Draft Better Resets Handbook

Towards Consumer Centric Network Proposals

September 2021

AUSTRALIAN ENERGY REGULATOR

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Amendment Record

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1 Request for submissions

We, the Australian Energy Regulator (AER) invite interested parties to make submissions on this Better Resets Handbook – Towards Consumer Centric Network Proposals by 5pm AEST 20 October 2021. Submissions should be emailed to regulatoryinnovation@aer.gov.au. Alternatively, you may mail submissions to:

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We prefer that all submissions be publicly available to facilitate an informed and transparent consultative process. We will treat submissions as public documents unless otherwise requested. All non-confidential submissions will be placed on the AER's website. For further information regarding the AER's use and disclosure of information provided to it, see the ACCC/AER Information Policy.

We request parties wishing to submit confidential information:

- clearly identify the information that is the subject of the confidentiality claim
- provide a non-confidential version of the submission in a form suitable for publication.

1.1 Questions for stakeholders

For this consultation on the Better Resets Handbook – Towards Consumer Centric Network Proposals (the Handbook) we are particularly interested in hearing from stakeholders on the following questions:

1. Do you consider the Handbook as set out will achieve the AER’s aim of incentivising proposals that reflect consumer preferences and are capable of acceptance
    a) If yes to 1, what do you see as the main benefits of the Handbook? Are they the same as those set out in this document or do you consider there additional benefits which are not listed?
    b) If no to 1, what are your reasons for this? Further, what changes do you consider could be made to the Handbook to achieve the aim of incentivising proposals that reflect consumer preferences and are capable of acceptance?
2. Do you agree with the proposed targeted review stream and that this a positive change to how we regulate networks? Please include reasons for your views in the answer provided.
3. Do you consider the Handbook will improve the level of consumer engagement undertaken by network businesses and result in consumer preferences being better reflected in proposals? Please include reasons for your views in the answer provided.
4. Are the incentives offered by the Handbook sufficient for network businesses to seek access to the targeted review stream process? If you do not consider the incentives are sufficient, then what additional incentives do you think could be provided within the current regulatory framework?
5. The targeted review stream is a new process which we expect to refine and improve as we learn from each iterative application. Therefore our preference would be to first apply the targeted review stream process to a limited number of network businesses. This approach would allow us to better manage the risks of introducing a new process, maximise learnings and manage resourcing constraints. What approach or criteria should we use to determine which network businesses should be selected?

6. Do you agree with the approach to commence the full application of the targeted review stream process to the revenue proposals due in January 2023[1]?
    a) We would be open to considering applying of the targeted review stream process partially to a proposal which is submitted before January 2023. This would allow us to test the process before it is fully applied. Would you be supportive of this approach? Please include reasons for your views in the answer provided.
    b) For stakeholders that answered yes to 6(a), what approach or criteria should we use to determine which network business' proposal should be considered for a partial application?
7. Do you agree with the expectations for the topics set out in sections 4 to 8 of this document? If not, what changes do you consider need to be made to the expectations? Please include your reasons for any proposed changes.
8. Is there any further clarification or issues which the Handbook should set out?

[1] Specifically, Ausgrid, Essential Energy, Endeavour Energy, Evoenergy (electricity distribution), TasNetworks (distribution and transmission) and Power and Water.

2 Introduction

2.1 Who we are and purpose of this document

The Australian Energy Regulator (AER) exists to ensure energy consumers are better off, now and in the future. Consumers are at the heart of our work, and we focus on ensuring a secure, reliable and affordable energy future for Australia. Energy is an essential service for Australian households and businesses, and a critical contributor to the long-term success of the Australian economy.

This document, the Better Resets Handbook – Towards Consumer Centric Network Proposals (the Handbook) seeks to encourage networks to better engage and have consumer preferences drive the development of regulatory proposals and create a more efficient regulatory process. This gives effect to one of our 'tilt' priorities in our Strategic Plan for 2020–25, to achieve our objective of delivering efficient network regulation while incentivising networks to become platforms for energy services:

> *Incentivise proposals that reflect consumer preferences and are capable of acceptance, including through:*
>
> *– establishing a Statement of Expectations for networks that aligns with the National Energy Objectives/National Gas Objectives*
>
> *– enhanced consumer engagement (e.g. NewReg).*

This Handbook is new name for the Statement of Expectations for Networks referred to in our Strategic Plan for 2020–25.

