Vector Limited
101 Carlton Gore Road
PO Box 99882, Newmarket
Auckland 1149, New Zealand
www.vector.co.nz

Corporate Telephone
+64-9-978 7788

Corporate Facsimile
+64-9-978 7799

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Mr Chris Pattas
General Manager - Networks Branch
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3000

By email: VICelectricity2016@aer.gov.au

Dear Mr Pattas

Submission on the AER's Preliminary Positions on Replacement F&As for Victorian Distributors

Introduction

1. Vector Limited ("Vector") welcomes the opportunity to make this submission on the Australian Energy Regulator's ("AER") consultation paper on its *Preliminary positions on replacement framework and approach* for electricity distributors in Victoria, dated May 2014. The relevant distributors are CitiPower, Jemena, Powercor, SP Ausnet and United Energy, and the relevant period is the next regulatory control period of 1 January 2016 - 31 December 2020.

2. Vector is pleased with the AER's decision to replace the current Framework and Approach for Victorian distributors to reflect ongoing and impending changes to regulatory arrangements in the National Electricity Market ("NEM").

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

4. We do not consider, however, that the AER's proposal to impose exit fees is an appropriate mechanism to promote competition in the metering market in Victoria. We discuss below why exit fees would not give the proposed reform the best chance of success.

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

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

Luz Rose
Senior Regulatory Analyst
Luz.Rose@vector.co.nz
+644 803 9051

Vector supports a competitive metering market in Victoria

7. Vector supports the Australian Government's market-led approach to achieving its efficiency and competition objectives in the metering market and the electricity sector. Our view is influenced by our experience in the New Zealand metering market, which follows a market-led model. The New Zealand market is competitive and provides evidence that it is possible to achieve consumer acceptance, positive business cases and a competitive smart metering market all at the same time.

8. We agree with the AEMC's proposal that types 5 and 6 metering services should become competitive in the future. A competitive market for these services would deliver benefits to consumers in Victoria. We support efforts to improve the ability of these services to become contestable. Re-classifying them under alternative control in these circumstances, however, does not promote contestability if all it does is signal the cost of the exit fee.

9. We do **not** support the AER's proposal to impose exit fees for the replacement of existing meters. Exit fees do not have precedence in similar industries or any basis (i.e. they do not meet regulatory principles as we discuss below), and do not promote competition. As such, they are likely to prevent the development of a fully competitive smart metering market in Victoria, or its development in a timely manner.

10. We recognise, however, that the transition to newer technologies such as smart metering is not costless, and as the Power of Choice review recognised, it is in the long-term interest of consumers. As provided for in the NER (Rule 7.3A(g)), we agree that electricity distributors in Victoria should be able to recover the cost of their efficient regulated investment, but consider that exit fees are not the appropriate mechanism for doing so.

11. In this submission, we propose alternative approaches that would allow cost recovery by distributors without stifling market entry and competition, and without harming electricity consumers in Victoria.

Exit fees are not the appropriate mechanism

Exit fees do not meet regulatory principles

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

1) minimising market inefficiencies and distortions, 2) providing the right incentives for market entry and investment, and 3) promoting consumers' interest or avoiding harm to consumers.

13. 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;

- *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.

14. We consider that the imposition of exit fees does not meet the above principles, and therefore propose that the AER consider other cost recovery mechanisms that do not involve exit fees.

Exit fees do not promote competition

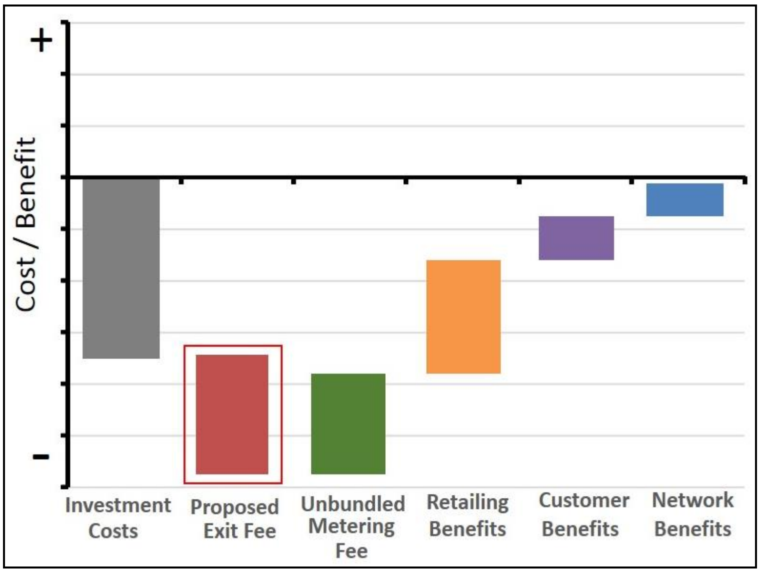
15. Vector notes that transitions to more competitive arrangements have been undertaken in similar markets without resorting to exit fees. These include 1) the introduction of competitive electricity retail market in Australia, 2) the transition to competitive metering for large customers, also in Australia, and 3) we understand, for some environmentally friendly power generation and small generators overseas. 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.

16. In our May 2014 submission to the AEMC, we argued that exit fees would create a significant barrier to market entry. This could frustrate the policy objective of expanding competition in metering services in Victoria.

17. Potential entrants would face the proposed exit fees. This cost, as reflected in Figure 1, actively disincentivises investment. In addition, this 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.

18. 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



19. 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 Victorian consumers of the benefits of market competition.

Alternative cost recovery options

20. The consultation paper states that "there is a strong expectation that in transitioning from the Victorian Government's Order in Council (OIC) an exit fee will apply" (page 15). We note that the National Electricity 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.

21. 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.

- **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 that investors' perceptions of regulatory risk should be minimised and stranded investment should be avoided.

- **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. It is also inconsistent with the transition of similar markets to competitive arrangements without imposing 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.

- **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. It 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.

Concluding comments

22. Vector understands that the AER intends to issue further consultation papers that will examine exit fees. We fully support such initiatives and **recommend** that the AER consider the options we propose above.

23. 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.

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

25. 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

Bruce Girdwood
Group Manager Regulatory Affairs