Overview of the Better Regulation reform package

April 2014

AUSTRALIAN ENERGY REGULATOR

Inquiries about this document should be addressed to:

Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001
Tel: (03) 9290 1444
Fax: (03) 9290 1457
Email: AERInquiry@aer.gov.au

AER reference: 50303

Contents

1 Key points

The Australian Energy Regulator (AER) is Australia's national energy market regulator. This paper focuses on our role in regulating the energy network businesses that operate electricity networks and gas pipelines. In this role we promote the efficient investment in and use of energy services for the long term interests of consumers. This objective is enshrined in the National Electricity and Gas Laws.

We determine the total amount of revenue each regulated electricity network or gas pipeline business can earn. Consumers pay network charges to fund these revenues. Network charges can be up to 50 per cent of the final price consumers pay for energy services.

National electricity and gas objectives

The objective of the National Electricity and Gas Laws is to promote efficient investment in, and efficient operation and use of, energy services for the long term interests of consumers of energy with respect to: (a) price, quality, safety, reliability and security of supply of energy; and (b) the reliability, safety and security of the national energy systems.

We make revenue or price determinations for an energy network business prior to the start of each regulatory period. The length of the regulatory period can vary, but most are five years. The network business proposes the revenue it requires to meet its service and reliability obligations over the next period. We then publish the proposal for public scrutiny and conduct our own analysis to determine whether the proposal is efficient. The determination process typically takes around fifteen months for electricity and ten months for gas.

Underpinning our approach to our role is a set of key principles:

- Where possible our economic regulation should be incentive-based. Incentives should be balanced to encourage network businesses to spend efficiently relative to their expenditure forecasts and service obligations. This should be supported by a robust approach to assessing efficient expenditure forecasts and the testing of past performance. (Section 3)
- Necessary and efficient investment should be encouraged. The method of determining the rate of return that electricity and gas network businesses can earn on their networks should balance predictability with the need to take into account changing market conditions. (Section 4)
- There should be a strong consumer engagement framework. Effective consumer engagement encourages greater involvement and communication between electricity and gas network businesses and the communities they serve. (Section 5)

In 2013 we undertook a Better Regulation program to enhance our approach to network regulation, guided by these key principles. This approach is set out in a series of guidelines that are available from our website.

This paper provides a high-level introduction to how the reforms work together as a cohesive package of measures to support incentive-based regulation. From a new annual reporting on network business efficiency, new tools for assessing businesses' forecasts of the expenditure needed, stronger incentives on businesses to spend efficiently, to a better way of determining the return that network businesses can earn on their investments. These enhancements are overlayed with a better consumer engagement framework, including the creation of a consumer challenge panel to assist us to make better regulatory determinations by providing input on issues of importance to consumers.

2 Incentive-based network regulation

2.1 Background

We approve two key types of expenditure forecasts prior to the start of each regulatory period—total capital expenditure (capex) and total operating expenditure (opex). Capex is spent on purchasing and installing assets like poles and wires and other equipment that transports energy to customers. Some categories of capex are relatively certain and recurrent. However, more often capex is non-recurrent and lumpy, typically varying from year to year since capital assets are generally expensive and long lived. Opex is spent on the non-capital cost of running an electricity network and maintaining the assets. Opex is generally recurrent and predictable from year to year.

Incentive-based regulation is a form of regulation where we forecast and lock in the total opex and capex a business will require to meet its pre-defined service and reliability targets at the start of each regulatory period. Businesses are then given financial rewards where they improve their efficiency and spend less than the forecast during the regulatory period. Put simply, if the business spends less than the forecast it will still earn revenue to cover the total forecast amount. Hence it can 'keep the difference' between the forecast and its actual expenditure until the end of the regulatory control period. Conversely, if its spending exceeds the forecast, it must carry the difference itself until the end of the period.

Similarly, businesses are rewarded where they improve service quality that is valued by customers and penalises them where service quality falls. Consumers benefit from efficiency improvements, that are not at the expense of service quality, through lower regulated prices.

Overlaying this are our incentive schemes for capex and opex which also affect how an underspend or overspend is shared with consumers, which we discuss in section 3.

This approach creates incentives for a business to become more efficient. So, over time, its spending pattern will reveal its efficient costs. This information is then used to forecast its future spending needs. However, in some cases a business may not respond to financial incentives to become more efficient. This will be indicated in our examination of its past performance and our benchmarking analysis comparing it to other businesses (we explain our assessment approach further in section 3). In such cases we use benchmark information to determine forecasts of efficient expenditure needs.

We see incentive-based regulation as a preferable approach to 'cost of service' forms of regulation that simply allow network businesses to recover the costs of providing services. This creates limited incentives for ongoing efficiency improvements and revealing true efficient costs.

2.2 Applying incentive-based regulation

We apply incentive-based regulation across all energy networks we regulate through the building block model. This is a model that calculates the total revenue that is required by the business, based on forecasts of opex, return on assets, depreciation and tax.[1] Regulated prices during a period are based on the building blocks and forecast demand.

The process of applying the building block model is set out in the electricity and gas rules. In electricity, we begin this process by publishing a "framework and approach" paper two years prior to

[1] Capex is funded through an allowance for return of capital (depreciation) and return on capital (given by the weighted average cost of capital (WACC) multiplied by the RAB). We discuss the WACC in section 4.

the end of the current regulatory period. The framework and approach paper provides an opportunity for interested parties, including consumers, to have a say in which services we should regulate and how much control we have over determining the prices for network services. The framework and approach paper also sets out information around incentive schemes that will apply to the network businesses to encourage efficient investment and performance. This facilitates early public consultation and assists the network businesses in preparing their regulatory proposal.