2.2 Our role in regulating energy networks

As economic regulator of energy networks in all states and territories except Western Australia, we play an important role in the energy transition. We regulate 30 gas and electricity network businesses with a combined asset base of over $100 billion. Our primary role is setting the maximum revenue and prices that network businesses can recover from users of their networks. We aim to ensure consumers pay no more than necessary for safe and reliable energy.

Our framework for regulating electricity networks is set out in the National Electricity Rules (Electricity Rules) and Law (Electricity Law). For natural gas pipelines, it is set out in the National Gas Rules (Gas Rules) and Law (Gas Law). In this document when we refer to the Rules or the Law we mean the both the Electricity and Gas versions.

Network businesses submit revenue proposals, which we assess against factors including: efficiency of costs; quality of engagement with customers; projected demand for energy; age of infrastructure; operating and financial costs; and network reliability and safety standards. Our decisions on revenue generally apply for five years. To recover these revenues, network businesses adjust their prices annually, in accordance with the Rules requirements (including any relevant AER pricing decisions).

2.3 Where are we now?

Our approach to regulating energy networks is evolving. One of the main themes of network regulation in the past decade has been the increased focus on consumer engagement. For the National Electricity Objective and National Gas Objective to be achieved, revenue proposals and AER determinations must reflect the long term interests of consumers. Consumers have gone from being outsiders to being an integral part of the regulatory process. We want to see this continue.

We established the Consumer Challenge Panel in 2012 and trialled the NewReg approach to engagement in a joint initiative with Energy Networks Australia and Energy Consumers Australia across 2018 to 2021. We have also seen network businesses undertake their own innovative approaches on consumer engagement, especially since the removal of merits review in 2017. These are positive developments we want to encourage and build upon as a best practice regulator.

We are in an environment where the energy system is rapidly changing, affecting customer preferences and how energy networks are used. Over the next 5–10 years we expect to see significant network investment to manage the impact of the energy transition. In this energy transition, it is more important than ever to ensure customer preferences drive outcomes and we continue to evolve how we regulate to ensure the long term interests of consumers are met.

Now is an important time to provide more clarity to consumers, network businesses and governments about our expectations. It is almost a decade since our Better Regulation reform program. The guidelines and decisions we have published since then provide a lot of information on what we expect from revenue proposals. However, we recognise it is not easy for consumers or businesses to work through our decisions and identify our expectations. Providing additional clarity should benefit consumers and network businesses, and help make the regulatory process more efficient.

2.4 Structure of this document

Section 3 outlines how the Handbook will operate

Section 4 outlines our expectations for consumer engagement

Section 5 outlines our expectations for capital expenditure

Section 6 outlines our expectations for operating expenditure

Section 7 outlines our expectations for regulatory depreciation

Section 8 outlines our expectations for tariff structure statements (electricity distribution only)

3 Our Better Resets Handbook – Towards Customer Centric Network Proposals

3.1 What is our objective for the Handbook?

The Handbook aims to incentivise networks to develop high quality proposals through genuine engagement with consumers. This will lead to regulatory outcomes that better reflect the long-term interests of consumers.

Proposals which are developed through genuine engagement with consumers are more likely to be largely or wholly accepted at the draft decision stage, creating a more efficient regulatory process for all stakeholders. We consider that this will also will lead to many other benefits including; improved relationships and understanding between networks and consumers, greater faith from all parties in regulatory processes, and the generation of new ideas and regulatory approaches that benefit both consumers and networks.

