition to smart metering is a complex issue and it would be challenging to achieve an outcome that simultaneously meets the expectations and needs of all stakeholders. In our view, the Issues Paper should have covered this transition, which is critical to the emergence of competition in the ACT metering market.

16. Signals from the AER on how this critical transition would be undertaken are important for those having to face new arrangements, including ActewAGL, other market participants and potential entrants. Importantly, it would signal that this transition will be managed without harming electricity consumers or causing consumer backlash in the ACT.

Exit fees not the appropriate mechanism

Exit fees do not meet regulatory principles

17. It is good regulatory practice that decisions on the recovery of investment costs should meet key economic and consumer protection principles. These include:

    - minimising market inefficiencies and distortions;
    - providing the right incentives for market entry and investment; and
    - promoting consumers' interest or avoiding detriment to consumers.

18. In our submission to the AEMC on the expansion of competition in metering services, dated 29 May 2014, we recommended that to minimise market inefficiencies and distortions, any proposed measure should:

- *not distort efficient investment*. Marginal prices should equal marginal costs. Residual costs should be recovered through non-distortionary methods.

  In particular, new investment decisions should not have to take sunk (investment) costs into account. Sunk costs are unavoidable and including them in decision making leads to sub-optimal investment or a decision not to invest. This could occur despite the incremental benefits being greater than the incremental costs on a purely economic basis. Efficient investment only considers the incremental costs and benefits involved;

- *minimise investors' perception of regulatory risk*. This is promoted by providing the right incentives for market entry and investment; and

- *not lead to stranded investment*. Writing off the value of regulated assets would increase investor perception of regulatory risk. This could potentially lead to an increase in the sector's Weighted Average Cost of Capital, which would be applied over a much larger asset base.

19. We consider that the imposition of exit fees does not rate well against the above principles. We therefore continue to propose that the AER consider other cost recovery mechanisms that do not involve exit fees, such as those outlined in the Appendix.

Exit fees do not promote competition

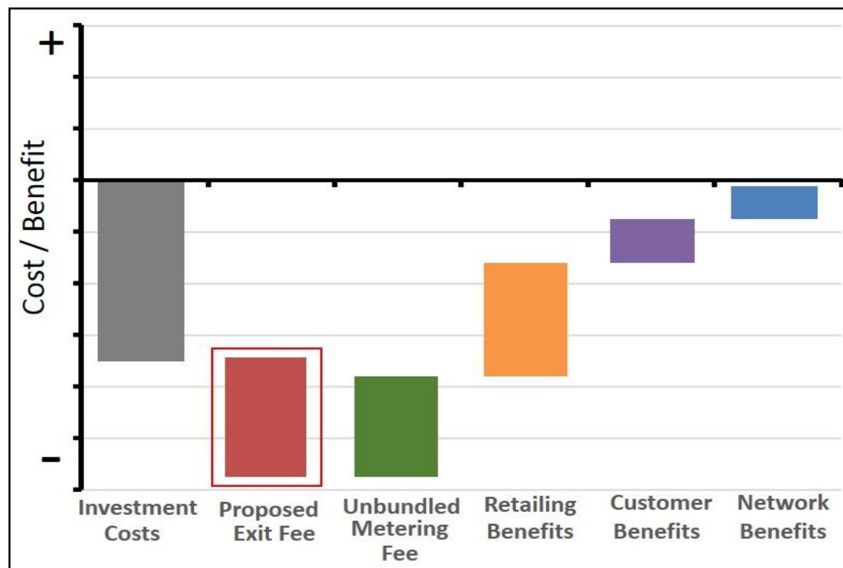
20. In our May 2014 submission to the AEMC, we argued that exit fees would create a significant barrier to market entry. The higher the exit fee, the greater the cost barrier that must be overcome by any potential entrant in making a competitive business case.