Following the framework and approach paper stage, a network business submits to us its expenditure proposal, including its proposed building blocks. When we receive a business' revenue proposal we publish it on our website and invite stakeholders to comment. We will also publish an issues paper identifying key issues early in the determination process. For example, this issues paper contains our 'first pass' assessment indicating our preliminary view on the business' expenditure proposal.[2] The issues paper will assist stakeholders who are interested in making submissions on the proposal.

Stakeholders can also attend our public forums on the business' proposal and on our draft determination. Our draft determination sets out our views on all elements of the proposal taking into account stakeholder views. Stakeholders are again invited to make submissions on our draft determination and the business can revise its proposal. After considering submissions and the revised proposal, we publish our final determination and analysis.

We make our network determination decisions in the context of the overall regulatory framework. Our decisions are not just a sum of parts, but are balanced overall packages. We consider how each element of a determination fits with the total, and take into account stakeholder views.

Importantly, we do not approve funding for an energy network business' specific projects or programs, but rather a total forecast for capex and opex. Once a total forecast is set, it is for the business to decide which suite of projects and programs are required to meet their service and reliability requirements.

Affected parties can apply to the Australian Competition Tribunal for a review of the merits of our determination. There is a threshold for an affected party to seek merits review. First, they must identify an error in one of our determination decisions. Second, they must establish that correcting that error will result in a decision that overall is materially preferable in terms of the long-term interests of consumers. That is, it contributes to the achievement of the national electricity objective or the national gas objective. Our decisions are also subject to judicial review by a court. Judicial review, however, is limited to considering whether the decision contains an error of law. It does not involve an examination of the merits of the decision.

[2] This first pass assessment will typically involve high level expenditure assessment (using economic benchmarking and category analysis) and consideration of the business' performance in the most recent annual benchmarking report.

3 Balanced incentives and efficient expenditure forecasts

In this section we outline the Better Regulation reforms that enhance incentive-based regulation. These measures provide balanced incentives to encourage businesses to make efficient decisions on how to allocate expenditure during the regulatory period. In particular:

- Our expenditure incentive schemes encourage a business to pursue efficiency improvements in opex and capex. These efficiency gains are then shared with consumers. The business stands to receive rewards and penalties for its performance under the schemes. These are the capital expenditure sharing scheme (CESS) for capex, and the efficiency benefit sharing scheme (EBSS) for opex. The CESS and EBSS incentives are balanced and constant to promote efficient spending decisions in terms of the timing, amount and type of expenditure. The service target performance incentive scheme (STPIS) incentivises a business to maintain or improve the quality of its services. Our expenditure incentives are also balanced with STPIS incentives so a business does not make expenditure savings at the expense of service quality.
- We also have a framework that supports a business considering non-network alternatives. Non-network alternatives defer or reduce the need for expenditure on building more network capacity. Our regulatory investment tests mean a business must consider and consult on non-network alternatives when planning major network investments. In addition, our demand management incentive scheme supports investigation of innovative demand management solutions regardless of their success in reducing expenditure.

These incentives are effective when a business is responsive to financial incentives and expenditure forecasts are based on efficient costs. The tools we use to assess expenditure forecasts and to determine whether a business is responding efficiently are discussed in section 3.2.

3.1 Balanced incentives to encourage efficient spending

Our capex and opex incentive schemes complement our existing incentive schemes for service and demand management. Taken together these incentive schemes create balanced incentives. A business may decide to reallocate its expenditure so it benefits under the incentive schemes, or to avoid penalties. If incentives are not balanced the business may redirect capex to opex or vice versa, where it may not have been efficient to do so. Balanced incentives encourage a business to make efficient spending decisions in the long term interests of consumers.

Once we determine a business' expenditure forecast for a regulatory period, the business decides how to allocate its expenditure over that period. Based on its assessment of its priorities and to manage its overall service level performance and risk the business can decide to:

- provide services using different mixtures of capex and opex
- alter the quality of the services it provides
- implement non-network alternatives to defer, reduce or avoid the need for expenditure to build more network capacity.

3.1.1 Trade-offs between capex and opex

Our expenditure incentive schemes provide balanced and constant incentives so a business can make efficient decisions when choosing whether to incur opex or capex. In this way, trade-offs

between capex and opex are incentive neutral. For example, suppose a business decides to spend money on opex which it would otherwise have spent on capex. Under our expenditure incentive schemes the business incurs a 30 per cent penalty for becoming less efficient with opex, but this is offset by a 30 per cent reward for becoming more efficient with capex.

Capex incentives

As the end of a regulatory period approaches the time left for a business to retain any capex savings gets shorter. So, the earlier a business incurs an underspend in the regulatory period, the greater its reward will be. As a result, without a CESS the incentive for a business to underspend on capex declines throughout the period. The business may choose to spend capex later, or spend on capex when it may otherwise have spent on opex, even if it may not be efficient to do so.

