Consumer reference group:

Workshop overviews and issues for discussion

May 2013

AUSTRALIAN ENERGY REGULATOR

Contents

Contents **2**

1 NSP consumer engagement **3**

1.1 What is the problem the AER is trying to fix? 3

1.2 What the AER is intending to do about the problem? 3

1.3 What does the AER want you (the CRG) to focus on (butcher's paper questions)? 3

2 Rate of return **6**

2.1 What is the problem the AER is trying to fix? 6

2.2 What the AER is intending to do about the problem? 6

2.3 What does the AER want you (the CRG) to focus on (butcher's paper questions)? 7

3 Expenditure forecast assessment **8**

3.1 What is the problem the AER is trying to fix? 8

3.2 What the AER is intending to do about the problem? 8

3.3 What does the AER want you (the CRG) to focus on (butcher's paper questions)? 9

4 Expenditure incentives **10**

4.1 What is the problem the AER is trying to fix? 10

4.2 What the AER is intending to do about the problem? 10

4.3 What does the AER want you (the CRG) to focus on (butcher's paper questions)? 12

1 NSP consumer engagement

1.1 What is the problem the AER is trying to fix?

At present, most network businesses undertake some form of consumer engagement. However, there is considerable variation in how network businesses consult within the business and across the sector. Often it is ad hoc and late in the process.

One of the focuses of the new rules is improving the level of engagement that network businesses have with their consumers. This guideline aims to facilitate the alignment of network service with the long term interests of consumers by setting out a principles based framework for consumer engagement. Our aim is to see network businesses engage genuinely with consumers as part of their usual way of doing business.

1.2 What the AER is intending to do about the problem?

The Guideline and Explanatory Statement will set out the AER's expectations around network businesses' consumer engagement. Based on information from multiple sources including consultation with consumer representatives, it is proposed the guideline be structured around four components (briefly described in Attachment A). The AER would expect each network business to develop consumer engagement approaches and strategies addressing each of these components of the guideline.

a. Principles: a set of best practice principles to guide engagement with consumers.

b. Priorities: the need to identify issues and set priorities for engagement with consumers (i.e. analysing and understanding consumers' needs as part of business planning).

c. Delivery: the activities the AER would expect network businesses to undertake to engage effectively with consumers (set at a high level).

d. Results: a clear articulation of the outcomes and measures of success.

An Explanatory Statement will accompany the Guideline. The statement will explain the underlying reasons to our approach in preparing the Guideline. It will also contain examples and case studies to provide a clear indication of what the AER expects from the network businesses. However, it is not our intention to be overly prescriptive. We do not want to limit innovation or provide a 'checklist' of activities for NSP compliance.

1.3 What does the AER want you (the CRG) to focus on (butcher's paper questions)?

We seek your views on how to address several inherent tensions that exist within certain elements of the guideline.

1.3.1 Prescribing consumer engagement processes and activities

It is tempting to prescribe certain engagement activities. Doing so provides the clearest statement on what the AER considers the network businesses need to do. The network businesses have also advised us they want to know what they will have to do. The issue is whether it is desirable to be precise about what good consumer engagement looks like. The risk is that prescriptive consumer engagement would discourage network businesses from undertaking innovative engagement

activities that maximise effectiveness (and/or minimise cost). In other words, we do not want consumer engagement to become another compliance activity. We are seeking cultural change that hopefully results in continual and self perpetuating improvement to network businesses' consumer engagement.

The approach we think is appropriate, therefore, is to highlight certain high level activities we consider represent good examples of consumer engagement. For example, we might suggest a network business should identify from its consumer base an appropriate range of subgroups for which different consumer engagement strategies and approaches will be required.

> ***Question 1: Being mindful of the issues discussed above, what consumer engagement activities should we point to in the consumer engagement guideline?***

1.3.2 Measuring success

The AER wants to be confident that a network business' regulatory proposal is consistent with the long term interest of consumers. To achieve that, consumers need an opportunity to influence that proposal. This Guideline proposes to go one step further and suggest that network businesses adopt the same framework to engage with consumers outside of reset periods.

The question is how will we know when the network businesses have (at least adequately) engaged with consumers? Measures of success may relate to outputs (delivery) or outcomes (results). The AER is trying to achieve more informed consumer submissions, better proposals etc – this link to outcomes. Some network businesses are concerned about knowing when they have done enough engagement with the correct consumer cohorts (delivery). Is this something we want to know given the overall assessment of consumer engagement is inherently subjective?