21. Exit fees are a significant hurdle for potential investors, particularly for a first-mover investor (as subsequent investors may not have to face the same cost). This cost, as reflected in Figure 1, actively disincentivises investment.

22. In addition, exit fees would not create a level and competitive playing field as successive entrants do not face the same costs and can easily under-price the first movers.

23. Exit fees, which need to be absorbed by the new entrant metering provider, are therefore likely to prevent market entry that would facilitate competition.

Figure 1. Exit fees as a significant cost barrier to market entry



24. In our view, exit fees are likely to prevent (at best, significantly delay) the emergence of a competitive smart metering market for residential and small business consumers until such time that the fees are reduced. Should investment in smart metering be stifled or delayed, there is a risk that the temptation to impose a regulated rollout of smart meters would emerge. We would not want a regulated rollout replicated in other jurisdictions, as was undertaken in Victoria, which resulted in cost blowouts to consumers.

25. New and potential entrants should not face exit fees, particularly when transitions to competitive arrangements in similar markets have been achieved without resorting to exit fees. Exit fees were not imposed in the following transitions:

- the introduction of competitive electricity retail market in Australia;
- the transition to competitive metering for large customers, also in Australia; and
- we understand, for some environmentally friendly power generation and small generators overseas.

26. Imposing exit fees for the displacement of legacy meters for residential and small business consumers means these consumers are being charged to enter the competitive metering market, while larger customers paid nothing. There may be an equity issue if large consumers were able to transition to a competitive metering market without exit fees but small consumers (or their metering providers) did face these fees.

27. If the AER does not want to frustrate the transition to a competitive metering market, it should not resort to exit fees. Or it should at least consider other approaches that do not require exit fees that disincentivise new entrants,

particularly first-movers, and deprive ACT consumers of the benefits of market competition or its emergence in a timely manner.

Alternative cost recovery mechanism

28. We note that the Rules do not necessarily mandate the use of exit fees but provide that distributors be reasonably compensated (Rule 7.3A(g)). There are other options available for delivering this compensation and, as far as we can tell, the Rules do not preclude these.

29. There are a range of other cost recovery options that the AER and stakeholders can consider against regulatory principles, including those that have been identified by AEMC staff.[2]

30. In our May 2014 submission to the AEMC, we identified and assessed at a high level some options for the recovery of efficient regulated investment against regulatory principles. Most of these options remove the need for exit fees and would not involve consumers paying more for their smart meter. These options are outlined in the Appendix.

31. Our preferred approach is a combination of the unbundled legacy metering charge with the "residual metering charge" (which could include, for example, the asset book value and administration costs) being recovered as part of the standard control service over a considerable period of time.

32. We recommend that the AER require greater transparency from distributors, including ActewAGL, demonstrating that the level of costs (including exit fees if the AER adopts them) to be recovered can be relied on. Importantly, the AER should require distributors to demonstrate that its cost recovery process would avoid the 'price spikes' or consumer backlash experienced under Victoria's mandated rollout of smart meters.

33. We note that the AEMC is not averse to a combination of approaches. The second option outlined in the AEMC staff paper for its stakeholder workshop on "Network Regulatory Arrangements", held on 1 August 2014, is described as:

> Allowing some costs to be recovered through an exit fee and the remainder through distribution use of system charges. Further consideration is needed to determine what can be done within the existing regulatory framework, or whether amendments to the Rules would be required to enable this.

34. While we consider the above option suggested by AEMC to be an improvement over a straight exit fees option, this option is still less desirable than our preferred option above, because it retains an exit fee. As stated above, exit fees do not meet

[2] AEMC 2014, *op.cit.*, page 5

regulatory principles and create a barrier to entry that could frustrate market competition.

35. The ActewAGL proposal (pages 340-341) states that:

> The final form and level of ActewAGL Distribution's exit fee will depend on the outcome of the rule change process. ActewAGL Distribution notes that exit fees are currently applied in some other jurisdictions, and these fees provide a guide to what may be reasonable for the ACT. For example, the AER approved SA Power Network exit fee for customers consuming above 100MWh transitioning from ACS Type 6 service into the competitive market. The exit fee was determined at $232, which reflected a $170 capital cost component and a $62 administrative cost component.

