

# Process for reviewing the rate of return guidelines

Response to AER Consultation Paper

28 August 2017

## Contents

|    |                              |   |
|----|------------------------------|---|
| 1. | Overview                     | 3 |
| 2. | Review timeline              | 3 |
| 3. | Proposed review process      | 4 |
| 4. | Additional issue - open data | 7 |
| 5. | Recommendations              | 8 |

## 1. Overview

Energy Networks Australia welcomes the opportunity to respond to the Australian Energy Regulator (AER) Consultation Paper *Process for reviewing the rate of return guideline*. Network businesses support the AER's objectives and efforts in openly setting out and consulting upon its proposed process early.

Many elements of the AER's proposed process align with industry's proposals for this process. These include:

- » *Greater consumer participation* - the AER has proposed this through the Consumer Reference Group, Consumer Challenge Sub-Panel as well as targeted workshops and information sessions; and
- » *'Hot tubbing' of expert advisers* - to identify material issues of agreement and disagreement.

The AER's proposed timetable should allow sufficient time for all participants to reasonably engage and provide input to the development of the final guidelines.

Network businesses understand that energy prices are a concern to consumers and will contribute to establishing guidelines that deliver outcomes that are in the long-term interests of consumers, including by ensuring network businesses are able to achieve a reasonable and sustainable return on investment.

Energy Networks Australia members are committed to open and constructive engagement with the AER, consumers and other stakeholders, with the objective of contributing to the development of a rate of return guideline that is capable of being accepted and applied by all parties.

## 2. Review timeline

Energy Networks Australia strongly supports the extended process set out by the AER in the Consultation Paper.

The timeline appears appropriate, noting that there does need to be sufficient flexibility should any revisions to relevant National Electricity and Gas Rule provisions be made that fundamentally impact on the nature of the task that the AER has.

There is the potential for this to arise through ongoing COAG Energy Council policy development processes. The Council's April Communique indicates that it is undertaking further work on a possible binding rate of return guideline.

If this work results in key concepts for decision under the Rate of Return guidelines changing, by virtue of amendments to the relevant rules, there would need to be a careful evaluation of the appropriateness of reliance on any preceding consultation that was predicated on materially different rule provisions.

## 3. Proposed review process

### 3.1 Consumer Reference Group and Consumer Challenge Panel

Energy Networks Australia supports the proposed formation of a Consumer Reference Group (CRG) and the dedicated Consumer Challenge subpanel (CCP). Network businesses support a dedicated consumer focused channel of information dissemination and input.

Network businesses consider the activities and considerations of the Consumer Reference Group could be positively supplemented by periodic convening of extended meetings of the Consumer Reference Group as a broader 'Stakeholder Engagement Group'. This could usefully involve the invited participation of representatives of network service providers, and other relevant parties such as financial investors, and take the form of additional workshops, for example.

Energy Networks Australia would welcome opportunities for the Consumer Reference Group (and the CCP), networks and any economic experts or advisors to jointly engage with the AER, to facilitate dialogue and assist in information sharing on critical rate of return issues for both customers and networks.

This type of engagement has occurred in the recent AER review of inflation process and has positively contributed towards aligned expectations and improved stakeholder transparency. Furthermore, expanding consumer workshops in this way would assist network businesses efficiently engage with stakeholders rather than, for example, establishing a separate stakeholder group.

### 3.2. Issues Paper

Energy Networks Australia supports the AER Issues Paper to be released in October setting out preliminary views on potential areas of high, medium, and low focus for the AER's further considerations. This could also assist stakeholders better understand, to the extent possible, the outcomes and implications of the substantial legal reviews undertaken over the past few years.

In our view the Issues Paper can best foster reasonable stakeholder engagement by providing early views into the review, even if these views are exploratory or indicative in nature, rather than the Issues Paper only focusing on high-level questions seeking stakeholder input.

This approach would enable stakeholder submissions to quickly establish the scope of issues and their level of importance; that is, those requiring greater or lesser focus through the remainder of the review. In turn, this would enable the 'hot tub' expert advisory phase to focus on areas of greatest significance and most potential benefit.

### 3.3. 'Hot-tubbing' of expert advisers

Energy Networks Australia supports the proposed introduction and role of 'hot-tub' expert advisory processes as set out in the Consultation Paper.

The operation of the mechanism could be further developed in consultation with stakeholders to assist in achieving outcomes that are accepted and supported by all parties. Key design features for transparency and maximizing its value to the deliberative process would be:

- » **Transparency** – the AER's approach contains a number of features supporting transparency. Two additional suggestions are that the face-to-face sessions be as publicly accessible as possible, with parties having the capacity to observe the proceedings (in person or via webcast), and that a transcript or agreed summary of the session be published shortly afterwards. This latter suggestion is consistent with past useful AER practice in a similar roundtable session in the 2009 Statement of Regulatory Intent on cost of capital parameters review process;
- » **Flexible and iterative** – experts should have the capacity to iteratively ask for other experts' views, to draw out specific issues in contention, frame matters for further AER consideration and investigation, and establish common ground; and
- » **Open to input** – though fully interactive involvement of all attendees will be impractical, mechanisms could be established for key stakeholders to be able to pose questions to the experts, in addition to AER Board members.

Energy Networks Australia looks forward to further discussions on the potential details on how appointments are made and the operational processes of both the expert hot-tub and the independent review panel. This is to ensure transparency and confidence of all critical stakeholders in the process and reasonableness of any conclusions reached through access to relevant technical, regulatory and economic expertise.

### 3.4. Independent panel review of the draft guideline

Energy Networks Australia supports the proposal to utilise an independent expert panel as an enhancement to the current process, and one that has been used by comparable international regulators such as the NZ Commerce Commission.