We have stated that network businesses should monitor, review and evaluate their consumer engagement activities and plans periodically. One would expect that this would involve the development of Key Performance Indicators (KPIs). The question is who should develop the KPIs – each network business, the AER or should the industry develop industry wide KPIs? If the AER states KPIs, will they drive certain behaviour rather than driving genuine engagement?

> ***Question 2: What are the measures of successful consumer engagement? How, when and where should these successes (or otherwise) be reported?***

1.3.3 Getting the network businesses to buy-in

While this Guideline cannot compel any particular form of consumer engagement from electricity or gas businesses, there are links to how we assess expenditure proposals. In electricity, this link is explicit. The new electricity rules require us to consider the extent to which the proposed expenditure addresses the concerns of electricity consumers as identified in the course of the business' engagement with electricity consumers. While not explicit in gas, it is open for us to similarly assess their expenditure proposals.

Therefore, a part of getting network businesses to buy-in is to demonstrate that the quality of their consumer engagement will be a factor in how we assess their expenditure proposals. In addition, in writing up our assessment of the quality of their engagement, we may publicly comment on any shortcomings that we have identified. We may also consider some type of annual performance report, which includes consumer engagement.

> ***Question 3: How else might we obtain network business buy-in to the guideline?***

Service provider consumer engagement guideline

Guideline objective: Aligning network services with the long term interests of consumers

1. Best practice principles

The Guideline will list best practice prinicples. The principles are:

1. Inclusive and accessible
2. Transparent
3. Communication
4. Collaboration
5. Integrity

Best practice principles should be applied across the 4 components.

See draft best practice principles

2. Priorities

Service providers should for example:

- understand prospective areas of consumer interest
- determine issues requiring consultation
- undertake market reserach
- prioritise engagement topcis/activities
- develop consumer engagement activities

3. Delivery

Implement targeted engagement plan/strategy. Businesses should for example:

- ensure plans remain aligned with best practice principles and target areas
- monitor progress and carry out transparent reporting arrangements
- evaluate and review
- be innovative
- demonstrate how the guideline has been adopted

4. Results

- Report on consumer engagement activities – demonstration of meaningful, genuine and transparent engagement
- How businesses have used information from consumers
- Present evidence of consumer engagement

2 Rate of return

2.1 What is the problem the AER is trying to fix?

The allowed rate of return is the estimate of the appropriate cost of capital expenditure for the business. Depending on the rate determined it can contribute about 40 per cent of the final revenue allowance and therefore the network charges customers pay.

A good estimate of the rate of return is necessary to promote efficient prices in the long-term interests of consumers. Efficiency is promoted when revenues align with costs. The cost of capital is one component of these costs. If the allowed rate of return is higher than the cost of capital then revenues are not aligned with costs. Customers will pay excessive prices and businesses may seek to over-invest in network solutions. Conversely, if the allowed rate of return is lower than the cost of capital, again, revenues are not aligned with costs. Network companies may seek to defer or refuse to undertake expenditure, which could lead to a decline in the service and reliability outcomes for consumers.

There were five main problems under the old rules:

1. "Mechanical" outcomes that failed to take into account the "bigger picture". We determined the overall rate of return by estimating and bringing together individual components. Nothing allowed us to consider the overall outcome and whether it was in the long term interests of consumers.

2. There were different frameworks for electricity distribution, electricity transmission and gas. These different frameworks resulted in different estimates of the cost of capital for each sector for no good reason.

3. The old rules primarily relied on the application of one estimation method—the "Sharpe CAPM". The AER could not take into account other relevant information.

4. Elements of the old rules were highly prescriptive. The AER could not readily adjust its approach to account for changing market circumstances. This was particularly a problem with the estimation of the cost of debt, where we were locked into assessing a type of bond that was no longer traded following the GFC.

5. Estimates of the cost of capital were based on a short sampling period. This led to substantial movements in the cost of capital from one decision to the next in response to financial market volatility. There were cases where our estimate of the rate of return varied substantially between decisions made within a few months of each other.

2.2 What the AER is intending to do about the problem?

We will develop a new guideline setting out our approach to the methodologies we will use to establish a rate of return that meets the new rate of return objective. The new objective is for the overall rate of return to correspond to the efficient financing costs of a benchmark efficient business. The main issues we are exploring are the methods, approaches, and market data for estimating return on equity and return on debt, to meet the overall rate of return objective.

