

Pathway to the 2022 Rate of Return Instrument

Response to Consultation Paper and Rate of Return Annual Update

20 December 2019

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Key messages

- » **The design of the instrument review process should follow from purpose** - The rate of return instrument process needs to be designed with direct reference to how each step will advance clearly defined purposes
- » **A balanced treatment of evidence and outcomes is critical** - The pathway to the 2022 instrument needs to better take into account stakeholder feedback on improving the balance in the treatment of evidence compared to the previous guideline process
- » **More significant changes are needed to build confidence** - Network businesses have developed a range of suggested improvements to the proposed process which would contribute to building confidence in both the process and outcome (See Section 4)

1 Overview

Energy Networks Australia (ENA) welcomes the opportunity to respond to the AER Consultation Paper *Pathway to the 2022 Rate of Return Instrument*.

As a key participant in the 2018 Rate of Return review process, ENA recognises that significant AER and stakeholder efforts were directed toward the goal of reaching a rate of return instrument that promoted the long-term interests of customers consistent with the National Electricity and Gas Objectives.

A range of parties – including ENA and its members – approached the 2018 review with a positive and public commitment to trialling new approaches and techniques to reach the best possible outcome, including a decision that would enhance stakeholder confidence in relation to this important economy-wide regulatory setting. This commitment is continuing.

Network businesses consider it is important to revisit a critical purpose of the review process – in particular- the AER’s goal of enhancing stakeholder confidence in the decision process and outcome – as consideration is given to the pathway to 2022.¹ This should enable the process to be specifically designed to contribute to achieving this purpose.

This need arises because networks and other review participants do not consider the 2018 rate of return instrument review delivered an outcome that adequately took into account information, evidence and input provided. A consistently reported theme of

¹ AER *Consultation Paper Pathway to the 2022 Rate of Return Instrument*, November 2019, p.6

feedback provided to the AER through the Brattle Report *Stakeholder Feedback on the AER's Process for the 2018 Rate of Return Instrument* is that a range of network and investor stakeholders considered the 2022 instrument review would need to build confidence that a balanced treatment of evidence would occur in relation to rate of return approaches, data and methodologies.²

A thorough examination of the proposed 2022 review process taking into account the above feedback, with a positive openness to consider substantive changes in both process steps and more critically AER decision-making approaches is an opportunity to respond to this feedback.

To assist the AER in taking forward these matters, energy network businesses have prepared a set of initial proposed enhancements to the process proposed in the Consultation Paper for discussion (See **Section 4**).

Through further steps in this review, ENA and its members are also keen to collaborate with both the AER and the full range of affected stakeholders to consider further substantive changes that would promote the goals of a review process which features enhanced confidence, transparency and predictability.

2 Evaluation of 2018 review

2.1 Scope of review impacts

The outcome of the AER's rate of return instrument review is likely to be the single most important regulatory decision impacting on infrastructure investment and usage decisions made across the entire Australian economy.

This is because it impacts every grid customer across the National Electricity Market, all customers of regulated gas distribution networks in eastern Australia, and indirectly influences investment and infrastructure usage signals across the entire Australian economy over decades to come. The decision also impacts financial returns on around \$100 billion of existing investment, as well as billions of dollars of capital expenditure financed annually by networks to support safe, reliable and efficient network services to customers.

For this reason, it is critical that the review is a robust, evidence-led process enabling the full range of data, evidence and models to be tested and discussed by all stakeholders.

It is crucial that all stakeholders have confidence that the process is one that ensures that all relevant evidence is properly considered in a balanced way and that the outcomes properly reflect the weight of evidence.

² Brattle Group *Stakeholder Feedback on the AER's Process for the 2018 Rate of Return Instrument*, 27 June 2019, p.10-12

2.2 Network perspectives on the 2018 review

2.2.1 Lack of clarity in proposed approach to stakeholder feedback

Network stakeholders raised a number of significant concerns with AER staff, leadership and Board through the 2018 review around the treatment of evidence, the outcomes of the review, and the AER's explanations of its reasoning. Specifically, network stakeholders raised significant concerns that the AER process risked being perceived as featuring predetermined outcome such that:

- empirical evidence that was inconsistent with a reduction in rate of return outcome was dismissed with insufficient reasoning; and
- weak evidence that was consistent with an outcome of reducing the rate of return was given inappropriate weight.

Many of these concerns were repeated and comprehensively detailed by stakeholders in the subsequent Brattle review. For example, the Brattle review noted the following observations from stakeholders:

There was a perception among some stakeholders that the AER applied higher standards of evidence to submissions from groups seen to be aligned with networks than to those seen to be aligned with consumers.³

[S]takeholders from both network and consumer groups thought that the AER did not substantively engage with the evidence that the stakeholders presented during the process. Stakeholders thought that the AER did not provide adequate reasoning for its positions in its decisions. Relatedly, stakeholders perceived that the AER's decisions did not necessarily treat issues in a way that corresponded to the importance that stakeholders assigned to the issues.⁴

Stakeholders claimed that evidence that pointed towards a lower rate of return seemed to be accepted or given greater weight, whereas evidence pointing towards a higher rate of return seemed to face a much more critical review, or that the AER appeared unwilling to ignore countervailing evidence even if it had major flaws.⁵

In another example, the networks presented evidence that inputs into estimations for beta and the MRP considered by the AER had increased since