The Handbook will:

- Set out our expectations for consumer engagement and key topics in revenue proposals which are likely to have the most impact on consumers (capital expenditure, operating expenditure, regulatory depreciation, and tariff structure statements).
- Outline what we will do when a proposal meets our expectations. Specifically, what recognition we will provide businesses for meeting our expectations and how this will influence our assessment of the proposal.

We believe the Handbook will provide a number of benefits.

By encouraging network businesses to improve their consumer engagement, the consumer will be put further into the centre of the regulatory determination process. This will allow consumers to have a greater influence over the development of regulatory proposals by the network businesses and, more importantly, ensure networks businesses deliver the outcomes valued by consumers.

As the economic regulator of energy networks, we are required to make decisions which best advance the long term interests of consumers, as expressed in the National Electricity Objective[2] and National Gas Objective[3]. If a network business meets our expectations this will increase the likelihood that its regulatory proposal advances the long term interests of consumers, giving us the confidence to rely on a more targeted assessment to meet our obligations.

Network businesses will be rewarded for meeting our expectations set out in the Handbook. Under the existing regulatory framework, we can provide reputational and procedural incentives.

By providing greater clarity, and rewarding good customer engagement and well-justified proposals, there will be increased efficiency in the regulatory process. This should increase the likelihood that more issues

[2] To promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to:

- price, quality, safety and reliability and security of supply of electricity
- the reliability, safety and security of the national electricity system.

[3] To promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas.

can be settled at the draft decision stage or proposals even fully accepted. The network businesses can then focus their resources on meeting the needs of their customers, rather than extended engagement with the regulator.

3.2 How will it work?

3.2.1 Setting out our expectations

This Handbook:

- Sets out our expectations of how network businesses will engage with consumers and how outcomes of that engagement should be reflected in their proposals. These expectations are drawn from the consumer engagement framework first developed for the 2021–26 revenue determinations for the Victorian electricity distribution networks. **See section 4.**
- Sets out our expectations for capital expenditure, operating expenditure, regulatory depreciation and tariff structure statements (electricity distribution only). We focus on these topics areas as they tend to have the most significant impact on consumers in terms of price and service outcomes. **See sections 5 to 8.**

Our expectations for each topic area are drawn from the Rules, published guidelines, guidance notes, AER assessment tools and previous AER decisions. The expectations represent key features and supporting evidence which would be required for a proposal to be considered well-justified and therefore qualify for a targeted and proportionate review.

3.2.2 Targeted review stream

Where a proposal meets our expectations for any of the topics covered in **sections 4 to 8** of this Handbook, we will:

1. Publicly recognise the proposal has achieved this early in the assessment process – this would occur prior to the draft decision stage.
2. Undertake a targeted review rather than our standard assessment approach.[4]

We refer to this as the *targeted review stream* – see **Figure 1** for more detail**. Figure 1** also highlights how the targeted review stream is different to our standard approach to assessing proposals.

The Handbook, including the targeted review stream, will operate within the regulatory framework set up by the Rules and Law. Our expectations are not in addition to these requirements, but rather our views on how a proposal can be better substantiated to meet the Rules requirements for key topics. Our role as the economic regulator for energy networks means we must satisfy ourselves that a proposal meets the Rules requirements before we can accept it. Where our expectations are met, it will allow us to undertake a more efficient process to determine whether we can accept the relevant parts of a proposal – a targeted review.[5]

[4] This commitment will be subject to stakeholder submissions and any material changes in circumstances which would influence our assessment.

[5] The conditions outlined above do not displace any requirements in the Rules, including the requirement to publish a framework and approach paper prior to an electricity proposal being submitted. The Electricity Rules require the framework and approach paper to cover a number of prescribed issues. We consider this will largely continue to be the main purpose of the framework and approach paper. However, as we apply the targeted stream review approach we will give consideration to whether and how the framework and approach paper could be better utilised.

This will also likely reduce the work required at the later stages of the regulatory process (namely the revised proposal and final decision).