The CESS encourages efficient capex investment decisions by providing a business with the same reward for a capex efficiency saving and same penalty for a capex efficiency loss regardless of which year they make the saving or loss in. Put another way, the CESS creates a constant incentive for capex. The CESS rewards a business if it made a capex efficiency saving, and penalises it if it made a capex efficiency loss. When the CESS is implemented, a business will retain 30 per cent of an underspend while consumers will receive 70 per cent of the benefit of an underspend. A business would also bear 30 per cent of the cost of an overspend, while consumers would bear 70 per cent.

The explanatory statement to our capital expenditure incentives guideline has further detail and worked examples of how the CESS operates. Briefly, we calculate the cumulative capex underspend or overspend in a regulatory period. We then apply the sharing ratio of 30 per cent to work out what the business' share of the underspend or overspend should be. To work out the CESS payments, we subtract any financing benefit or cost the business received from the underspend or overspend during the period from its share of the underspend or overspend. The CESS payments that relate to underspending or overspending in one regulatory period will be added or subtracted to the business' regulated revenue in the following regulatory period.

Opex incentives

Where we are confident that a business' past opex is efficient, our preference is to use this as a base for forecasting future costs. This is known as the revealed cost approach. In practice, under this approach we examine the actual opex a business spent in one year of the regulatory period (the base year), and use this to forecast opex needs for the next period. However, if this was applied without refinement, a business would have an incentive to spend more opex in the year it expects we will use as a base for its next forecast. This is because spending more in the expected base year would make its future opex allowance larger.

The EBSS reduces the incentive a business has to inflate its opex. It provides a continuous incentive for businesses to achieve efficiency gains in such a way that they will not benefit from inflating opex in any one year. The EBSS allows the business to retain underspends for a total of six years, regardless of the year in which they underspend. Consumers then benefit from lower forecast opex in future regulatory periods, which leads to lower prices in the future.

The combined effect of our revealed cost forecasting approach and the EBSS is that opex efficiency savings or losses are shared approximately 30:70 between the businesses and consumers. For example, for a one dollar saving in opex the business receives 30 cents of the benefit while consumers receive 70 cents of the benefit.

The explanatory statement to the EBSS has further detail and examples of how the EBSS operates. Briefly, a business with a five year regulatory period will receive EBSS carryover amounts so that it receives exactly six years of benefits from an efficiency improvement (or six years of penalties for an efficiency loss). The benefit (or loss) is passed on to consumers after this EBSS carryover period of six years has expired. The efficiency improvement or loss is reflected in the forecast opex consumers fund.

3.1.2 Maintaining or improving service standards

Incentive-based regulation and our expenditure incentive schemes encourage a business to become more efficient by spending less. The STPIS counter balances this incentive so cost reductions are not at the expense of service quality. The STPIS provides incentives for network businesses to maintain or improve network service standards. There are different schemes for distribution and transmission as follows:

- The distribution STPIS provides a financial incentive for distribution network businesses to maintain and improve service performance. Penalties and rewards under the distribution STPIS are calibrated to how willing consumers are to pay for improved service. This aligns the distributors' incentives towards efficient price and non-price outcomes with the long term interests of consumers.
- The transmission STPIS incentivises transmission network businesses to provide greater transmission network reliability when network users place greatest value on reliability. Further, to improve and maintain the reliability of the elements of the transmission network most important to determining spot prices in the national electricity market.

We did not review the STPIS as part of the Better Regulation program, but we designed our expenditure incentive schemes to complement it. Expenditure incentives are balanced with the incentives under the STPIS. Overall, businesses are encouraged to make efficient decisions on when and what type of expenditure to incur, in order to meet service reliability targets.

3.1.3 Encouraging demand management and non-network alternatives

Another way for businesses to spend less is by implementing demand management strategies and non-network alternatives. These strategies effectively reduce network utilisation during peak usage periods. This can be an efficient way of deferring, reducing, or avoiding the need for expenditure on building network capacity. Consumers benefit from reduced expenditure on network augmentation through lower prices.

We developed the regulatory investment test for distribution (RIT-D) as part of the Better Regulation program. The RIT-D sits alongside the existing regulatory investment test for transmission (RIT-T). These set out a process which requries network businesses to consider and consult on non-network alternatives at the beginning of the planning process for major network investments.

Expenditure on non-network alternatives generally takes the form of opex rather than capex. Successful non-network alternatives result in a business spending less on capex than it otherwise would have. Balanced expenditure incentives mean a business has an incentive to implement a new non-network alternative if the increase in opex is less than the corresponding decrease in capex.

Under our expenditure incentives the business receives a net reward for implementing a successful non-network alternative. For example, when a business spends more on opex it receives a 30 per cent penalty under the EBSS. However, when there is a corresponding decrease in capex the

distributor receives a 30 per cent reward under the CESS. So, where the decrease in capex is larger than the increase in opex the distributor receives a larger reward than penalty, a net reward. This is because the rewards and penalties under the EBSS and CESS are balanced and symmetric.[3]

Demand management strategies and non-network alternatives still require expenditure to implement. However, the savings associated with demand management projects may be seen by network businesses as less certain than traditional solutions, particularly if it is an innovative or untried solution. As such, we have a demand management incentive scheme in place to encourage businesses to investigate and implement innovative demand management strategies regardless of whether they are successful in reducing expenditure or not.[4] Any potential substitution between opex and capex resulting from projects approved under the demand management incentive scheme is incentive-neutral because the CESS, EBSS and STPIS provide balanced incentives for opex and capex savings.[5]

3.2 Assessing a business' expenditure and determining efficient forecasts

In this section we discuss how we assess a business' expenditure proposal and determine a substitute forecast when required. Businesses must provide economic analysis to justify the efficiency and prudency of their expenditure proposals. In the absence of sufficient justification we are unlikely to accept their forecast expenditure.

