

## **Submission to the Australian Energy Regulator (AER)**

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### **Consumer Challenge Panel**

**Submission to the AER on its Consultation Paper on a process for review of  
the Rate of Return Guideline**

**Sub-Panel CCP16**

**David Prins (chair)**

**Louise Benjamin**

**Eric Groom**

**Bev Hughson**

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# 1. Background

## 1.1. Review of the AER's Rate of Return Guideline

On 31 July 2017, the AER announced<sup>1</sup> that it was initiating a review of the Rate of Return Guideline<sup>2</sup> to apply to electricity and gas distribution and transmission businesses.<sup>3</sup> On that date, the AER published a Consultation Paper on a process for the review, requesting submissions from interested parties by 28 August 2017. This submission is in response to the AER's initiation of the review and publication of its Consultation Paper. It focuses on the process issues raised in the Consultation Paper, rather than on substantive issues in regard to the form and content of any new or revised Guideline, on which we expect to engage with the AER and other interested parties during the course of the review.

### 1.1.1. The role and importance of the rate of return in network pricing determinations

The AER determines the amounts of revenue that electricity and gas network businesses can recover for the use of their networks. The AER is guided in its role by the National Electricity Objective (NEO) and the National Gas Objective (NGO), along with the Revenue and Pricing Principles (RPP). These objectives and principles are set out in the National Electricity Law and the National Gas Law, and focus on the long-term interests of consumers. The RPP indicate that the objectives are achieved through the AER's determination of the efficient costs of providing the regulated services.

A key component of the allowed revenue is the return on capital, which is determined by applying the 'allowed rate of return' to the value of the regulatory asset base of the network business. The AER must determine the allowed rate of return such that it achieves the 'allowed rate of return objective', as defined in the National Electricity Rules (NER) and the National Gas Rules (NGR).

The return on capital makes up approximately 50 per cent of a network business' allowed revenue. The allowed rate of return is therefore a key driver of the quantum of network charges.

The materiality of the rate of return in setting network prices speaks to the importance of the process for creating a new guideline, as well as the content of any new guideline, being guided by the long-term interests of consumers.

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<sup>1</sup> The announcement of the initiation of the review is available on the AER website at <https://www.aer.gov.au/communication/aer-kicks-off-its-review-of-rate-of-return-guideline>

<sup>2</sup> The National Electricity Rules and National Gas Rules refer to Rate of Return Guidelines (plural). The Consultation Paper to which this paper responds also refers consistently to Guidelines (plural). However, there is currently a (singular) Rate of Return Guideline, and wording on the AER website referenced in this submission refers to this singular Guideline. This submission therefore refers to the existing singular Guideline, while noting that the Rules refer to Guidelines.

<sup>3</sup> Documentation on the current project to undertake the review is being made available to stakeholders on the AER website at <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/review-of-rate-of-return-guideline>

### 1.1.2. The need for and timing of this review of the Rate of Return Guideline

Changes to the NER and the NGR in 2012 included a requirement for the AER to develop guidelines which outline its approach to setting the rate of return for regulated electricity and gas network businesses. The AER completed the first Rate of Return Guideline in December 2013.<sup>4</sup> Following more recent rule changes, the AER is required to complete a review of the current guideline within five years (December 2018) of publishing the current guideline.

It is this review that the AER has recently initiated.

The AER is also currently reviewing the regulatory treatment of inflation. In that review, network businesses have submitted a variety of proposals on the estimation of expected inflation, and how inflation is treated within the regulatory framework, including in the AER's forecast revenue modelling framework. Some of the proposals, if adopted, may require changes to the Rules, such as the adoption of a nominal debt and real equity, and the associated treatment of the regulatory asset base. There are clearly issues being raised in the review of inflation that are pertinent to the review of the Rate of Return Guideline.<sup>5</sup>

### 1.1.3. Rate of Return Guideline to be 'binding'

The current guideline is not binding on the AER or on regulated businesses. Many stakeholders, including consumer representatives, invested considerable time and effort in the current guideline, only to find that in practice the network businesses' submissions have not been compliant with the rate of return guideline, and regulatory decisions of the AER on rate of return have been referred under limited merits review to the Australian Competition Tribunal. Network businesses have also applied to the Federal Court for judicial review of the AER's decisions, and the AER has applied to the Federal Court for judicial review of Tribunal decisions relating to the rate of return.