We plan to address the five issues above in our guideline as follows:

1. **Driven by high level objectives**. We will focus on the objective of the law to promote the long term interests of consumers. The new rate of return objective allows us to consider the rate of return holistically rather than as an aggregation of individual components.

2. **Consistency of approach**. A common rate of return framework will apply in all our decisions. There could be different outcomes for different service providers, but this will be a considered decision. For example, we are required to consider the risk in providing regulated services.

3. **Consideration of a broad range of material**. We will set out the information we intend to take into account, and our approach in bringing it together to formulate our estimate of the rate of return. We must exercise regulatory judgment to bring together the range of material and settle on a final estimate of the rate of return. However, we understand the importance to all stakeholders of a predictable and transparent outcome.

4. **Flexibility of approach**. Because we will consider a broad range of contemporaneous information, our approach should be able to react to changing market circumstances. We are required to publish our rate of return guideline every three years. We can update the guideline to account for advances in finance theory or fundamental shifts in market circumstances.

5. **Addressing market volatility**. We are exploring several approaches to this issue. First, we could continue with our current approach. Second, we could employ a longer sampling period. Third, we could move to a portfolio approach that employs market samples of debt issues across the regulatory period.

2.3 What does the AER want you (the CRG) to focus on (butcher's paper questions)?

- Considering the five key issues that we are trying to address described above, do consumer groups have a preference for how much detail is included in the rate of return guideline? Should the guideline set out a single primary model for estimating the rate of return? For example, if we choose one primary model should the guideline specify the numerical inputs, range of inputs or just outline a process for their estimation at each determination? Our current preference is to exercise our regulatory judgment for each parameter, rather than the overall rate of return estimate. Do you agree with this approach?

- If we have one primary model for estimating the rate of return on equity, is there a role for other available information to play in assessing whether the return is consistent with the overall rate of return objective? Other information might include RAB multiples, broker reports on estimated rate of return, and results from alternative financial models.

- We are open to the option of introducing a portfolio approach to the return on debt, rather than setting the debt allowance based on a short averaging period (as we have done to date). A portfolio approach will likely produce more stable prices over time because it evens out fluctuations in the cost of debt. Do consumer groups see merit in this portfolio approach, (provided transitional arrangements can be overcome)?

- Businesses have indicated they would prefer both approaches to estimating the cost of debt as options in the guideline. This would necessitate two benchmark efficient entity definitions. This may introduce a potential gaming opportunity as businesses select the most advantageous approach and may seek to switch back in future resets. Do consumers groups have views on this? Can the gaming risk be appropriately managed?

3 Expenditure forecast assessment

3.1 What is the problem the AER is trying to fix?

As part of a revenue determination, the AER must approve a forecast of required operating and capital expenditure. Prior to the most recent changes, the electricity rules restricted our ability to determine efficient forecasts of required expenditure. These restrictions, now removed, limited our ability to depart from the proposal submitted by the business.

In addition to the rule restrictions, due to a lack of consistent and comparable data, we have also had limited ability to set forecasts of required expenditure by comparing across networks. This process of comparing across networks is referred to as benchmarking and is a focus of the rule change approved by the AEMC late last year.

3.2 What the AER is intending to do about the problem?

Our expenditure forecast assessment guidelines will:

- Put in place systems for developing consistent and comparable datasets across networks to support our benchmarking efforts, including a new annual benchmarking report that will set out the comparative costs and relative efficiency of service providers
- Explain to all stakeholders how the AER will undertake expenditure assessments under the new rules and what data will be required.

To achieve this, we have split the guideline development into two workstreams:

- Economic benchmarking - looks at key high level network statistics like peak demand and number of customers and compares this to the expenditure on the network and the number of employees, to examine relative efficiency from a top down perspective.
- Category analysis - breaks down the expenditure of the network business into standard categories (e.g. classes of asset for replacement capital works) to allow a bottom up analysis of the relative efficiency of work practices. The inputs to this analysis are labour and materials and the outputs will include classes of expenditure relating to customer connections, asset replacement and network augmentation.

It is the AER's intention to undertake benchmarking of network businesses against their peers at both the high level (through economic benchmarking) and at the more detailed category analysis level. This should allow the AER to better examine the overall relative efficiency of businesses. We will combine these techniques with our existing assessment processes to provide a more robust assessment of expenditure proposals, including:

- engineering reviews
- trend analysis
- governance and policy reviews
- modelling.