³ Brattle Group (2019), p.10

⁴ Brattle Group (2019), p.10

⁵ Brattle Group (2019), p.10

2013, yet in the AER's 2018 decision, values for beta and the MRP decreased. These stakeholders claimed to have lost confidence in the process as a result of the AER's inconsistent assessment of evidence. Stakeholders highlighted that while the AER allegedly said throughout the process that the networks submitted good evidence, none of this evidence seemed to have weight in the final outcome.⁶

Stakeholders cited several instances where the AER did not provide satisfactory reasons for taking or not taking information into account. These stakeholders felt that there was a sense of inevitability in the outcome of the review (i.e., the outcome was somewhat pre-determined) and that the evidence they provided against this outcome was ignored.⁷

Stakeholders said the AER had created crosschecks to test whether its proposal for the return on equity was reasonable. However, the return on equity that the AER determined did not pass the crosschecks that the AER had set up. When the AER proceeded with this return on equity, it provided no reasoning for discounting the result of the crosschecks.⁸

More generally, stakeholders thought that there were insufficient opportunities at times to provide further evidence when the AER dismissed a submission's evidence.⁹

The Consultation Paper does not appear to address these serious concerns. Instead it indicates that in using an external body to conduct the process, the AER sought to encourage discussion about the process and not the content or outcomes of the 2018 review.¹⁰

ENA considers that the way in which the AER assesses the evidence is the most important aspect of any review process for all stakeholders. It is important that the way in which the AER goes about assessing the evidence and setting out that assessment, which was a key focus of the Brattle review document that reflects the concerns of stakeholders, is at the core of planning for the 2022 instrument process. The centrepiece of that process must be consideration of how the AER might build greater confidence in the way it goes about assessing evidence in a balanced way.

In this regard, the AER is currently proposing to retain the same basic structure to the process of the next review. This leaves it unclear how ongoing concerns around the

⁶ Brattle Group (2019), p.11

⁷ Brattle Group (2019), p.11

⁸ Brattle Group (2019), p.11

⁹ Brattle Group (2019), p.12

¹⁰ AER Consultation Paper Pathway to the 2022 Rate of Return Instrument, November 2019, p.1

balance, approach and treatment of evidence in the past review will be addressed in the planned 2022 review.

It would strengthen confidence and transparency for the AER to work with stakeholders and indicate how it is responding to feedback given by a significant segment of review participants that the 2018 process did not lead to a reasonably balanced assessment of the evidence, but rather that the process risked a perception that it delivered a predetermined outcome.

The AER Consultation Paper asks many of the same questions as stakeholders have responded to in the Brattle review.¹¹ Perspectives on and stakeholders' answers to any of these questions are set out in the final Brattle report. The most productive area of focus therefore is likely to be around how the AER proposes to change its processes and approaches to address the stakeholder concerns expressed, particularly in relation to restoring confidence of all stakeholders in a balanced assessment of evidence.

2.2.2 Ensuring confidence in treatment of evidence

A multi-staged process, incorporating largely identical process elements, over a slightly extended timeline does not represent a response to material concerns put by networks and other stakeholders around the balanced assessment of evidence and significant unexpected changes in AER approach through the previous review.

In particular, there is no *a priori* reason to consider that lengthening the same process is likely to result in greater confidence around a more balanced assessment of the evidence.

A critical purpose of an extensive consultative review process should be to bring to the AER the best available evidence, data and models to inform its decisions on rate of return issues. This is important to the goal of the AER making an evaluative assessment of rate of return matters that best promotes the National Energy Objectives (i.e. the NEO and NGO) and gives effect to the binding rate of return legislation.

Part of ensuring decisions that best promote the National Energy Objectives are decisions which are widely identified as independent and based on a balanced consideration of best available evidence. This will promote confidence in and the transparency and stability of the framework, which in turn reduces the efficient cost of financing energy network infrastructure – driving down prices for customers.

In this way, the instrument consultation and review process are ultimately a means to the end of a decision which meets the National Energy Objectives and enjoys the confidence of major stakeholders. If it has not delivered on that outcome, it has materially failed in its principal objective.

¹¹ AER *Consultation Paper Pathway to the 2022 Rate of Return Instrument*, November 2019, p.19

The AER Consultation Paper indicates its aim for an ‘accessible, transparent and collaborative’ instrument, to promote confidence in decisions.¹² AER has received strong feedback from a range of stakeholders that the existing process has not led to this outcome of confidence. An important focus going forward, therefore, is the best means of restoring and strengthening this confidence. This outcome will not be achieved by minor or incremental modifications to individual process steps of the review.

Energy Networks Australia have developed a number of proposed steps and approaches for the 2022 instrument review which would assist in providing greater confidence in the treatment of evidence.

Taking as a specific illustrative example the tasks surrounding the preparation of its explanatory materials, the AER could:

- » where it disagrees with the Concurrent evidence session or Independent Panel, undertake to clearly explain why and what evidence they rely upon.
- » where the AER rejects empirical evidence, show clearly that issues which are said to potentially exist and impact on its reliability do actually exist and are material.
- » where cross checks are used, make a clear pre-commitment as to how they will be used and, more importantly, how failure to pass a cross-check will be judged and what changes to the outcome would be put in place where failure occurs.

