

## New Reg: Towards Consumer-Centric Energy Network Regulation

### AusNet Trial – AER Staff Guidance Note 2: Scope of Negotiation (July 2018)

The Australian Energy Regulator (AER), Energy Consumers Australia (ECA), and Energy Networks Australia (ENA) have established a project aimed at improving consumer engagement and enabling customers to shape aspects of network revenue proposals submitted to the AER for approval (the **New Reg model**). AusNet Services (**AusNet**) has agreed to trial the New Reg model for its Victorian electricity distribution network business (the **AusNet trial**). A Customer Forum (the **Forum**) has already been established to negotiate and agree key aspects of AusNet's regulatory revenue proposal, so that the proposal better reflects the preferences of AusNet's customers.

This note is one of a series of guidance notes prepared by AER staff that sets out the topics within the scope of negotiation between AusNet and the Forum, and the boundaries of negotiation for those topics, prior to AusNet submitting its revenue proposal to the AER for formal assessment. More information on the New Reg model, the AusNet trial, and the role of the AER in the trial, is provided in the first guidance note in this series.<sup>1</sup>

#### Introduction and purpose

AusNet has proposed a number of topics to be negotiated with its Customer Forum in advance of submitting its 2021-25 revenue proposal to the AER. We have considered AusNet's proposed topics against the scope criteria set out in the [Early Engagement Plan](#) and the [Early Engagement Memorandum of Understanding](#) (MOU), based on our understanding of AusNet's rationale for proposing those topics.

The purpose of this guidance note is to set out the view of AER staff on the appropriate scope of negotiation between AusNet and the Forum.

#### Summary of our views on the scope of negotiation

Our views on which topics should be in scope or out of scope are summarised in the following table, with our reasons set out in the remainder of this guidance note.

Topic proposed by AusNet	In scope of AusNet/Forum negotiation?	Relevant to AusNet's revenue proposal?
Operating expenditure	Yes – material, price/service trade-offs	Yes
Major augex projects	Yes – price/service trade-offs	Yes
Revenue path profile	Yes – price timing trade-offs	Yes
Customer experience	Yes – customer views significant	If cost or incentive scheme implications
Customer hardship arrangements	Yes – customer views significant	Likely dealt with through other processes
Major repex projects	No – but price/service trade-offs	Yes
DER integration expenditure	No – wider consultation appropriate	Yes

<sup>1</sup> AusNet Trial – AER Staff Guidance Note 1: How the AER will support AusNet's Customer Forum, July 2018.

<b>Topic proposed by AusNet</b>	<b>In scope of AusNet/Forum negotiation?</b>	<b>Relevant to AusNet's revenue proposal?</b>
Innovation expenditure	No – technically complex in the available time	Yes
Regulatory protections	No – no specific proposals	Unlikely
Metering	No – policy issue, although metering also affects customer experience	Not the policy aspects

## **Distinction between ‘in scope’ and ‘out of scope’ topics for negotiation**

### *‘In scope’*

As set out in the Early Engagement Plan and the MOU, the AER, the Forum and AusNet are all expected to agree to the scope of the negotiation. The Forum is not expected to negotiate AusNet's entire revenue proposal, because some aspects of the proposal will be unlikely to benefit significantly from customer views. In addition, the Forum only has a limited time available to familiarise itself with the issues, direct relevant customer research, and prepare itself for negotiations.

The AER's involvement with the Forum and AusNet, prior to AusNet's revenue proposal being formally submitted to the AER, is not intended to ‘pre-approve’ any matters in the proposal. Also, due to the dynamic nature of the process and the limited time period in which material is provided to AER staff in advance of meetings, AER staff will not review all the material AusNet provides to the Forum. However, by focusing on a selected number of topics, we will be in a better position to set out the ‘boundaries of negotiation’ for those topics.