3.2.1 General approach to assessing expenditure forecasts

Our general approach is to assess the efficiency of a network business and determine whether previous spending is an appropriate starting point. If a business is efficient and has been responding to our expenditure incentive measures, its past expenditure is often a good indicator of how much it will need to spend in future. If the business is not responding to incentives, we will set forecasts with reference to benchmarks that reflect efficient costs.

To assess a business's proposed expenditure, we apply a range of techniques that typically involve comparing the proposal to estimates we develop from relevant information sources. Where these techniques indicate the expenditures are not efficient, we will set our own efficient forecast. These techniques include:

- economic benchmarking—productivity measures used to assess a business efficiency overall
- category level analysis—a key benchmarking tool, comparing how well a business delivers services for a range of individual activities and functions, including over time and with its peers

---

3 Distributors must include spending on non-network alternatives in developing their expenditure forecasts, and efficient spending for non-network alternatives would be included in a distributor's allowance. The rewards and penalties under the CESS and EBSS would only apply to non-network alternatives implemented during the period that were not accounted for in the distributor's expenditure allowance.

4 The rules have since changed the name to 'Demand Management and Embedded Generation Connection Incentive Scheme' (DMEGCIS) to explicitly cover innovation with respect to the connection of embedded generation.

5 The innovation allowance under the demand management incentive scheme is incorporated into a business' opex allowance each year. We may exclude this from actual and forecast opex when calculating carryover payments for the EBSS. Under the EBSS we can exclude any categories of opex not forecast using a single year revealed cost approach where it would better achieve the requirements of the EBSS. Innovation projects are excluded from forecast opex so not considered to be forecast using a single year revealed cost approach.

- predictive modelling—statistical analysis to predict future spending needs, currently used to assess the need for upgrades or replacement as demand changes (augmentation capex, or augex) and expenditure needed to replace aging assets (replacement capex, or repex)
- trend analysis—forecasting future expenditure based on historical information, particularly useful for opex where spending is largely recurrent and predictable
- cost benefit analysis—assessing whether the business has chosen spending options that reflect the best value for money
- project review—a detailed engineering examination of specific proposed projects or programs
- methodology review—examining processes, assumptions, inputs and models that the business used to develop its proposal
- governance and policy review—examining the business's strategic planning, risk management, asset management and prioritisation.

The expenditure forecast assessment guideline sets out the principles guiding our reliance on assessment techniques and a business' forecasting approach. These include validity, accuracy and reliability, parsimony, robustness, transparency and fitness for purpose.

3.2.2 Benchmarking

Our expenditure assessment tools and techniques are underpinned by a nationally consistent framework for network businesses to report information to us. This consistent approach to information reporting lets us compare the costs of conducting similar activities across networks. Benchmarking lets us compare electricity network businesses against each other and determine how efficient they are by comparison.

We are publishing annual benchmarking reports from September 2014 which provide regular information on the relative efficiency of network businesses during the regulatory period. Public scrutiny of businesses' performance in these reports encourages businesses to improve, and identifies areas we are likely to target in assessing future expenditure proposals.

We will take into account the most recent benchmarking report when forming a view about efficient expenditure levels at the time of a determination. Inefficient networks may face cuts to their proposed expenditure.

3.2.3 Forecasting and reviewing capex

During a determination we assess the business' past capex spending and future capex needs. We:

- assess the business' proposed forecast of the total capex it needs to spend over the next period
- update the business' regulatory asset base (RAB) to include the capex it spent in the past during the period, and in future we can exclude any inefficient capex overspends
- calculate the rewards and penalties the business will receive under the CESS for capex underspends or overspends it incurred during the period.

We assess the business' total capex forecast by considering the efficiency of the proposed expenditure. Our assessment of the total forecast capex can be informed by indicators of overall network performance and risk. We utilise a range of tools to inform that consideration. We have

developed a new tool to better forecast the expenditure needed to build, upgrade or replace network assets to address changes in demand (augmentation capex, or augex). This complements our existing tool that examines the expenditure needed to replace aging assets (replacement capex, or repex). We also consider capex forecasts associated with connections and other customer driven work, non-network capex (for example IT equipment) and the capitalisation of overhead costs.

We will use our capex forecasting techniques to review what the business spent on capex during the period. The capital expenditure incentives guideline sets out our staged process for this ex post review. From 2014, if a business' capex exceeds what was forecast, we will examine their spending. If we determine all or some of the overspending was inefficient, the business may not be allowed to add the excess spending to its RAB.[6]

3.2.4 Forecasting and reviewing opex

During a determination we assess the business' past opex spending and future opex needs. We:

- assess the business' proposed forecast of the total opex it needs to spend over the next period
- calculate the rewards and penalties (carryover amounts) the business will receive under the EBSS for opex performance during the period.

We prefer to forecast opex using a 'base-step-trend' approach. Under this approach, we identify an efficient cost base, which we can then adjust (step-change) if the circumstances have changed from when the previous expenditure was incurred. Potential step changes and trends may be driven by regulatory changes, input cost changes, output growth and productivity changes.