A suggested set of broader and substantive process enhancements which relate to the gathering and analysis of evidence and the formal process of the review are summarised in **Section 4** as a basis for further discussion.

2.2.3 Goal of a well-evidenced and predictable outcome

While perspectives on outcomes of the 2018 instrument process may differ, it would not be a robust or adequate response to stakeholder concerns for the AER to indicate that on balance consumer groups considered the rate of return was too generous, and network and investor stakeholders considered the estimate too low.

Areas of focus and desired long-term outcomes are shared between participants, however, the determination of a best estimate of a forward-looking rate of return is not a consensus-based activity. The AER is empowered and obligated to make the best possible decision based on the available evidence, regardless of whether a broad set of stakeholders agree – this is part of the function of being a statutorily independent regulator.¹³

In these circumstances, it would be inappropriate for the AER to assess its own performance on simple ‘rules of thumb’ such as whether the balance of stakeholder views appeared to support its decisions. Rather, the AER should seek to develop and

¹² AER *Consultation Paper Pathway to the 2022 Rate of Return Instrument*, November 2019, p.6

¹³ See for example *National Electricity Law*, s.181(3)-(5) and s.18R

reliably measure key performance indicators and metrics around the review process (these are discussed in **Section 4**).

Any approach which defined reasonableness by reference to ‘all parties appear equally unsatisfied with the outcome’ would not serve the long-term interests of consumers, as it would self-evidently create perverse incentives for all parties to seek to adopt more extreme positions simply to affect the likely ‘band’ of outcomes.

There was an illustration of the potential operation of this process in the 2018 review. For example, the AER Consumer Reference Group – a body supported by access to, and briefed by, AER technical staff, publicly advocated in presentations to AER stakeholder forums a rate of return for network infrastructure comparable to government guaranteed cash term deposit rates.

Left unchecked over time, incentives arising from any even informal ‘parties equally unsatisfied’ decision assessment criteria will undermine incentives for more constructive engagement and ‘difference narrowing’. Such a criteria would also cloud the actual function of the instrument review– establishing an unbiased forward-looking evidence-based assessment of the opportunity cost of capital that promotes the National Gas and Electricity Objectives.

3 Proposed review timeline and process

3.1 Review timeline

ENA supports the proposed extension of the instrument review. Some aspects of the 2018 guideline review process were unduly time-constrained and consequently ineffective. For example:

- » The AER was unable to rely on key aspects of the Joint Experts Report because it considered that not all experts were able to properly engage with that process; and
- » It is unclear whether the Independent Panel had sufficient time to either read Energy Networks Australia’s submission in response to the Draft Guideline, or time to properly engage with the main issues raised in it.

A lengthening of the timelines would also potentially permit greater stakeholder engagement with any AER Issues Papers released through the process, which were highly clustered in time in the 2018 process.

3.2 Review process tasks

One way to approach the proposed review process is to consider the series of ‘jobs’ or tasks to be completed through the process and identify which party can best carry them out.

This functional definition could reduce role duplication and provide clarity to each element of the process. The objective for the AER should be to have these individual

roles defined and well-understood well in advance of the review – with resourcing decisions flowing from these role definitions.

The table below sets out some of the primary tasks of consumer representatives through the review, with ENA’s direct observation (as a participant) on which party appeared to be primarily responsible for each task in 2018. This may provide assistance to the AER as it considers the process steps and stakeholder engagement context for a future instrument review.

Table 1 - Rate of Return Instrument review tasks

Task	Who carried this out in 2018 review
1. Representing the views and perspectives of <u>current</u> consumers on potential investment and reliability trade-offs	Consumer Reference Group – however, it was at times unclear by what mechanism CRG gathered or tested views attributed to consumers
2. Representing the interests of <u>future</u> network users where these differ from current users	Unclear - without a party specifically tasked with representing the interests of future customers, there is a material risk that shorter-term perspectives can be prioritised
3. Providing an alternative consumer focused set of technical evidence and arguments/experts	CCP/CRG
4. Identifying priority issues for the review for consumers	CCP/CRG
5. Discussing or reaching shared positions on preferred AER instrument positions	CRG – the CCP appeared to reach and advocate different positions than adopted by CRG which caused confusion about which view best represented customer views

A critical gap in tasking is apparent in the absence of a clearly defined representative for *future* consumers and grid users.

This is important because rate of return decisions critically affect long-term investment signals and consumer outcomes. Directly, for example, a rate of return instrument can have an operational impact on network investment incentives up to 9 years following its finalisation.

Where the typical network asset life may be 40-60 years, this can mean that consumers and grid participants who have no opportunity to participate in any given instrument review will nonetheless have the performance, capacity and nature of network services available to them critically shaped by an AER instrument decision made decades previously.

Indirectly, investment signals from an individual instrument could be expected to have even longer cumulative impacts, due to their impacts on the timing or permanent deferral of different types of investments.

Networks have a role in representing the interests of their future customers, and a clear incentive to do so. Nonetheless, future customers deserve a clearly separate and identified advocate and voice through future review processes, able to independently articulate the perspectives of prospective and future consumers and grid users.

3.3 Consumer Reference Group

The binding instrument legislation indicates that the Consumer Reference Group (CRG) may:

...carry out its activities, including giving advice or recommendations to the AER about the instrument, in the way it considers appropriate.¹⁴

This would appear to require the AER to consult with the CRG once formed about its manner of operation.