36. We note that a $232 exit fee is much higher than the exit fees proposed by NSW distributors for FY 2015-2016, which are $195.24 (Ausgrid), $65.74 (Endeavour Energy) and $131.57 (Essential Energy).[3] Under our proposed approach, we foresee the cost recovery period to be longer, the higher the remaining asset book value.

37. Additionally, the "administrative cost component" quoted above is, or at least looks, excessive. It is our understanding that administration fees are intended to recover the costs of removing the metering information from the distributors' systems. Even if this process is manual, it should not could cost so much. If the process could be automated, we would expect the cost to be very low.

38. In principle, if administration fees are charged, they should be no higher than the efficient and reasonable costs of a distributor, and distributors should be incentivised to manage these costs as efficiently as possible.

Concluding comments

39. Vector agrees with the COAG Energy Council that the AER is the appropriate regulator to determine any cost recovery mechanisms (or any exit fees), given the inter-linkages of price setting and the determination of the regulatory framework for distributors for the next regulatory control period.

40. We understand the AER intends to issue further consultation papers that will examine exit fees. We fully support such initiatives and **recommend** that the AER consider our preferred option and those outlined in the Appendix that do not involve exit fees. It would be a good opportunity for a more careful assessment of the costs and benefits of imposing exit fees on various market participants and consumers against other options.

[3] These amounts are taken from the regulatory proposals of Ausgrid, Endeavour Energy and Essential Energy for the regulatory control period 2014-2019.

41. We also encourage the AER to coordinate with the AEMC in the development of its consultation papers to avoid confusion, regulatory overlaps and unnecessary costs.

42. We look forward to participating in the consultation process on exit fees.

43. Please do not hesitate to contact us should you or your staff wish to discuss any aspect of our submission, particularly in relation to exit fees.

Yours sincerely

Ian Ferguson
Regulatory Policy Manager

APPENDIX: Assessment of Alternative Cost Recovery Options against Regulatory Principles

Option	Vector's comments
Option A **No sunk cost recovery**	This option would not distort efficient investment in the smart metering market as it ensures sunk costs would not be taken into account by new entrants when making investment decisions. However, it is contrary to the principles of minimising investors' perceptions of regulatory risk and avoiding stranded investment.
Option B **Exit fee mechanism**	This option would ensure that distributors can recover their sunk costs, so would avoid stranded investment. However, as stated above, it would substantially distort investment decisions and inhibit the emergence of market-led smart metering. This is also inconsistent with the transition of similar markets to competitive arrangements that did not require exit fees.
Option C **Appropriate unbundled metering service fee**	This option would ensure the unbundled metering service fee (which is yet to be set for the next regulatory control period) includes a portion for sunk cost recovery. This fits well with the regulatory principles above and has the advantages of transparency for consumers. However, the fee may need to be set at a uniform level across networks and thus, on its own, may not be sufficient to recover all sunk costs on all networks.
Option D **Enable asset value to be recovered as part of standard control service**	This option is consistent with the regulatory principles above. However, it may lead to some concerns regarding transparency of and justification for the charges. This would also imply backtracking on the classification of Types 5 and 6 metering services as alternative control services under existing arrangements and as proposed for the 2014-2019 regulatory control period.

Option	Vector's comments
Option E **Combination of Options C and D**	In our view, this option has the ability to overcome the disadvantages with Options C and D while retaining their benefits. This may be the best available option.
Option F **Capping exit fees**	Should the AER still decide to impose exit fees, capping these fees would mute disincentives for investment and price spikes that could trigger consumer backlash. The challenge is to set the caps at 'efficient' (or close to efficient) levels to avoid or minimise market distortions.