Benchmarking data will supplement existing performance reporting. We will publish the benchmarking data and results to give stakeholders an opportunity to comment on the findings of the economic

benchmarking analysis. Our performance reports will also include information on the overall health of the network. This may include information such as the age profile and utilisation of the assets. This information will assist all stakeholders in understanding the key expenditure drivers over the longer term, rather than as just a five-year-by-five-year proposition.

The expenditure forecast assessment guidelines will also propose the consistent application of existing modelling techniques across all network businesses. This includes the application of two models the AER already has under development. These models forecast the expenditure required for replacement of existing assets (known as the Repex model) and the expenditure required for augmenting the capacity of the existing network (known as the Augex model).

The Repex model provides an objective framework to assess the forecast from the network business. The model takes into account the past replacement expenditure, asset profile (age, type, number etc) and efficiency improvements. The intention is to extend the model to also use benchmark data from other network businesses for assessment purposes. The Augex model will also provide an objective framework to assess forecast augmentation expenditure given their past expenditure on given augmentation projects. As with the Repex model, the intention is to extend the model to also use benchmark data from other network businesses for assessment purposes.

The expenditure forecast assessment guidelines will also outline the consultation steps in the assessment process. This will cover the matters to be addressed and the interaction between the AER's papers, being:

- Initial consultation documents culminating in the AER's framework and approach paper (which will outline the regulatory controls the AER will apply and the application of schemes and guidelines in a determination)
- The AER's annual benchmarking reports
- The issues paper to be released in advance of the AER's draft determination
- The draft and final determinations.

3.3 What does the AER want you (the CRG) to focus on (butcher's paper questions)?

The discussion points below relate to issues specific to our assessment of expenditure proposals from businesses and the information consumers would find useful. There are interconnected issues about consumer preferences for how risks should be allocated between consumers and the businesses. These issues will be explored in our discussion of the incentive framework (next item on the agenda).

- What information would consumers find useful to include in annual benchmarking and performance reporting?
- What information consumers would find useful reported directly from network businesses? (i.e. without AER commentary to guide their considerations)
- Is there a process where confidential information might be circulated to consumers groups without jeopardising the legitimate business interests of the network businesses?
- How consumer preferences (such as willingness to pay) can be better reflected in our assessment of expenditure forecasts? This may relate to specific projects proposed by network businesses or overall programs such as funding reliability improvements.

4 Expenditure incentives

4.1 What is the problem the AER is trying to fix?

As part of our rule change proposal, we identified a concern that the current regulatory regime was not providing strong enough incentives to limit the expenditure of network businesses to their efficient levels. This problem was twofold:

1. Businesses had an incentive to overspend on capital, as they could eventually earn returns on it regardless of the efficiency of the cost

As discussed in the previous agenda item, the AER is required to approve a forecast of required capital and operating expenditure prior to the start of the regulatory period. Under the old rules, any capital expenditure the business incurred over the period was automatically added to its regulatory asset base. This occurred regardless of whether the expenditure was above the forecast determined at the start of the period. Once in the regulatory asset base, the business earned returns on that capital for the life of the asset, as funded by consumers.

2. Businesses had an incentive to overspend on capital towards the end of the regulatory period, regardless of the efficiency of the timing

Under the current arrangements, the strength (or power) of the incentive on the business to spend capital efficiently is not consistent throughout the regulatory period. If a business spends more than the forecast in the first year of the period, it must fund the cost of that overspend itself for the remainder of the period. That capital is not yet in the business' regulatory asset base, and it is not earning returns on it from consumers. However, if the business spends more than the forecast in the last year of the period, it only bears the cost of that overspend for one year. That is, at the next determination that capital is rolled into the regulatory asset base and the business can earn returns on it from consumers.

The type of incentive described above is 'not constant' over the period. Conversely, schemes that apply the same incentive in all years of the regulatory period are known as 'continuous'.

4.2 What the AER is intending to do about the problem?

The AER is seeking to design the incentive framework to encourage businesses to only invest in necessary projects in an efficient manner, in terms of both cost and timing. The AER is also reviewing the existing incentives for businesses to incur efficient operating expenditure.