In network businesses view, it is important that the CRG has – and is seen to have – this envisaged independence and autonomy for increasing consumer confidence in the process. As an example, a CRG which is directed to only consider a subset of issues by the AER would not be serving its function or promote consumer confidence in the outcome of the review.

Equally, the CRG has an obligation to customers and taxpayers to ensure its resources are efficiently utilised and focused on the issues materially relevant to the making of the draft instrument. Once the role and function of the CRG is determined, key output focused performance indicators should be established and publicly reported through the process. This would provide confidence in the transparent and effective functioning of this body.

Decisions on resourcing for the CRG should flow from their intended function and role in the review. These decisions should take into account whether this role would involve the CRG in:

1. **Gathering consumer views directly and validating positions CRG proposes to advance in the review**

In the 2018 review, the CRG appeared to have no resourcing or independent capacity to survey consumer views and was consequently restricted to drawing inferences from individual Reference Group members' experiences and broader consumer research about what consumers wanted. Network businesses were not aware of any clear evidentiary base to support some positions initially advanced by the CRG around the balance of investment and reliability-related risks consumers were supportive of, and it was unclear how these positions could be

¹⁴ *National Electricity Law*, s.18N(1)(b)

reconciled to the systematic consumer feedback that was collected by networks on the same topic via their consumer engagement programs.

2. Commissioning of independent or joint industry/CRG work

This could provide the basis for agreed expert reports on individual review issues, a concept collaboratively trialled by ENA and CRG on some issues in the 2018 process.

3. Undertaking ongoing collaborative discussions and 'negotiations' with other stakeholders

This could cover the operation of the instrument review process, priorities for AER attention, or substantive matters under review. This type of engagement was trialled in an initial way, including reaching shared position on some narrow technical issues around averaging periods, through the 2018 review.

3.4 Consumer Challenge Panel role

The Consumer Challenge Panel (CCP) should play a different role than it played in the 2018 review, in which it largely appeared to advocate for a single directional downward movement in regulatory returns.

The CCP's role as a 'critical friend' in a review process should see it in some cases, when the evidence indicates it is appropriate, arguing that aspects of the AER's approach to parameters or other issues may result in an underestimate of required returns. This does not appear to have occurred in any identifiable instance across the dozens of methodology or parameter estimation issues considered in the 2018 review.

In contrast, across a range of parameters, energy networks supported maintaining a number of parameters at levels materially below where relevant empirical evidence using AER methodologies updated for new evidence suggested these parameters lay.

To this end, the CCP should be provided with guidance - noting that the CRG is representing a consumer perspective - to focus its analysis on providing a balanced assessment of evidence. This should include identifying instances of potential underestimation by the AER where appropriate - from the perspective of ensuring the interests of future and potential users of network infrastructure in ensuring efficient levels of investment are represented.

In addition, the CCP should play a role adapted to the specific circumstances of the instrument process - in which it is the AER making a draft and final proposal that will be binding on all parties - in assessing the level and adequacy of consumer engagement undertaken by the AER and Consumer Reference Group in the review.

This role appropriately reflects the specific design and operation of the binding instrument framework, in which networks do not propose a rate of return for acceptance by the AER and which is completely distinct from a network proposal and determination process. Rather, under the binding instrument legislative framework the AER has the full responsibility under the framework to develop, draft and make a binding instrument which discharges its NEO and NGO obligations in a manner

consistent with the Revenue and Pricing Principles and consistent with the Rules framework.¹⁵

3.5 Investor and Retailer Groups

Energy Networks Australia did not have direct experience with the operation of either the Investor or Retailer Reference Groups established by AER.

As an observation from participation in the broader instrument process, however, the conduct of these Reference Groups appeared to be quite 'siloed' and it was not clear how the AER had incorporated different perspectives of the Groups in its decision-making.

Generally, ENA considers that there are opportunities to better utilise the Investor Reference Group, including the potential for joint meetings between networks and these Reference Groups.

3.6 Concurrent evidence sessions

The concurrent expert sessions were useful and there should be additional sessions to ensure that there is an opportunity to properly consider all issues that are both contentious and material.

The process for the expert session should enable a focus on areas of different perspectives, and the evidence which supports these different views. Provision of more time prior to the expert sessions would enable this to occur more effectively than was possible in the 2018 review.

The experts should confer prior to each session to determine where they agree and where they disagree, and to develop a series of precise questions or issues to be discussed during the session.

Ideally, the experts would summarise their views in a joint report prior to each session, so the discussion in each session could be appropriately targeted. This would overcome one weakness of the 2018 process, where significant portions of the expert sessions were allocated to areas or issues:

- » where there was no real disagreement among experts; or
- » that were beyond the control of the AER (such as whether the instrument would be legislatively binding).

The process of the production of a final written report summarising areas of agreement or common ground and disagreement or differing views is a useful resource for all stakeholders and should enable the steady narrowing of views over time (or clarity about the assumptions and evidence they are based on).

¹⁵ See for example *National Electricity Law*, s.181(3)

For transparency and regulatory confidence in relation to this single critical regulatory decision, it is vital that interested stakeholders are able to:

- » attend and witness the sessions; and
- » understand through written pre-session and post-session reports areas of common ground and where views differ.