To determine the base level of expenditure we start by assessing the actual spending of the business in one year of the previous regulatory period. In a five-year regulatory period, this is typically the third or fourth of year the previous period. We will first test whether those revealed costs are efficient by employing our assessment techniques including economic benchmarking and category level analysis. If our analysis identifies inefficiencies in our preferred base year expenditure we will consider two options. We may use a different year of actual expenditure, or an average of multiple years, that we consider is reflective of efficient costs. Or, where we do not consider that past expenditure is representative of efficient costs, we will use our assessment techniques to either adjust the base year, or determine a total opex forecast that we consider represents the efficient costs of providing the required services.

3.2.5 Accounting for shared assets

Network businesses may use electricity assets to provide both regulated electricity services and other services we do not regulate. These assets are called shared assets.[7] When an electricity network company invests in a new asset, like a power pole, its cost is added to the business' RAB. The return that the network business earns on the asset is recovered from consumers. If a business is also paid for providing unregulated services, like carrying the communications cable on the power pole, they are essentially being paid twice for the same asset.

---

6 We cannot exclude inefficient capex overspends if a business spent the capex prior to 2014, but this timing differs slightly for different businesses.

7 An example of a shared asset is a power pole, paid for by electricity consumers, which also supports a fibre optic cable for communications services. We regulate electricity supply but not communications services. So the power pole is a shared asset.

The shared asset guideline sets out our approach to sharing the benefits with consumers when a network business is paid for providing unregulated services. As part of our determination we will collect descriptions of the shared assets the business uses to provide unregulated services, and the services it forecasts will be provided. We will reduce the amount the business can recover from electricity consumers to reflect the unregulated revenues. Network businesses have the opportunity to propose alternative approaches. However, we will be unlikely to accept alternatives if they leave consumers worse off than under our approach in the shared asset guideline.

Our shared asset mechanism forecasts the annual unregulated revenue that a network business is expected to earn from shared assets. This forecast is then compared to the revenue that is required to provide regulated services. If the total unregulated revenue is expected to be greater than 1 per cent of the regulated revenue, we will apply a cost reduction. This clear and transparent materiality threshold balances administrative effort with potential consumer benefits. We will reduce a business' regulated revenues by ten per cent of the value of unregulated revenues earned from shared assets. This reduces the amount to be recovered from consumers and consequently electricity prices.[8]

[8] The potential value of the cost reduction is capped by the electricity rules, so that the reduction cannot exceed the regulated revenue from those assets.

4 The rate of return supporting necessary and efficient investment

The rate of return should support continuing investment in safe and reliable energy networks without requiring consumers to pay for excessive returns to network businesses.

4.1 Why the rate of return is important

The return on investment makes up approximately 50 per cent of revenue needs for network businesses. A good estimate of the rate of return is necessary to promote efficient prices in the long term interests of consumers. If the rate of return is set too low, the network business may not be able to attract sufficient funds to be able to make the required investments in the network and reliability may decline. On the other hand, if the rate of return of return is set too high, the network business may seek to spend too much and consumers will pay inefficiently high prices.

The allowed rate of return is the forecast of the cost of funds a network business requires to attract investment in the network. To estimate this cost, we consider the cost of the two sources of funds for investments—equity and debt. The return on equity is the return shareholders of the business will require for them to continue to invest. The return on debt is the interest rate the network business pays when it borrows money to invest.

The value of the business' capex investments in its RAB is multiplied by the allowed rate of return to determine the total return on capital the network business can charge consumers. So we also aim to set a rate of return that enables business to make efficient choices between capex and opex.

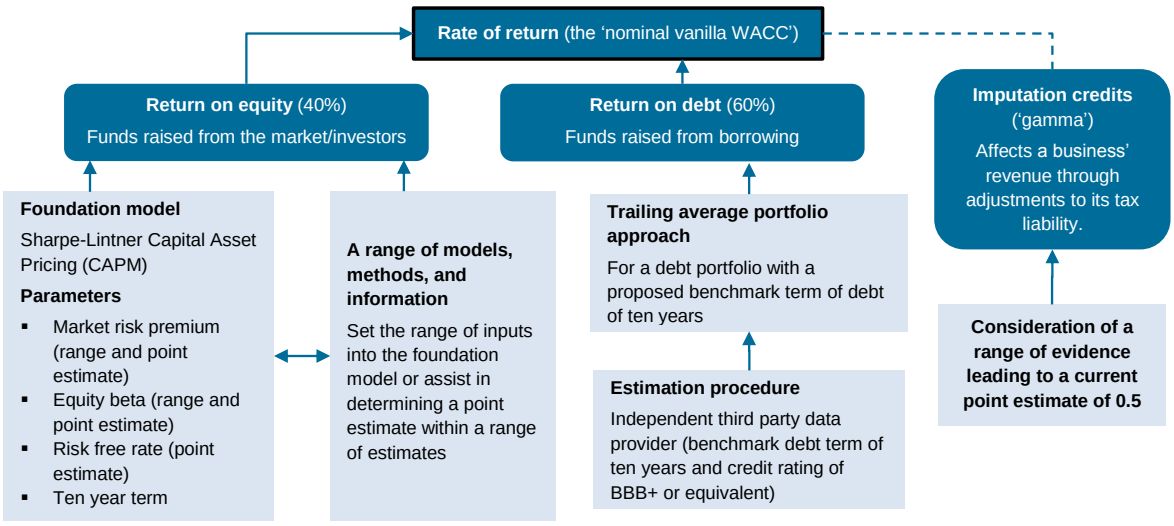
4.2 Our approach

Applied consistently over time, the approach in our rate of return guideline for estimating the rate of return will provide greater regulatory stability and increased certainty. This is achieved through greater transparency of the key components of the rate of return and how these are assessed.