The COAG Energy Council has now committed to developing a framework for a binding rate of return guideline. In practice this means that the arguments regarding rate of return that were previously heard in the regulatory process for each individual network business, in the Tribunal, and in the courts, will now be heard instead in this review process for creating any new guideline.

Regulatory determinations that lead to appeals to court are not efficient regulatory processes. They leave uncertainty about the outcome of a regulatory determination after the determination has come into effect, and add considerably to the cost of regulation. This is not in the short-term or long-term interests of consumers or of stakeholders generally.

It is therefore important that

- The AER process for developing the Rate of Return Guideline should be robust, transparent and comprehensive, incorporating broadly based consultation with all interested stakeholders, and should minimise the risk of the final binding guideline itself being referred for judicial review.
- The contents of the final binding guideline should be clear and unambiguous (while providing for the structured exercise of the AER's discretion), thus minimising the risk that their application to regulatory determinations will be referred for judicial review.

<sup>4</sup> Documentation on the previous project to create the initial guideline is available on the AER website at <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/rate-of-return-guideline-2013>

<sup>5</sup> For more information on the current review of expected inflation, see <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/review-of-expected-inflation-2017>

## 1.2. The Role of the Consumer Challenge Panel

The AER established the Consumer Challenge Panel (CCP) in July 2013 as part of its Better Regulation reforms. These reforms aimed to deliver an improved regulatory framework focused on the long-term interests of consumers.

The CCP assists the AER to make better regulatory determinations by providing input on issues of importance to consumers. The expert members of the CCP bring consumer perspectives to the AER to better balance the range of views considered as part of the AER's decisions.<sup>6</sup>

The author of this submission is CCP16, a sub-panel of the AER's Consumer Challenge Panel that the AER has established to focus specifically on this review. CCP16 welcomes its involvement in the review, and outlines in this submission where it would add value to the review.

## 2. Review timeline

Table 1 below is copied from the AER Consultation Paper. It sets out the AER's proposed timeline for the review. We understand that at this stage the timeline is indicative only, and has been developed to accommodate the AER's preliminary views on new process steps and the estimated time requirements of including those steps.

**Table 1 Indicative timeline for the guidelines review process**

Date	Milestone
July 2017	Review process consultation paper
October 2017	Issues paper
November 2017 – December 2017	Submissions on issues paper
February 2018 – March 2017	Hot-tubbing sessions
May 2018	Publication of draft guidelines
June–August 2018 (approximately 10 weeks)	Independent panel process
August 2018	Submissions on draft guidelines
17 December 2018	Publication of final guidelines

We understand that the AER must publish the final rate of return guideline (or guidelines) by no later than 17 December 2018, as this is five years from publication of the current guideline (17 December 2013). This would mean that any new draft guideline would need to be published by 24 August 2018 – this being 80 business days prior to 17 December 2018.

The AER has stated its view that development of the rate of return guideline is sufficiently complex to justify an extension of time between the draft and final guidelines. The AER therefore proposes to expand the time period between the draft and final guidelines by publishing a new draft guideline in May 2018, while retaining the December 2018 timing for the publication of the final guideline (or guidelines).

Stakeholders will need time to respond not only to any draft guideline, but also to the network businesses' responses to any draft guideline.

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<sup>6</sup> Detailed information on the CCP is available on the AER website at <https://www.aer.gov.au/about-us/consumer-challenge-panel>

CCP16 endorses the view of the AER that the draft guideline should be published in May 2018, to expand the time period between the draft and final guidelines.

### 3. Proposed participants and steps in the review process

This section 3 of our submission follows the format of section 3 of the AER's Consultation Paper.

In section 3 of the Consultation Paper, the AER sets out its preliminary views on the proposed participants and steps that might be included in the review process.

CCP16 endorses the AER's view that due to the significance of the Rate of Return Guideline for the sector, the review process should include more consultation than is strictly required under the NER and the NGR.

CCP16 seeks to explore with the AER and with consumer groups / the Consumer Reference Group how the detail of the process should be developed from what is outlined in the Consultation Paper, to ensure that the process is robust, transparent and comprehensive, incorporating broadly based consultation with all interested stakeholders, and minimising the risk of the final binding guideline itself being referred for judicial review.