Experts should be provided for the entirety of each session and be able to discuss and be questioned on any issue in their area of expertise. This is to be preferred over fostering a system of parties (including the AER) 'swapping out' experts for different sessions.

Experts contributing to the Concurrent Sessions and associated reports should formally undertake to offer their professional expertise on an independent basis, for the purpose of assisting the AER make its determination. In particular, where an expert is indicating a view in the Sessions or reports, they should have a positive obligation to identify any material inconsistencies with past academic or expert opinions expressed, and disclose reasons why their previous views have changed, or can otherwise be distinguished on the facts of the present matter.

In moving to a draft instrument, the AER's draft explanatory statement should indicate clearly where it has disagreed with any agreed positions taken by experts and should fully identify its reasons for doing so.

3.7 Independent Panel

3.7.1 Independent Panel role

The AER has indicated that a key purpose of the Independent Panel is to promote stakeholder confidence in both the process and the ultimate decision, by increasing transparency and confidence in the development of the instrument.

To undertake this function, the Panel needs to form a view on whether the rate of return resulting from the draft and final instrument is appropriate – not just 'capable of promoting' the National Energy Objectives. As the AER has itself argued in the past, a broad range of rate of return outcomes are conceptually capable of contributing to the achievement of the National Energy Objectives.

An independent review which does not consider the actual quality of decision-making and reach a view on whether the actual rate of return approach proposed is appropriate and will promote the required legislative objectives to the greatest degree will not provide:

1. incentives for a high-quality decision based on sound evidence;
2. guidance to the AER on errors or weaknesses in its proposed approach, noting that no alternative independent mechanism now exists for addressing these issues;
3. confidence to external parties that the reasoning and impact of the regulator's decision has been meaningfully assessed against a rigorous standard.

Rather, if the task of the Panel is restricted to the narrower and lower standard of the draft instrument just being 'capable' of contributing to the National Energy Objectives, the Panel's focus naturally could be misdirected to superfluous commentary on issues not in contention, or guidance as to how reasoning could be better expressed, leaving substantial evaluative judgements critical to the decision content entirely unexamined.

This risk has arguably already been realised under the current approach. The 2018 Independent Panel report contained significant guidance to the AER on areas where it merely needed to 'explain' its decision more clearly. Requests for the AER to 'explain' or 'clarify' its reasoning made up two-thirds, or 20 of the 30, of the specific recommendations of the Independent Panel.¹⁶

The Panel further discussed issues such as the rounding of parameters and taking the gamma estimate to three decimal places (a technical issue which was not even disputed in a previous series of Competition Tribunal cases). This appeared to be a lost opportunity in which significant Panel resources were directed to a number of immaterial issues which were not priorities for any stakeholder.

The AER's Consultation Paper indicates a concern with the risk of 'blurring the lines' of AER Board authority if the Independent Panel undertakes the role of making a 'separate decision'.¹⁷

There is no necessary basis for this concern to impact the question asked of the panel. The legislative responsibility for making the decision, and the basis for the AER making it is clearly set out in specific enabling legislation which the AER has previously indicated it considers allows the sound exercise of its functions.¹⁸ There is no basis for any confusion as to the final identity and authority of the AER in making the instrument.

Further, the AER's position that the Panel will not be provided any material in addition to that before the regulator entirely removes any prospect of the Panel being viewed as a form of additional or substitute decision-making body in the process.

3.7.2 Panel's consideration and ensuring focus on material issues

Through the 2018 review, stakeholders (including networks) sought an opportunity to ensure that each member of the Independent Panel reviewed major submissions to ensure familiarity with the major issues in discussion in the review.

It remains unclear the extent to which the 2018 Independent Panel had any reference to any stakeholder submissions or associated expert materials. The detailed analysis and focus on matters that no stakeholder considered important, and the lack of any detailed commentary on several central contentious issues in the review appears to

¹⁶ Independent Panel *Review of the Australian Energy Regulator's Rate of Return Draft Guidelines*, 7 September 2018, p.V-VIII

¹⁷ AER *Consultation Paper Pathway to the 2022 Rate of Return Instrument*, November 2019, p.19

¹⁸ *National Electricity Law* s.18I-K and s.18R

indicate that Energy Networks Australia's submission and materials were not reviewed. This represents a striking outcome for any form of independent process of review, which is not consistent with the intended goal of enhancing stakeholder confidence.

It is clear that without greater capacity to be made aware of key issues of material dispute in the review, the Independent Panel process risks not achieving its goal of enhancing stakeholder confidence.

As an example, the 2018 Independent Panel report gave extremely brief consideration to dividend growth estimates of the market risk premium, which was one of the key elements of industry submissions and one of the most contentious and material issues discussed throughout the whole process. This is in contrast to its substantive and lengthy treatment of the number of decimal points to which gamma should be rounded (which no stakeholder had considered relevant enough to raise). This outcome indicates there may be gains to be made from exploring avenues to ensure the Independent Panel has brought to its attention critical areas of the decision for stakeholders.

To this end, there should be an optional provision for stakeholders to submit a short (5 page) summary of critical areas for review in the AER's draft instrument. The Panel should be provided copies of these summaries from each major stakeholder group engaged in the review as important background material for its task, with an expectation that these will be reviewed.