Our approach will allow the rate of return to change through time as market conditions change. It provides for the recovery of efficient financing costs and less cash flow volatility for the businesses. In turn, this leads to more stable price movements for consumers. The framework will support the attraction of long term capital while addressing the long term interests of consumers.

The estimation method set out in our rate of return guideline is shown in Figure 1. We consider that efficient network businesses funds their investments by borrowing 60 per cent of the required funds, while raising the remaining 40 per cent from equity.

Figure 1 Better Regulation rate of return guideline estimation method overview



4.2.1 The benchmark efficient business

We estimate the returns on equity and debt for a hypothetical benchmark efficient business, rather than the actual costs of any particular network business. By setting a rate of return based on a benchmark, rather than the actual costs of individual businesses, network businesses have incentives to finance their business as efficiently as possible. This is important in the context of the revenue and pricing principles set out in the electricity and gas laws. Under these principles, network businesses should, among other things, be afforded a reasonable opportunity to recover at least efficient costs. In addition, businesses should be provided with effective incentives in order to promote economic efficiency.[9] Consistent with these principles, our rate of return estimate is based on an efficient benchmark that affords an opportunity to recover efficient costs. Further, businesses are incentivised to seek out economic efficiencies by being rewarded if they can achieve lower costs of equity and debt than assumed for the benchmark efficient entity.

This approach is supported by the rate of return objective that is enshrined in the electricity and gas rules. This objective is for the overall rate of return to correspond to the efficient financing costs of a benchmark efficient business.

We define the benchmark efficient business as one which only provides regulated electricity or gas network services, operating within Australia. This applies to both electricity and gas, as the risks across both industries are sufficiently similar that a single benchmark is appropriate.

4.2.2 Return on equity

Our approach to the return on equity provides predictability for investors and consumers while incorporating the latest market data. Recognising there is not one perfect model to estimate the return on equity, our approach draws on a variety of models and information.

Our starting point is the standard Capital Asset Pricing model (CAPM)—our 'foundation model.' We then use a range of models, methods, and information to inform our return on equity estimate. We use this information to either set the range of inputs into the CAPM foundation model or assist in determining a point estimate within a range of estimates at the overall return on equity level.

[9] Section 24, National Gas Law & Section 7A, National Electricity Law

4.2.3 Return on debt

Our approach to the return on debt closely aligns with the efficient debt financing practices of regulated businesses. Our approach is to consider the average interest rate that a network business would face if it raised debt annually in ten equal parcels. This is referred to as the trailing average portfolio approach. This approach assumes that every year, one-tenth of the debt of a network business is re-financed. As the return on debt is an average of the interest rates over a period of ten years, this approach leads to a relatively stable estimate over time.

We will apply a gradual transition to this approach. The starting point will be set by estimating a benchmark cost assuming all debt is refinanced during a predetermined averaging period. From there we will update the regulatory allowance every year over ten years until it is reflective of the debt financing costs of a benchmark business that refinances one-tenth of its debt portfolio annually.

5 A strong stakeholder consultation framework

Consumer engagement is about working openly and collaboratively with consumers and providing opportunities for their views and preferences to be heard and to influence service providers' decisions. Effective consumer engagement requires commitment from both service providers and consumers. Stronger consumer engagement can help us test service providers' expenditure proposals, and can raise alternative views on matters such as service priorities, capital expenditure proposals and price structures.

Underpinning our regulatory approach are the Better Regulation reforms creating a stronger consumer engagement framework:

- We expect all network businesses to implement our consumer engagement guideline and demonstrate an ongoing commitment to genuine engagement. When assessing a business' proposed expenditure we will consider how the business engaged with consumers in preparing its proposal.
- As part of the determination process the Consumer Challenge Panel will provide input on consumer perspectives.
- To promote a transparent regulatory process our confidentiality guideline sets out how a business must make confidentiality claims over information it submits to us. We seek to balance protecting confidential information with enabling stakeholders to have access to sufficient information on issues affecting their interests.