As set out in the Early Engagement Plan and MOU, the AER's discretion will not be restricted in any way by agreements made between the Forum and AusNet – the AER will undertake its assessment of AusNet Services' proposal as required by the National Electricity Rules (NER). Specifying the topics that are in scope, and providing guidance on the boundaries of negotiation for those topics, should make the process more efficient. It will reduce the risk that the Forum and AusNet reach an agreed position on a particular matter, which the AER subsequently determines, when assessing AusNet's revenue proposal, to be inconsistent with the regulatory framework. For instance, the position might not be permissible under the National Electricity Law (NEL) or the NER, or the reasons for changing a standard AER approach might not be persuasive.

### *‘Out of scope’*

Ultimately, however, the negotiation process is between AusNet and the Forum. The AER is not a party to the negotiations. AusNet and the Forum may decide to discuss, or negotiate and reach an agreement on, matters that we have not explicitly agreed to be in scope. For instance, AusNet has not proposed that all categories of its forecast capital expenditure (capex) program should be in scope (eg, capex on information and communications technology), and we have not agreed that all the capex categories AusNet has proposed to be in scope should be. Nonetheless, based on what it finds from customer research and engagement, the Forum might be in a good position to test AusNet's explanations of the value customers would get from AusNet's forecast expenditure more generally.

## Scope criteria and timeframe

The MOU sets out that, in agreeing matters to be included within the scope of negotiation, AusNet, the Forum and the AER should have regard to:

- the requirements of the NEL and NER
- the extent to which AusNet has discretion to propose a matter
- the extent to which the matter can be influenced by customer views
- the materiality of any proposed expenditure
- the extent to which an expenditure trade-off is available
- the technical complexity of the matter and the degree of specialist expertise required to assess it.

Consistent with the MOU,<sup>2</sup> we consider that an additional scope criterion should be:

- the extent to which the matter is a policy or wider issue better dealt with through a different and more expansive consultative process than the Forum's negotiation with AusNet.

We set a deadline of mid-June 2018 for AusNet to propose in scope topics. We did so to allow sufficient time for the Forum to direct further customer research and prepare itself for negotiations, as well as sufficient time for us to provide guidance on the boundaries of negotiation for in scope topics, prior to negotiations commencing later in the year.

## In scope topics not relevant to AusNet's revenue proposal

We will be encouraging the Forum to focus its time on:

- preparing itself to effectively negotiate topics that are in scope and relate to AusNet's revenue proposal
- seeking evidence from consumer research to support its negotiation positions.

However, given customer research and engagement is still ongoing, the Forum might continue to identify opportunities for AusNet to provide improved customer outcomes, potentially at negligible cost to AusNet. Or the Forum might consider that the cost of improving certain customer outcomes should be borne by AusNet's shareholders rather than electricity consumers.<sup>3</sup>

If AusNet agrees to implement these kinds of initiatives, then there might be no impact on AusNet's 2021-25 revenue proposal to the AER. That is likely to be the case if the improved customer outcomes sought by the Forum have no effect on the forecast operating expenditure (opex) or capex AusNet includes in its revenue proposal. Also, AusNet could make commitments to improving certain aspects of customer experience, and reporting on its progress in doing so, at any time—it does not need to wait until it has submitted its revenue proposal. Such matters could therefore be in scope for negotiation, but would not form part of the revenue proposal and would not require involvement from AER staff.

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<sup>2</sup> Clause 3(d) of the MOU states that the Forum "is not expected to be involved in policy decisions".

<sup>3</sup> It is not straightforward to ensure that AusNet's shareholders bear all of the costs of such initiatives. That is because, under the efficiency benefits sharing scheme (EBSS), distribution network businesses would normally be expected to recover a portion of unfunded costs in the subsequent regulatory period (ie, after the 2021-25 period), ultimately only incurring approximately 30 per cent of any additional costs.

## **Opex – in scope**

### *AusNet's proposal and its rationale for the topic being in scope*

AusNet proposes that opex be in scope, because it is a key driver of customer charges, and the opex forecast in its entirety is a key element in delivering a revenue proposal acceptable to its customers. However, AusNet does not expect the Forum to supersede the AER's role in undertaking a technical assessment of the efficiency of AusNet's opex forecast.