To address the AER's concerns around new material being provided to the Panel, this document could be required to be provided to the AER as a separate attachment in stakeholder submissions in response to the draft instrument.

ENA considers that it would be a useful addition for the Independent Panel to also review, and report on, the AER's final instrument. This could include any comments on how the Panel's recommendations have been addressed in the final instrument. This feedback report could then be used, for example, to inform future rate of return instruments.

4 Recommended review process enhancements

Recommended process step	Comments
Before the review	
AER should set out a purpose for the review process and design the process around that purpose.	This purpose needs to include promoting confidence in the outcome of the decision and balanced treatment of evidence.
Testing of stakeholder confidence in the process (note - both prior to the review and after).	The performance indicator should be that stakeholder confidence in the treatment of evidence, predictability and independence of the process should stay the same or increase following the review.
Establishing set of common 'agreed data'.	AER should set out the range of materials, data and evidence it proposes to rely on, and publish and provide access to this data. This would assist in enabling the review to proceed on a set of 'agreed facts'.
Pre-established return on equity cross-checks and defined responses for failures in cross-checks.	AER should define upfront its proposed cost of equity cross-checks and provide clear guidance on what actions will result from the failure of any or all of these cross-checks.
During the review	
Gather and test empirical evidence on a full range of grid customers and consumers perspectives on price/reliability and investment risk trade-offs (including drawing on established Value of Customer Reliability information)	This would provide clarity and predictability and help fully inform AER instrument decisions relating to price/reliability and investment risk trade-offs.
Draft and final decision to include discussion of how investment risks, reliability, infrastructure availability risks have been balanced.	It is important for transparency for stakeholders to understand how risks have been balanced, and how the AER has satisfied itself that this risk package best promotes the National Energy Objectives and takes account of the Revenue and Pricing Principles.
Use of financeability checks.	AER draft and final instrument should be robustly tested for their financeability impacts on the defined benchmark efficient entity

Independent Panel to be informed of priority stakeholder issues.	Stakeholders should be invited to include a 5-page summary of key issues with the AER draft instrument with their submissions to the draft instrument.
Independent Panel to be required to provide a view on the appropriateness of the draft rate of return proposed by the AER.	The existing tasking of the Panel focused on whether the AER's decision is 'capable of promoting' the NEO/NGO does not provide any material guidance on, or adequately direct the Panel to test, the strength and quality of AER methodologies or estimates.
Independent Panel to be required to separately identify in summary table form substantive recommendations, and requests for clearer explanation of AER positions	The 2018 Independent Panel report featured a predominant focus on requests for 'clearer' explanations of AER reasoning. For the assistance of stakeholders, it should be clear where the Panel has substantively queried an AER approach.
Final decision to indicate in summary table form where stakeholder input has altered the draft decision.	Indicating where a decision is different based on further information and evidence is important for transparency. The 2018 Explanatory Statement noted and mentioned evidence throughout, but did not identify where this input had changed the decision. Just as energy network businesses' regulatory proposals routinely identify where stakeholder engagement has led to different proposals, the AER should identify which specific elements of its draft instrument have been changed by stakeholder input.
After the review	
Independent Panel to be required to publish assessment of AER final instrument.	This report should indicate whether the issues it raised with the draft instrument have been addressed and provide input and learnings for the next instrument review.
Re-testing of stakeholder confidence in process after the completion of the review.	The performance indicator should be that stakeholder confidence in the treatment of evidence, predictability and independence of the process should stay the same or increase following the review.

5 Rate of return annual update

The Rate of Return Annual Update represents a significant and positive addition to available information and evidence for stakeholders on rate of return issues and is welcomed.

Generally, the Annual Update is clearly structured and contains useful and relevant information for stakeholders. The following sections provide specific suggestions to further enhance the Update, focused on structure, contents, additional measures for consideration and a number of areas where clarification would be valued.

5.1 Structure and contents of annual update

To assist stakeholders in understanding the significance of some key data and estimates, it may be valuable for further context to be provided around the use of information.

In addition, it would be valuable to see future Updates capture estimates from each of the previous years, to enable identification of trends over time.

Details of these suggestions are set out below.

Area	Suggestion	Comment
All sections - Indication of how information used	Structure of update	It would be useful to stakeholders for the AER to briefly summarise how it relied on each piece of information presented in the Update in making its 2018 guideline. This is done in some areas, but is absent from others (for example, Section 6 Market Risk Premium).
All sections - setting out past estimates	Structure of update	Ensuring each annual Update includes the full set of previous years parameter estimates would be helpful to see trends over time (i.e. 2021 update to include estimates from 2018, 2019, and 2020). Each Update could also plot the return on equity and return on debt estimates over time - similar to charts produced by IPART in its biannual WACC update.
Return on equity cross-check	Structure of update	Section 8 of the Update provides an update of only one of a number of return on equity cross-checks. It may be useful to provide an update on other cross-checks, given the AER's approach of examining the overall pattern of this information to inform its point estimate. ¹⁹

¹⁹ See AER *Rate of Return Instrument - Explanatory Statement*, December 2018, p.102

5.2 Potential additional measures and data

The Update provides useful and relevant measures and data across a range of parameters, which is welcome. Energy network businesses have a number of additional suggestions for possible data sources for tracking.