Similar high-level principle considerations that apply to the expert advisory 'hot-tub' process discussed above in Section 3.3 also apply to the operation of the expert panel. For example, as a core element of transparency the expert panel review report should be made publicly available at the time it is completed.

#### 3.4.1 Task definition

The task definition of the expert panel is critical to its value in the process. The removal of access to limited merits review for network determinations represents a material change in the overall operation of the rate of return and revenue setting

process. This has flow-on implications which should be considered for the appropriate scope of the independent expert panel to enhance acceptance and support of the outcome by all stakeholders.

The expert panel review process could be enhanced from the role outlined in the process paper to a role in ensuring the outcomes of the rate of return guideline are soundly based, well-evidenced, and free of errors that may impact the long-term interests of consumers.

Optimum benefit from the time and resources of the panel will be achieved by ensuring the independent scrutiny is not too narrowly defined but covers core elements of the AER's analysis, decision-making and the practical outcomes of its decisions.

Network businesses support the objective of the panel review avoiding duplication of the extensive consultation and evidence-gathering process undertaken by the AER.

However, it should be noted that, in its essence, the function and confidence-enhancing benefits of an independent review panel requires empowerment in its role to fully assess the deliberative elements of a decision-makers' task and the conclusions it reaches.

That is, an independent review panel should be able to pass commentary on, and substantively influence a decision-making process. In this regard it is noted that the New Zealand Expert Panel process has drawn on internationally recognised cost of capital and finance expertise such as Stewart Myers and Julian Franks, and has a broad remit to examine the advantages and disadvantages of a range of models, as well as methodology and estimation issues. Recent expert reports have provided extensive guidance to the Commerce Commission on the questions it has faced.

The existing task is described in the AER Consultation Paper as assessing whether:

*...the AER has conducted an effective review process, engaged with the material before us with an open mind, and have reached a decision that is supported by our stated reasons and the information before us.*

The AER has invited views on whether there are alternative approaches to obtaining meaningful contributions from the review process, and on the appropriate role of the independent panel.

ENA has several proposed modifications of the AER's proposed task for the panel:

- » **Testing of the results or outcomes** – the expert panel should be tasked with assessing whether the outcomes that result from the application of the AER's proposed models, methodologies and data are, in the view of the panel, likely to achieve the policy objective set out in the allowed rate of return objective.

As an example, this would involve the expert panel considering whether the 'real world' application of a proposed foundation model, using the data inputs and parameter estimate approaches of the AER, would produce a cost of capital estimate that ensures the long term interests of customers are taken into account by:

- providing network businesses with a return consistent with the efficient financing costs of the benchmark efficient entity with a similar degree of risk as that which would apply to a network providing the regulated services; and
  - is otherwise consistent with the allowed rate of return objective in the rules, taking into account National Electricity Rule Clause 6.5.2 (and National Gas Rule equivalents).
- » **Linkage between evidence and information and the decision** – the expert panel should be requested to establish whether the reasons contained in the AER’s decision, including in relation to any exercises of discretion, provide a sufficient link between the evidence and information presented before the AER and the reasonableness of the decision itself.

These suggested modifications are intended to enhance the capability of the decision being accepted and applied by all stakeholders by emphasising the need for enhancement of a clear and discernible link between the evidence and information available, and the reasonableness of the decision itself. This is an important public policy aspect for those that are materially impacted by a decision.

### 3.4.2 Composition of panel

Network businesses support the AER’s view that experts should be well-qualified, free of conflicts of interest, and independent from day-to-day AER rate of return processes.

Consideration should also be given to use of capital market practitioners or independent economic expertise, for example, potentially including input from the Reserve Bank of Australia, the Productivity Commission, the Australian Office of Financial Management or the Future Fund.

A restriction that Panel members must not have been engaged to provide advice to a network business or the AER on any AER regulatory determination process within the preceding two years is appropriate given the value in fostering confidence in panel members’ independence. Energy network businesses consider that the restriction should be framed to equivalently apply to recent prior engagement on behalf of customer advocacy groups or direct participation in a Consumer Challenge Panel.

ENA considers that consistent with the goal of seeking to rely on expertise which is independent from recent cost of capital determination processes and associated proceedings, that this restriction should be extended to members of the Competition Tribunal that have heard rate of return related matters within the past two years.

## 4. Additional issue – open data

In the interests of promoting transparency, the AER review process and expert reports should be based on open, web-accessible data sources. The AER and its consultants, and stakeholders and their consultants should also undertake to make any models developed for this process freely available to all other stakeholders, to

enable interested parties to see what makes the various models “tick”.

Conversely, where data or models were challenged, or alternative evidence was provided, industry and consumer groups would be expected to provide their data/models in an accessible format as well.

## 5. Recommendations

### Recommendations

1. The positive independent review panel process should be further enhanced with:
  - Publication of the expert report at the time of its completion;
  - Assessing whether the outcomes that result from the application of the AER’s proposed models, methodologies and data is likely to achieve the policy objective set out in the allowed rate of return objective; and
  - The expert panel being required to evaluate the linkage between the evidence and information available to the AER and its decision.
2. The proposed Consumer Reference Group process should be enhanced by providing opportunities for broader stakeholder input and information-sharing sessions.
3. AER Issues Paper should set out preliminary views on potential areas of high, medium, and low focus for the AER’s further considerations.
4. The expert advisory ‘hot-tub’ process should be transparent to all key stakeholders, with a published transcript and/or agreed meeting summary/outcomes.
5. Movement to standardised web accessible data should be promoted.