5.1 Ongoing consumer engagement

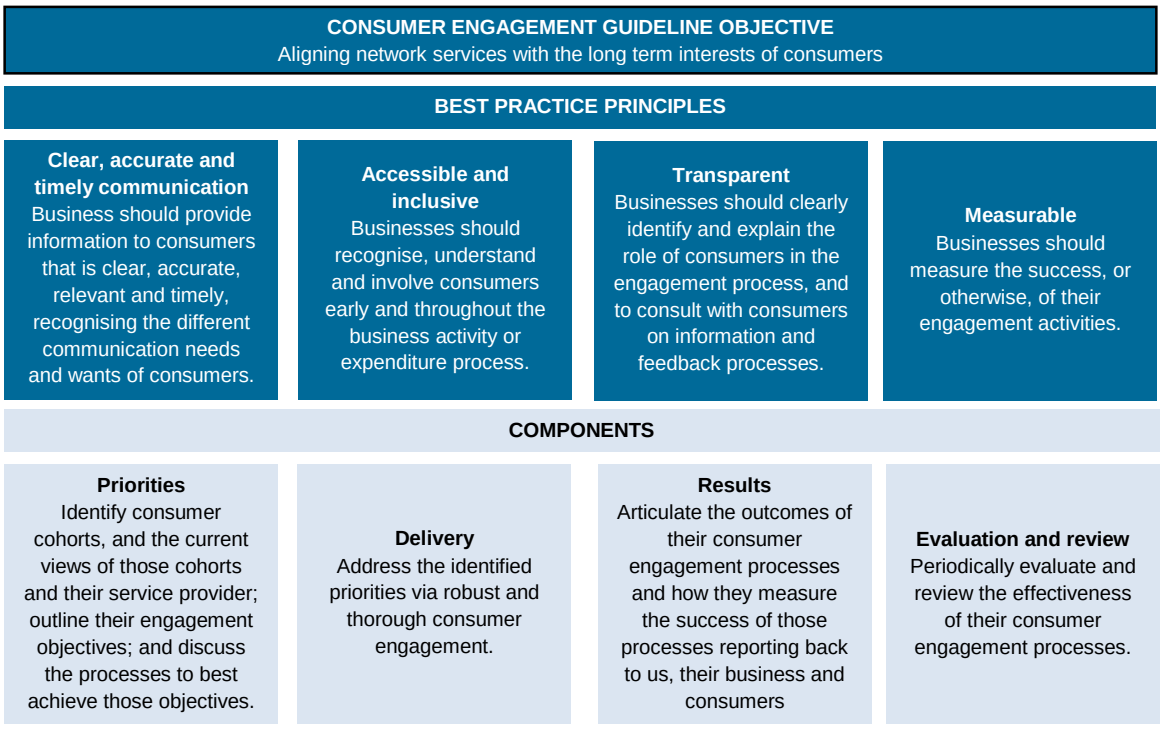
Our consumer engagement guideline sets out how we expect energy network businesses to engage with their consumers. Businesses should demonstrate a commitment to ongoing and genuine consumer engagement to provide services that better align with consumers' long term interests.

The guideline has a high level framework to help businesses integrate consumer engagement into their business-as-usual operations. The principles and components set out in the guideline are shown in Figure 2.

The onus is on businesses to develop and implement consumer engagement strategies as they are in the best position to understand their consumer base and its issues. Each business' approach should address the best practice principles that underpin the consumer engagement guideline. There are also four components in the guideline that set out a process for businesses to develop and implement new or improved consumer engagement activities to meet the best practice principles.

Implementing the consumer engagement guideline will help a business develop its next spending proposal and demonstrate how this proposal contributes to the objectives contained in the national electricity and gas laws. That is, that their spending proposals promote efficient investment in, and efficient operation and use of, energy services for the long term interests of energy consumers.

Figure 2 Better Regulation consumer engagement guideline



5.2 Consumer views on regulatory determinations

Regulatory determinations are technical and complex processes which can make it difficult for ordinary consumers to participate. We established a Consumer Challenge Panel comprising thirteen members as part of the Better Regulation program. The expert members of the Panel will provide input on consumer perspectives to better balance the range of views considered as part of our determinations. Their role includes advising on:

- whether the network businesses' proposals are justified in terms of the services to be delivered to consumers; whether those services are acceptable to, and valued by, consumers; and whether the proposals are in the long term interests of consumers
- the effectiveness of network businesses' engagement activities with consumers and how this engagement has informed, and been reflected in, the development of their proposals.

Stronger consumer engagement can help us test service providers' expenditure proposals, and can raise alternative views on matters such as service priorities, capital expenditure proposals and price structures.

Businesses must describe how they have engaged with consumers, and how they have sought to address any relevant concerns identified as a result of that engagement. Businesses present this information in an overview report to their regulatory or revenue proposals. Implementing the Better Regulation consumer engagement guideline will help a business demonstrate this.

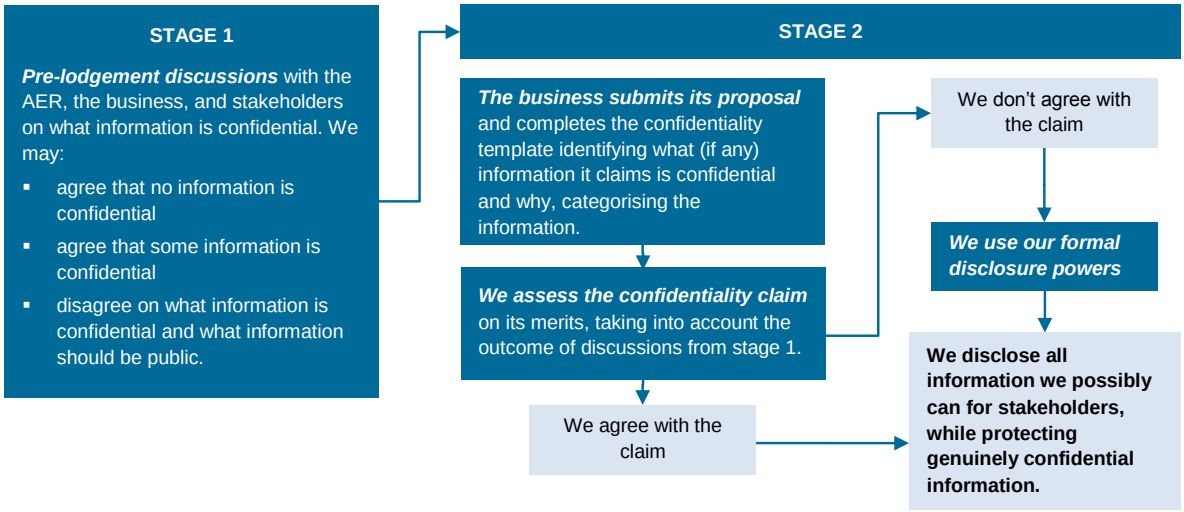
When assessing expenditure proposals we will have regard to how a business engaged with its consumers and accounted for the long term interests of those consumers. Consumer engagement is a factor we can consider when setting expenditure forecasts.