The most material of these is the proposal to progressively seek to incorporate a set of basic financeability metrics into the Update. These measures and metrics should be developed in close consultation with stakeholders, through a similar process as engaged in by the AER's Profitability Working Group in relation to profitability measures.

If feasible, some basic tests of financeability should be assessed against a notional benchmark efficient entity (BEE) with the gearing, credit rating and other characteristics consistent with those underpinning the BEE assumed in the 2018 instrument. An example of such a test could include: would the application of the instrument parameters to a notional benchmark firm, using the AER's approved Post-tax Revenue Model and current inflation estimation approach result in a negative net profit after tax on a prospective basis?

It is acknowledged that preliminary illustrative work around this topic using firm specific data occurred in 2018 around the final guideline outcomes. Annual financeability metric testing of this kind would help ensure the consistency of the risk and financing assumptions across the regulatory package applied to the benchmark efficient entity. For the avoidance of doubt, ENA is not suggesting that financeability metrics be tested against characteristics of actual network businesses in Updates.

Details of these suggestions are set out below.

Area	Suggestion	Comment
Financeability	Additional analysis	<p>Future Annual updates should include feasible financeability metrics for a firm with the characteristics of the AER's assumed benchmark efficient entity were it to be subject to the current instrument on a forward-looking basis (i.e. with no historical cost of debt transition path assumed)</p> <p>This analysis should seek to identify, for example, whether the 2018 instrument, combined with today's market rates, deliver cash flows consistent with the AER's credit rating assumptions and the resulting Net Profit After Tax from populating the AER PTRM with current market inputs and parameters set in the current instrument.</p>

Real rate of return measure	Additional data source	The annual Update should derive a real cost of debt measure, using the AER's preferred inflation measure, to enable stakeholders to understand the implied components of the AERs targeted real return approach. A real cost of equity should also be specified, consistent with the above and the AER's stated compensation target.
Figure 6 - Credit spreads from state government debt	Alternative data source	It is unclear whether spreads for 3-year State government bonds provide meaningful information on risk in the market, compared to other measures. An alternative conditioning variable not impacted by possible market perceptions around implicit Commonwealth guarantees of State government is Australian Bond spreads over government yields (see Figure 27 of the AER 2018 <i>Explanatory Statement</i>).

5.3 Areas of clarification

To promote a clear understanding and comparative use of domestic and international data, estimates of key parameters such as international betas should be undertaken on a consistent basis.

Details of these suggestions are set out below.

Area	Suggestion	Comment
Figure 3 - Presentation of international beta evidence	Clarification of data	International equity beta estimates should be presented on a basis consistent with the AER's gearing assumption of 60%, to allow for 'like for like' comparisons.
Table 11 - MRP surveys	Clarification of data	The AER presents MRP survey results from as far back as 2012. 13 of the 15 surveys presented are two years or more out of date. It would be useful if the AER could clarify what useful information such dated surveys convey about current forward expectations about the MRP.

5.4 Planned Working papers

Networks support the proposed productive use of the period before the scheduled 2022 rate of return instrument review to examine and potentially reach some initial settlement on a defined set of conceptual, methodological and estimation issues.

This will avoid important issues being inadequately considered through the instrument review phase.

Consistent with the approach taken in the early part of the 2018 guideline review process, there is likely to be value in the AER receiving input from stakeholders on potential subject areas for working papers to cover as part of this preparatory work. This would enable a clear focus of AER and stakeholder resources on issues considered to be material and relevant for review participants and the AER.

Potential useful topics for Working Papers may include:

- **Review of the current status and application of the 'standard' Capital Asset Pricing Model** - This could consider whether there are any recent or emerging developments in finance theory or other new information that has implications for the AER's 'foundation model' approach. This could examine evolutions of, and alternatives to the traditional Sharp-Lintner CAPM, including any developments which would suggest a different role for such models in future cost of equity estimation.
- **Use of samples in estimation of equity beta** - This review could usefully focus on establishing robust and clear principles for establishing a workable sample set for future beta estimates. In particular, this could address issues such as the falling sample size of currently listed Australian comparators, treatment of and weight given to estimates from previously listed comparators, and how to incorporate available international sample data in a manner consistent with the AER's inclusion of international data in other decision elements.
- **Estimating the cost of equity in a low or zero-bond rate environment** - Examining the implications for current cost of equity estimation approaches and asset pricing models of a continuation of historically low risk bond yields or a future movement to negative yields on risk-free rate proxies.

6 Responses to Consultation Paper questions

Question	Response
1. How could the CRG be adapted to improve their contribution to the review?	<ul style="list-style-type: none"> • If the CRG is to represent the views of consumers through the process, there needs to be the capacity and ability of the group to meaningfully inform and test its positions on material issues directly with a representative range of consumers • CRGs role should be defined in the establishment phase – i.e. Is it primarily an additional conduit for consumer perspectives? Is it a body whose focus should be defined by the AER? Is it a counterparty/empowered negotiating party? • CRG should be adequately resourced for its determined role and established early in the process
2. Is there anything that needs to change about the CRG nomination process?	<ul style="list-style-type: none"> • All members of the CRG should be clear on the intended role, obligations and likely intensity of the process
3. What characteristics should be sought for CRG members?	<ul style="list-style-type: none"> • This will depend on the chosen role. • ENA supports AER caution on an exclusive focus on detailed cost of capital expertise (though the CRG should have access to this) • A requirement and capacity to demonstrate how they have sought and reflected consumer views
4. What should the CRG’s main role be when in the 2022 process? Should the CRG’s main role be to provide technical submissions or more customer focused submissions to the review process?	<ul style="list-style-type: none"> • Networks consider it would be useful for CRG to have a role in bringing consumer perspectives relevant to rate of return issues that have been tested and evidenced to the process • Elements of the 2018 CRG submission did not appear to fully reflect the views of the CRG – but neither did it appear to significantly rely on the technical