### *AusNet's indicative questions for the Forum*

AusNet envisages that the Forum's role would involve a high level assessment of the overall reasonableness of AusNet's opex forecast, taking into account regulatory obligations, as well as a consideration of customer preferences broader than the appropriateness of individual inputs to the AER's standard 'base, step, and trend' approach to assessing opex. In particular, AusNet intends seeking the Forum's view on:

- the extent to which base year expenditure is appropriately targeted to deliver customers good value across a range of customer experience dimensions
- whether there are other areas AusNet should increase or decrease opex to deliver a different mix of customer outcomes
- whether customers are adequately sharing in the benefits of efficiency improvements made by AusNet.

The Forum has suggested it should also consider whether the efficiency improvements AusNet is targeting are sufficient. Another question the Forum has raised is whether the level of forecast opex typically allowed to cover a business-as-usual level of guaranteed service level (GSL) payments is appropriate.

### *Why we agree opex can be in scope*

We agree that opex can be in scope. Opex has a very direct and more immediate impact on the building block components of AusNet's revenue proposal than capex does, and a different mix of customer outcomes might have implications for the level of opex.

## **Augex major rebuilds – in scope**

### *AusNet's proposal and its rationale for the topic being in scope*

AusNet proposes that (at least) three major augmentation projects be in scope: two zone substation projects and one distribution feeder project (involving 3 feeders). AusNet considers that augmentation expenditure (augex) projects involve price-reliability trade-offs, and the customer outcomes/benefits of different options can be tested through customer research.

### *AusNet's indicative questions for the Forum*

AusNet's indicative questions to the Forum relate to the balance between cost and reliability, the willingness of customers to consider project deferrals, and the design of non-network options involving customer participation/impacts (such as demand management/response or appliance control). We understand that AusNet has explored customer views on reliability and demand response in the June customer focus groups, and that AusNet plans for the Forum to engage directly with some of the consumers potentially affected by the proposed augex projects.

AusNet notes that the negotiation stage with the Forum is in advance of the formal RIT-D process for the augex projects.<sup>4</sup> However, during the negotiation, AusNet intends seeking

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<sup>4</sup> The 'RIT-D' process is the regulatory investment test for distribution. The test is described in the AER's [Regulatory Investment Test for Distribution, Application Guidelines](#), 18 September 2017.

the Forum's agreement that AusNet has considered an appropriate range of options (including non-network options), and that AusNet's preferred option is the right one.

*Why we agree augex major rebuilds can be in scope*

We agree that AusNet's proposed augmentation projects can be in scope. The Forum could assist AusNet in forming a view about price-reliability trade-offs associated with the proposed projects. Ultimately, however, most major augex projects will also be subject to the RIT-D process, and other stakeholders will have an opportunity to comment on whether the RIT-D process was satisfactory. The AER has a potential compliance role if there is a dispute about that process.

## **Revenue path profile – in scope**

*AusNet's proposal and its rationale for the topic being in scope*

AusNet proposes that the profile of the revenue path during the 2021-25 regulatory period be in scope, because the Forum can usefully inform its desirable profile.<sup>5</sup>

*AusNet's indicative questions for the Forum*

AusNet proposes asking the Forum to explore whether this is a topic that matters to customers, and whether a smoother price path, or lower prices up front, are valued more.

*Why we agree the revenue path profile can be in scope*

We agree that the revenue path profile can be in scope. The AER has some flexibility in the way the revenue path is determined, although the NER requires a relatively close match between required revenue and the smoothed revenue in the final year of the regulatory period. This is an issue that has been observed in the current period in relation to a number of networks, with lower charges in the initial years of a period being followed by progressive increases in subsequent years. Supported by customer research, the Forum can indicate what type of revenue profile customers would prefer.

## **Customer experience – in scope**

*AusNet's proposal and its rationale for the topic being in scope*

AusNet proposes that customer experience be in scope. Specific issues would be identified from customer research and complaints data. AusNet notes that changes to customer service levels might have implications for capex or opex forecasts, or warrant the introduction of a new small scale incentive scheme provided for under the NER. Although AusNet has no specific proposal for such a scheme, AusNet would like to keep open the option of introducing such a scheme if the Forum considers that AusNet should be incentivised to target customer service levels through rewards/penalties.