5.3 Balancing transparency with protecting confidential information

Businesses must submit extensive amounts of information on their expenditure plans to support their regulatory proposals. Publishing this information promotes a transparent regulatory process. However, in limited cases the benefit of publishing some of this information may be outweighed by the potential harm. For example, a business may provide an estimate of the cost of providing a service it plans to competitively tender for. If we published their cost expectations it could impact their ability to be competitive in the tender, and ultimately increase the costs to consumers.

We want to balance protecting confidential information with disclosing information to create an open and transparent regulatory decision making process. This balance involves all stakeholders having access to sufficient information to understand and assess the substance of issues affecting their interests. Our Better Regulation confidentiality guideline sets out a two stage process for managing businesses' confidentiality claims, as shown in Figure 3.

Figure 3 The Better Regulation process for dealing with confidentiality claims



Electricity network businesses must make confidentiality claims in their regulatory proposals in accordance with our confidentiality guideline. We will also use our information gathering powers under the national gas law to require gas network businesses to use the confidentiality template in the guideline during gas determinations. Further, all energy network businesses must use the template to respond to notices we issue using our information gathering powers under the national electricity and gas laws.

We ask that all other stakeholders use the confidentiality template if they want to submit confidential material to us. There is no binding obligation for other stakeholders to do this. However, we consider the benefit of following our confidentiality process is a robust and transparent regulatory process for all our stakeholders.

6 Further information

This section summarises the elements in each Better Regulation guideline, and provides information on where to obtain further information.

6.1 The Better Regulation guidelines

The Better Regulation web page on our website at http://www.aer.gov.au/Better-regulation-reform-program has the factsheets for all our guidelines, and links to the web page for each workstream. There you can access the guideline documents, accompanying explanatory statement and factsheet for each workstream.

Workstream	Purpose	Guidelines
Expenditure forecast assessment	Describes the process, techniques and associated data requirements for our approach to setting efficient expenditure allowances for network businesses.	Expenditure forecast assessment guideline for electricity distribution Expenditure forecast assessment guideline for electricity transmission
Expenditure incentives	Creating the right incentives to encourage efficient spending by businesses and share the benefits of efficiencies with consumers.	Capital expenditure incentive guideline for electricity network service providers Efficiency benefit sharing scheme for electricity network service providers
Rate of return	Sets out how we determine the return that electricity and gas network businesses can earn on their investments.	Rate of return guideline
Consumer engagement	Sets out a framework for electricity and gas service providers to better engage with consumers. Aims to help businesses develop strategies to engage systematically, consistently and strategically with consumers on issues that are significant to both parties.	Consumer engagement guideline for network service providers
Shared assets	Outlines how consumers will benefit from the other services electricity network businesses may provide using the assets consumers pay for.	Shared asset guideline
Confidentiality	Sets out how energy network businesses must make confidentiality claims over information they submit to us. This guideline balances protecting genuinely confidential information with ensuring that stakeholders can access sufficient information on issues affecting their interests.	Confidentiality guideline
Power of choice implementation (RIT-D)	Establishes consistent, clear and efficient planning processes for distribution network investments in the national electricity market.	Regulatory investment test for distribution Regulatory investment test for distribution application guidelines
Consumer challenge panel	Provide an independent consumer perspective to challenge the AER and network service providers during determination processes.	n/a

6.2 Our consultation process

As part of the Better Regulation program we:

- Published a series of guidelines in November and December 2013.
- Established the Consumer Challenge Panel within the AER on 1 July 2013.

- Established a consumer reference group (CRG) to make it easier for consumer representative groups to have input into the Better regulation consultative process through workshops and discussions, without necessarily lodging formal submissions.

Each guideline released an issues paper in early 2013 calling for written submissions. We then held at least one workshop per workstream, prior to the draft guidelines being published in August 2013. Following the publication of the drafts, there was another round of consultation and written submissions, prior to the final guidelines being released over November and December 2013.

We focused heavily on direct consultation through workshops, forums, and bilateral meetings. We held almost 140 meetings with stakeholders over the course of the program.

We established the CRG of 21 members representing the spectrum of consumer interests. The CRG met regularly throughout the program, including two face-to-face meetings funded by the AER. In addition, the CRG created sub-groups on each workstream. This allowed consumer representatives to specialise in particular workstreams and to report their views to the full CRG for further consideration and comment. The CRG and sub-groups met on over 20 occasions during the program, and members also attended the broader workshops and forums.

We were committed to keeping stakeholders well informed on our work in the Better Regulation program as a whole, we:

- held an Australia-wide video conference at the start of the program for all stakeholders
- published a monthly newsletter highlighting the previous month's events and the current month's upcoming events, along with a 'spotlight' section on a particular workstream's
- regularly updated a calendar of events on our website
- published policy papers with perspectives on how the guidelines fit together.