	<p>judgement of the external consultancy which drafted the document. It may be useful for externally drafted submissions to clearly indicate whether primarily drafting assistance has been obtained, or whether the expert and technical views represent the views of the engaged consultant</p> <ul style="list-style-type: none"> • To avoid this issue entirely, it may be better for CRG to externally commission expert work it considers is required, and be collectively resourced and responsible as a body for making a submission that has the agreement of all CRG members • It is important for any positions that seek to represent overall consumer views on critical trade-offs or aspects of service (i.e. promoting efficient investment, prices and the value of reliability) have an empirical basis for these positions being reached and are openly consulted upon by the CRG (See <i>National Electricity Law</i> s.18N(2)(a)).
<p>5. What scope is there for the CRG and CCP to work collaboratively to jointly contribute to the 2022 process?</p>	<ul style="list-style-type: none"> • Adequate role definition between the intended functions of CRG and the CCP would assist in collaborative work (See Sections 3.2-3.4) • The CCP's twin objectives (advise on network proposals, and advise on the effectiveness of networks engagement activities) are directed to standard network determination processes - their function in generic reviews undertaken under different Law/Rules frameworks requires careful consideration • Possible useful functional roles for the CCP in such processes would be to: <ul style="list-style-type: none"> ○ Provide technical input and insights from a consumer perspective ○ Provide perspectives on the long-term interests of consumers (with an emphasis on the interests of future consumers not otherwise explicitly represented in the process) ○ Provide a critical assessment of AER review priorities

<p>6. Does the AER's support of the CRG need to change ahead of the 2022 review? If so, how should that support change?</p>	<ul style="list-style-type: none"> • Consideration of additional support should flow from final decisions on the role. • This issue will be further informed by outcomes of the review of the Consumer Challenge Panel and Energy Consumers Australia. There is no public information available on the outcomes of these reviews at this time. • The existing ECA project funding mechanism provides a basis for funding critical regulatory and rule reviews with an application process and standing funds available.
<p>7. Do the IRG and RRG need to be altered to enable them to be able to more effectively contribute to the development of the Instrument? If so, what changes should be made to the groups?</p>	<ul style="list-style-type: none"> • Networks did not engage closely with either of these Reference Groups, and so their future shape and focus is discussed only briefly (in Section 3.5).
<p>8. How could the concurrent evidence sessions be adapted to improve discussion on topics?</p>	<ul style="list-style-type: none"> • It is important for stakeholder transparency, credibility of the process and efficiency for stakeholders to be able to witness and follow the session in person. • Enabling greater time for engagement and discussion between the experts would allow a focusing of the sessions on points at issue. • Further suggestions and comments on this question are set out in Section 3.6.
<p>9. At what points in the process would the concurrent evidence sessions aid the most?</p>	<ul style="list-style-type: none"> • Holding the Concurrent Expert Session sufficiently before the AER Draft Instrument, such that its findings can feed into it, is appropriate. • There would be value in a Concurrent Expert Session being held early in the early 'scope setting' and issues prioritisation phase, to ensure that the focus of the review was informed by expert views on key priorities and developments.
<p>10. What could be done to better assist the concurrent evidence sessions to fulfil their role? Do the evidence sessions need to be extended to</p>	<ul style="list-style-type: none"> • More sessions would be useful, as some important issues received a relatively short discussion time.

<p>allow more discussion on certain topics or should the number of rounds be increased?</p>	<ul style="list-style-type: none"> • Experts should be provided for the entirety of each session and be able to discuss and be questioned on any issue in their area of expertise – rather than fostering a system of parties (including the AER) ‘swapping out’ experts for different sessions. • Further suggestions and comments on this question are set out in Section 3.6
<p>11. Do stakeholders consider the Joint Expert Report was useful to the process? How could it be improved?</p>	<ul style="list-style-type: none"> • Yes. The concurrent evidence sessions should result in a report (as occurred in 2018) which clearly sets out points of agreement or consensus on issues. This provides a transparent record of positions reached and issues considered by the Joint Experts.
<p>12. Are there any adjustments that could be made to the Independent Panel that would assist it in undertaking its role?</p>	<ul style="list-style-type: none"> • The Independent Panel as implemented in 2018 did not meet the goal set to enhance stakeholder confidence in the decision, in the context of the removal of limited merits review. • Adjustments should include: <ul style="list-style-type: none"> ○ Capacity for stakeholders to provide a short written document highlighting areas of requested Panel focus as part of their submissions to the AER on the draft instrument ○ Publication by the AER of a record of all verbal and written briefing materials provided to Panel ○ The Independent Panel should be required to publish a report following the final instrument ○ The Panel should provide specific recommendations for the AER to consider and identify these as high/medium or low priorities for addressing • Further suggestions and comments on this question are set out in Section 3.7