*AusNet's indicative questions for the Forum*

AusNet has proposed a number of questions for the Forum on a range of matters, including customer research design, customer outcomes and customer value, funding of improved customer experience, and the scope of GSLs.

*Why we agree customer experience can be in scope*

We agree that customer experience can be in scope. This is an area where the Forum could add significant value. However, it is possible that some or all of any initiatives proposed by the Forum might not have any bearing on AusNet's 2021-25 revenue proposal. This would be the case if those initiatives could be implemented at negligible cost, or if AusNet agrees to bear any relevant costs, at least in the 2021-25 regulatory period.

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<sup>5</sup> In the material presented to the Forum, AusNet refers to this topic as 'price path smoothing'.

The NER requires that the introduction of a new small scale incentive scheme involve wider consultation with all stakeholders in the national electricity market (NEM). Arguably, a scheme targeted just to the preferences of AusNet's customers might not generate much interest with wider stakeholders. Nonetheless, it might not be possible for a robust new scheme to be developed in time to be accommodated in the negotiation process, so the Forum might just seek a commitment from AusNet to prepare a proposal to send to the AER for consideration. The Forum could also propose implementing a new incentive scheme as a paper trial, which might provide useful information for implementing a revenue-at-risk mechanism at some point in the future.

GSLs are out of scope as they are a matter for jurisdictional regulators. However, as is noted above, the Forum has queried the level of opex in AusNet's revenue proposal to recover GSL payments, and we consider that the matter can be in scope.

### **Customer hardship arrangements – in scope**

#### *AusNet's proposal and its rationale for the topic being in scope*

As part of the customer experience topic, AusNet has proposed that customer hardship arrangements be in scope.

#### *AusNet's indicative questions for the Forum*

AusNet is interested in the Forum exploring the role that AusNet should play in respect of the hardship programs administered by retailers.

#### *Why we agree customer hardship arrangements can be in scope*

We agree that customer hardship can be in scope, subject to there not being any impact on AusNet's revenue proposal. Like other issues of customer experience, customer hardship arrangements could be an area where the Forum could add value. For example, the Forum could raise specific issues about these programs that could be subsequently considered by policy makers or that AusNet might be able to progress at negligible cost. However, we note that the AER has previously taken the view that policy makers have not clearly identified a role for distributors in providing support for vulnerable customers, as there is a clear separation of responsibilities under the retail law and rules. This would mean that any expenditure proposed in this regard would not be strictly related to the provision of distribution services and could not be included in the revenue proposal under the NER.

### **Repex major projects – out of scope**

#### *AusNet's proposal and its rationale for the topic being in scope*

AusNet proposes that a number of zone substation major refurbishment projects ('repex major projects') be in scope. At least 11 such major projects have been proposed by AusNet to date. AusNet considers the concepts and issues associated with the justification for each project are the same at each site. AusNet does not consider each project would need to be discussed with the Forum at length, as in AusNet's view the principles applied by the Forum and AusNet in reaching agreement would be largely common across all projects.

AusNet considers repex major projects should be in scope for similar reasons to augex, in particular, because they can involve price-reliability trade-offs. For instance, project deferral might result in worsened localised reliability, but lower prices for all AusNet customers. Non-network options, including customer demand management, could be used to manage the reliability impact/risk for the deferral period.

### *AusNet's indicative questions for the Forum*

AusNet's indicative questions to the Forum relate to the balance between cost and reliability, and the willingness of customers to consider project deferrals. We understand that AusNet has explored customer views on reliability in the June customer focus groups.

AusNet's standard refurbishment options include a more traditionally designed and timed option compared to a range of deferral and/or non-network options (and a 'do nothing' option). By the time of the July Forum meeting, AusNet expects to be able to present the Forum with the common impact of each standard refurbishment option, in terms of: customer bills (presented for each year of the 2021-25 period, and an NPV beyond that), localised outage duration, service target impact, and safety.