#### 3.1. Consumer Reference Group

CCP16 endorses the establishment of the Consumer Reference Group, to facilitate the participation and engagement of consumers throughout the process.

We encourage the establishment of the Consumer Reference Group as a priority for the AER, as soon as is possible, and not just prior to publishing the Issues Paper in October 2017. CCP16 looks forward to engaging with the Consumer Reference Group throughout the review process.

#### 3.2. Dedicated Consumer Challenge Sub-Panel

CCP16 is the Consumer Challenge Sub-Panel that is dedicated to the review of Rate of Return Guideline. Its members are David Prins (chair), Louise Benjamin, Eric Groom and Bev Hughson.

We set out in this paper our views on where there are opportunities for CCP16 input in this review.

The CCP's role is to challenge the proposals and analyses of both the AER and network businesses from the perspective of the long-term interests of consumers, and to suggest any approaches that the AER may explore through its process. The CCP engages with consumer advocates and consumer representatives and other relevant stakeholders in its deliberations and preparation of advice to the AER. In this project, the relevant stakeholders with which CCP16 intends to engage include the Consumer Reference Group and Energy Consumers Australia.

CCP16 emphasises that its role is not in any way a replacement for consumer engagement and advocacy. As discussed in the relevant sections of this submission, CCP16 endorses the AER's proposal to establish a Consumer Reference Group and to hold targeted workshops and information sessions, and encourages the direct involvement with the AER of consumer advocates and consumer representatives.

### 3.3. Targeted workshops and information sessions

CCP16 supports the AER's intention to facilitate a series of introductory workshops, targeted workshops and skills sessions.

The AER notes that in the past many consumers have found rate of return discussions inaccessible, even where there have been opportunities for consultation. We recognise the challenge to overcome these barriers. We see here a role for the Consumer Reference Group to assist with development of content and delivery, and identification of appropriate attendees. This requires early set-up of the Consumer Reference Group in time to be involved in this stage.

There is also a role for CCP16 to provide advice to the AER regarding the content and presentation of the proposed targeted workshops and information sessions from the perspective of the long-term interest of consumers.

The AER needs to take account of the imbalance in human and financial resources and information asymmetry as between the regulated businesses, and the consumer representatives who are much less well resourced. The regulated businesses are also able to call on expert consultants to support their arguments. Given the objectives to promote the long-term interests of consumers, this is something that the AER must address, in consultation with the Consumer Reference Group.

### 3.4. Issues Paper

CCP16 supports the AER's proposal to publish an Issues Paper in October 2017 to promote early consultation on substantive issues.

We see a role for the Consumer Reference Group and for CCP16 to provide the AER with advice regarding identification of the substantive issues from a consumer perspective, and how they might be presented in the Issues Paper, as well as providing formal advice to the AER on the publication of the Issues Paper.

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

'Hot-tubbing' of expert advisers is a mechanism which enables concurrent discussions with various experts that are participating in the review process. The mechanism has precedent in both court and administrative settings.

The purpose of 'hot-tubbing' is to identify, scope, and narrow the relevant issues, identify the points on which the views of the experts differ and the reasons for any disagreement.

We agree that there may be potential for this approach to add value to the process. This step in the process needs to be managed carefully. A rigorous process is required in order to make 'hot-tubbing' work well, otherwise it can be inefficient.<sup>7</sup>

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<sup>7</sup> Much has been written about the pros and cons of 'hot-tubbing', what works, and what does not work. We recommend the October 2013 paper *How Concurrent Expert Evidence Aids Understanding Issues* by Justice Rares, available at [www.fedcourt.gov.au/digital-law-library/judges-speeches/justice-raises/raises-j-20131012](http://www.fedcourt.gov.au/digital-law-library/judges-speeches/justice-raises/raises-j-20131012)

Those chosen to participate should be recognised as experts in their field who can present arguments that are pertinent and robust. We would expect the experts all to focus on the objective of the review, being to develop an approach to the assessment of a rate of return that is most consistent with the NEO, the NGO and the RPP, to ensure efficient investment and operation of the network that is in the long-term interests of consumers, and to focus on issues that are substantive and material. The choice of experts who meet these requirements will be key to ensuring the success of this step in the process.

CCP16 suggests that the AER should consider funding of experts that are appointed by consumer interests, who may not have the resources to appoint experts that are available to other interested parties.