4.2.1 Capex efficiency sharing scheme (CESS)

We intend to implement a capital expenditure sharing scheme (CESS) to share efficiencies (inefficiencies) between businesses and customers. The CESS should provide a stronger and more continuous incentive for businesses to incur efficient capex. The scheme provides financial incentives for network businesses to incur efficient levels of capital expenditure. This is because businesses and consumers will share the financial impact of a capital expenditure 'overspend'/'underspend'. This means that consumers will not fund all of a business' overspend, and a business will not keep all the benefits of an underspend.

Our scheme proposed for consultation provides a penalty for capital expenditure overspends of 30 per cent or more, and a reward for underspending of between 20 and 30 per cent. This means if the business spends above its allowance it bears above 30 cents for every dollar, with the rest funded by

consumers. Conversely, if the business spends below its allowance, it retains between 20-30 cents in every dollar with the rest benefiting consumers.

4.2.2 Ex post review

In addition to the ex ante incentives the CESS provides, the new rules allow us to assess the efficiency of a business' past capital expenditure. This is known as an ex post review. At the end of the period, if a business has spent more on capital than the forecast we may conduct an ex post review of all capital expenditure. Where we consider some of the capital expenditure was inefficient, the business will not be able to add these investments to their regulatory asset base and will therefore not earn a return on these investments from consumers. However we cannot exclude capital that is more than the value of a business' overspend.

Our proposal is to use ex post reviews in a targeted way—in the case of significant overspends. We prefer to rely on the CESS to be the primary tool for ensuring that businesses spend efficiently on capital.

4.2.3 Power of the incentive framework

There is a spectrum of possible incentive schemes ranging from the high powered, through to a "cost of service" model. Under a cost of service model, the business simply gets back what it spends, so may not seek out opportunities to reduce costs. Consumers bear all the risk of forecasting error under this model as any difference between forecast and actual expenditure is recovered from (or given back to) customers. At the other end of the spectrum under a more high powered incentive, a forecast is set at the start of the regulatory period and the business keeps any savings that it can achieve, but wears the cost of any overspend. Depending on the design of this model, including how closely an NSP's costs are linked to its revenues, consumers and business share the risk of forecasting error. Whereas the cost of service model is generally criticised for resulting in higher costs, putting in place a very high powered regime also has associated risks. For example, if the incentives are too high powered, the business may seek to reduce expenditure below efficient levels and service and reliability levels may decline.

Our current regulatory model is somewhere in the middle of the spectrum. There are elements that are cost of service, for example the pass-through and contingent project regimes. These regimes allow the business to recover the cost of certain expenditure if preset criteria are met, over and above the normal revenue allowance. By adjusting elements like the CESS described above or by including (or excluding) more expenditures, as pass-through events the AER can move the regime up and down the spectrum. We are keen to hear from consumers on where they think the appropriate balance rests.

We are also keen to explore the issue of the risk of forecasting error. This is where the expenditure forecast at the last determination differs from what was actually expended by the business. This divergence can be driven by uncontrollable events that are external to the business. For example, general economic growth can have a significant impact on the number of connections and the need to reinforce the network. Internal management decisions can also drive changes in expenditure. For example, smarter asset management strategies could reduce both operating and capital expenditure requirements. Given that there is a mix of uncontrollable and controllable reasons for forecast error, there is a question as to who should bear this risk, or a proportion of the risk.

4.3 What does the AER want you (the CRG) to focus on (butcher's paper questions)?

- Are you in favour of higher rewards or penalties to encourage service providers to reduce capital expenditure than the existing arrangements? Note that the higher the rewards/penalties are, the greater the proportion of underspends/overspends network business will incur. The network business will also bear a greater proportion of risk associated with forecasting error.

- Should the penalties for an overspend be the same as the rewards for an underspend? Do you consider that it is appropriate for a service provider to wear a greater proportion of the forecast error risk, even if the penalties are higher than rewards? Are there other elements of the framework that should also be considered, such as pass throughs or contingent projects in considering this issue?

- Should a consistent incentive framework apply to all businesses? Are there elements of the framework that should be determined on a business-by-business basis?

- Do you consider that network businesses should be exposed to uncontrollable outcomes? That is, should the CESS penalise network businesses for cost over-runs (and rewarded for cost under-runs) that are outside their control?

- Do you agree with our initial position on the ex post review process? In particular, do you agree with the staged approach and targeted approach to the review and the proposed interaction between the CESS and the ex-post review?