### *Why we consider repex major projects should be out of scope*

We consider that repex major projects should be out of scope. Extending the scope beyond the topics discussed above might prove challenging, particularly given that repex is a relatively complex technical topic to prepare to negotiate in the time available, and negotiations should be supported by appropriate customer research. However, if the Forum were nonetheless interested in negotiating this topic, for negotiation to be effective, we consider that AusNet should provide the Forum with further information about the trade-offs customers could make in respect of different refurbishment options (see below).

Information on customer preferences at an aggregate level, as AusNet proposes, might usefully inform the choice between standard refurbishment options, if there are a number of options with similar lowest lifecycle costs (or cost ranges). Including repex major projects in scope might allow customer tolerance for different risks to be tested and applied to AusNet's decision-making. For instance, where reliability is already relatively good, customers might be comfortable in the short term with lower reliability, or a risk of lower reliability, if that reduces costs overall, or provides the opportunity to test the extent to which more innovative non-network options can reduce costs over the long term.

On the other hand, there might be site-specific issues associated with each project—eg, noise or visual amenity—and so it might not be sufficient to just form an aggregate view of customer preferences.

Nonetheless, a better understanding of aggregate customer preferences could provide a good starting point for assessing options for many typical major refurbishment projects, as more localised customer preferences might only be relevant in a small number of cases. In addition, the costs involved in addressing localised customer concerns might not be material.

If the Forum wants to negotiate the topic, then we would recommend that AusNet:

- provides information to the Forum about the lifecycle costs for each option, the option value of deferral, and impacts on outage frequency (not just duration)
- makes clear the short term versus longer term customer bill impact, and considers what evidence AusNet has as to whether customers would be willing to pay a little bit more in the short term for the opportunity to pay less in the future
- considers whether one 'representative' major project, not involving site-specific factors, could be used as a trial
- indicates which projects might also be subject to the RIT-D (if any).

### **DER integration expenditure and DER connections policy – out of scope**

#### *AusNet's proposal and its rationale for the topic being in scope*

AusNet proposes that integration expenditure and connections policy for distributed energy resources (DER) be in scope, particularly in respect of solar PV export and connections. We

understand that AusNet has already undertaken research on the topic, and further explored customer views in the June customer focus groups, such as on the ability to export to the grid, willingness to pay for network access, and who should pay.

#### *AusNet's indicative questions for the Forum*

AusNet is interested in the Forum exploring the extent to which AusNet should further accommodate distributed energy export, especially from solar PVs, and customer views on full, partial or temporal restrictions on PV export or on new connections, as well as who should pay for any increase in costs arising from increased export.

#### *Why we consider DER integration expenditure and connections policy should be out of scope*

We consider that DER integration expenditure and connections should not be in scope. It is useful for AusNet to explore customer preferences on options for solar PV export and connections, and the Forum has already played a valuable role in influencing AusNet's customer research on this topic. Nonetheless, the topic should not be in scope because it is an issue that affects the sector more widely, and so would benefit from being considered through a more expansive consultative process than just the Forum's negotiation with AusNet.

We note that there are already a number of processes considering, or likely to consider, DER-related issues. The AER is consulting more widely on the appropriate treatment of DER in the service classification and asset exemption guidelines. The Australian Energy Market Operator (AEMO) and the ENA are also consulting on DER,<sup>6</sup> and the Australian Energy Market Commission (AEMC) is also likely to further consider this matter as part of its own review of the regulatory framework. The outcomes of these broader reviews should be applied to AusNet.

### **Innovation expenditure – out of scope**

#### *AusNet's proposal and its rationale for the topic being in scope*

AusNet proposes that around 15 'strategic' innovation projects be in scope. By strategic projects, AusNet means projects aimed at supporting 'transformational change' with a longer term payback to customers, and which—in AusNet's view—require regulatory funding because the returns to AusNet are 'truncated'.

#### *AusNet's indicative questions for the Forum*

AusNet wants the Forum to consider whether upfront customer investment in specific innovation projects is justified given the associated benefits, and whether AusNet should innovate in other areas.