A record of the discussions and conclusions reached should be published, either in summary form or as a full transcript of proceedings, as this will enhance transparency and improve stakeholders understanding of the key issues.

CCP16 seeks to discuss with the AER how it could contribute directly and indirectly to the 'hot-tubbing' process and outcomes.

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

The AER considers that a review of its draft guideline by an independent panel may be a useful step in promoting stakeholder confidence in both the process and the ultimate decision.

We agree that to get the most out of any independent panel review, it is important to consider what the independent review panel is expected to deliver.

We suggest that the purpose of the independent panel review might not just be to assess whether the AER has undertaken an effective review process. Rather, it might also provide advice to the AER on the issues and proposals being considered, from the perspective of finance and regulatory theory and practice. Overall, the AER would still retain discretion in the exercise of its judgement, as it does when it receives advice from any party.

There are precedents for such a panel in the reviews undertaken by the NZ Commerce Commission and the AEMC. The NZ Commerce Commission appointed a panel of finance experts (Professor Bradford Cornell, Professor Julian Franks and Dr Martin Lally) in 2006 to assist it in the review of its approach on the cost of capital. The Panel reviewed and provided advice on the submissions and accompanying technical reports received in parallel with the Commerce Commission's own processes. In its review of the economic regulation of NSPs, the AEMC engaged Professors Littlechild and Yarrow to provide a review of the issues raised, drawing on their considerable expertise and international experience. While not formally created as an expert panel, their appointment served a similar function.

CCP16 suggests that the AER might consider a role for the independent panel at an earlier stage: in advance of the publication of the new draft guideline. The independent panel might review the AER's processes and deliberations before the 'hot-tubbing', or as part of the AER's preparation of the draft guideline. A member of the independent panel might be an appropriate person to facilitate the 'hot-tubbing' process. Whatever its role, we suggest that the panel's findings should be made public, in the interests of transparency.

On a point of detail, one of the criteria suggested by the AER for eligibility to the independent panel is that "Panel members must not have been engaged to provide advice to a network business or the AER on any AER regulatory determination processes within the preceding 2 years."



We believe this might exclude appropriate people, and might allow inappropriate people. Rather, we believe this criterion should seek to exclude those who have or might be perceived to have a conflict of interest that would materially adversely affect their ability to serve on the panel, independent of such interests. Conflicts of interest may arise from the providing of advice on a regulatory determination process, but it might also arise in a different way, such as through material financial interests in a network business. Conversely, previous work might not be a conflict if it was on a totally different matter.

### 3.7. Submissions on a new draft guideline

Though not explicitly given a sub-section in section 3 of the Consultation Paper, we see submissions from interested parties on any new draft guideline to be important for the AER to consider in its finalisation of the new guideline. CCP16 would expect to provide advice to the AER on any draft guideline during its consultation period. The CCP16 advice would focus on substantive issues from a consumer perspective.

## 4. Summary of areas for CCP involvement

In summary, CCP16 proposes that it should be involved in the review process by challenging the AER's analysis from the perspective of the long-term interest of consumers through the efficient investment in and operation of the network, and suggesting any approaches that the AER may explore through its process in the following ways:

- Explore with the AER and with consumer groups / the Consumer Reference Group how the detail of the process should be developed from what is outlined in the Consultation Paper, to ensure that the process is robust, transparent and comprehensive, incorporating broadly based consultation with all interested stakeholders, and minimising the risk of the final binding guideline itself being referred for judicial review;
- Provide advice to the AER regarding the content and presentation of the proposed targeted workshops and information sessions from the perspective of the long-term interest of consumers;
- Provide the AER with advice regarding identification of the substantive issues from a consumer perspective, and how they might be presented in the Issues Paper, as well as providing formal advice to the AER on the publication of the Issues Paper;
- Review and provide comments to the AER on the analysis and proposals put forward by other stakeholders.
- CCP16 seeks to discuss with the AER how it could contribute directly and indirectly to the 'hot-tubbing' process and outcomes;
- Provide advice to the AER on any new draft guideline in its consultation period, focusing on substantive issues from a consumer perspective; and
- Throughout the process, engage with the AER and other interested parties including the Consumer Reference Group, Energy Consumers Australia, consumer advocates and consumer representatives.

CCP16 looks forward to this participation.