#### *Why we consider innovation projects should be out of scope*

We consider that the proposed innovation projects should not be in scope. We consider that this is a technically complex topic to prepare to negotiate in the available time. Although we acknowledge AusNet's position that the proposed projects are additional to the projects it will propose for the demand management innovation allowance (DMIA), we also note that AusNet has not fully explained the extent to which each of the innovation projects being proposed would not be already funded (eg, through other incentive schemes).

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<sup>6</sup> AEMO and ENA, *Open Energy Networks, A Joint AEMO and Energy Networks Australia Initiative Consultation on how best to transition to a two-way grid that allows better integration of Distributed Energy Resources for the benefit of all customers*, June 2018.



## **Regulatory protections – out of scope**

### *AusNet's proposal and its rationale for the topic being in scope*

AusNet proposes that regulatory protections, such as additional cost pass throughs and provision for contingent projects, be in scope. AusNet considers that, because regulatory protections allocate risks between networks and customers, customers might have a view on the appropriate sharing of risk.<sup>7</sup> AusNet has no specific proposals, but would like to keep open the option of introducing new protections to increase flexibility during the negotiations.

### *AusNet's indicative questions for the Forum*

AusNet considers the Forum might have a view on alternative cost-risk sharing for delivering certain customer outcomes. For example, the Forum might have a view whether ex ante expenditure forecasts or pass through events are more appropriate mechanisms for recovering increased costs associated with new or changed obligations (eg, cyber security legislation).

### *Why we consider regulatory protections should be out of scope*

We consider that regulatory protections should not be in scope, because AusNet is not intending to present the Forum with any specific proposals for regulatory protections.

## **Metering – out of scope**

### *AusNet's proposal and its rationale for the topic being in scope*

AusNet proposes that metering be in scope, and that the Forum should consider the benefits of smart meters and the merits of contestability of metering assets. AusNet considers smart meters are of strategic importance to the future optimised operation of the distribution network, and therefore to achieving lower costs for consumers, including lower network augmentation costs, and to delivering desired customer services. Smart meters can directly improve customer experience (eg, remote connection/disconnection, and reduced risk of electric shock).

### *AusNet's indicative questions for the Forum*

AusNet proposes asking the Forum to express a view on the reasonableness of metering charges, and whether they represent value for AusNet's customers over the 2021-25 period. AusNet is testing the value its customers place on smart meters through customer research, and we understand that the Forum is interested in AusNet exploring how it can find ways to maximise the value to customers from its existing meters. More generally, the Forum has been asked to consider whether the benefits of the Victorian specification for smart meters provides value for money for customers, and whether metering contestability would benefit Victorian electricity consumers – essentially seeking a view on the existing Victorian moratorium established by the Victorian Government.

### *Why we consider metering should be out of scope*

We consider that metering should not be in scope. The merits of Victorian meter specification, and the introduction of metering contestability, are policy issues. Nonetheless, the Forum might wish to encourage AusNet to consider better use of its existing meters to improve customer experience on the basis of minimal additional spend, and that would have no material implications for AusNet's revenue proposal.

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<sup>7</sup> AusNet has presented the prospect of a new small scale incentive scheme under the topic of regulatory protections. This is discussed above under customer experience.

## **Customer connections capex and contributions – out of scope**

At an earlier stage of the process, AusNet had considered that customer connections capex and contributions should be in scope. However, the Essential Services Commission (ESC) is currently conducting an electricity connections process review.<sup>8</sup> AusNet does not consider it sensible to seek agreement from the Forum on an outcome prior to the ESC's review being finalised.

AusNet proposes reconsidering whether there is time and merit in this topic being added to scope early next year. However, we consider that this would not allow sufficient time for customer research to be undertaken prior to the submission of AusNet's revenue proposal. As such, we consider that this topic should remain out of scope.

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<sup>8</sup> <https://www.esc.vic.gov.au/electricity-and-gas/electricity-and-gas-tariffs-benchmarks-inquiries-and-reviews/electricity-connections-process-review-2018>