A targeted review differs to our standard approach by:

- where our consumer engagement expectations are met, being able to place greater reliance that the elements of a proposal reflect the preferences and outcomes of network consumers.
- focusing our assessment on the key drivers and contentious issues of the proposal. These are the issues which will have a greater influence on whether we accept or reject an element of the proposal.
- more easily and efficiently examining an issue because the network business has followed our standard forecasting approaches, provided supporting evidence in line with our expectations, and consulted with its consumers.

An example of a targeted review is how we assessed AusNet Services' forecast capital expenditure in its initial proposal for the 2023–28 regulatory control period. In the Draft Decision, we undertook a targeted review because it met our expectations of a well-justified capital expenditure proposal. In particular, AusNet Services' customer engagement on its capital expenditure proposal reflected consumer preferences, it performed well on top-down tests of its initial total forecast and at the category level, and provided some well-justified business cases for key projects. This positive first pass outcome meant that we had confidence it was sufficient to undertake a targeted review of a sample of key projects and programs to test the prudency and efficiency of the forecast capital expenditure.

Figure 1 – Targeted review stream compared to current AER assessment approach

		Current	Targeted review stream
Pre-lodgement steps	Start pre-lodgement engagement	Network business commences pre-lodgement engagement with consumers. AER staff observe engagement process. Limited Consumer Challenge Panel involvement.	Network business commences genuine open consumer engagement. AER notified of intention to access the targeted review stream. AER staff support consumers in engagement process and provide feedback to network businesses where appropriate. Consumer Challenge Panel may observe consultation and engage where necessary.
	NSP draft proposal	A network business may publish a draft proposal to consult on.	Network business publishes a draft proposal for consultation with consumers and updates proposal based on feedback.
Post-lodgement steps	REG proposal	Network business submits proposal for AER assessment.	Network business submits proposal for AER assessment. Proposal must show how consumer feedback on the draft proposal has been accounted for. Proposal to also include an independent consumer report. AER may commission the Consumer Challenge Panel to provide an assurance report on the quality and outcomes of the engagement process.
	Early signaling		In electricity, this could occur at the issues paper stage. AER would provide a view on: 1. which aspects of the proposal have met our expectations and can be subject to a targeted review 2. for topics subject to a targeted review, signal which areas will be of particular focus and which are not 3. which topics will be subject to standard assessment approach.
	Forum and submissions	Seek stakeholder feedback on proposal. Issues paper highlights AER view of key themes and issues raised by a proposal.	Seek stakeholder feedback on proposal and AER issues paper positions.
	Draft decision	AER uses its discretion in determining the extent of assessment required to publish draft decision on individual components of the proposal as required by the Rules.	Additionally, draft decision will highlight which parts of the proposal were subject to a targeted review and accepted using that assessment approach. We will also highlight if a proposal is exemplary and has been accepted in its entirety.
	Revised proposal / Final decision	Standard assessment process using our full range of assessment tools, including on new issues raised in the revised proposal.	Highly targeted review of any outstanding issues.

This Handbook does not prescribe a particular model or format for consumer engagement. However, to be considered for the targeted review stream, the network business must satisfy the following conditions as part of its pre-lodgement engagement:

1. Notify the AER of the business' intention to access the targeted review stream in the early stages of its engagement with consumers on its proposal.

2. Publish a draft proposal, which incorporates the findings of its consumer engagement, for further consultation with consumers and other stakeholders prior to submitting the proposal to the AER. The proposal submitted to the AER must show how the network business has used consumer outcomes to set the agenda in the development of its proposal and accounted for feedback on the draft proposal to reflect customer preferences.

3. Submit an independent consumer report on the proposal, with the proposal, to the AER. This is to help us assess the quality of the engagement process and the extent to which a proposal reflects consumer preferences and desired outcomes. The independent consumer report should provide a consumer view of the effectiveness of the pre-engagement lodgement process in identifying consumer preferences and outcomes and how they have been incorporated into the proposal. The independent consumer report can also provide views on technical issues in the proposal in the case where consumers feel capable of putting forward positions on these elements of the proposal.[6] This report could be complemented by the AER commissioning the CCP to provide an assurance report on the network business' consumer engagement process.

4. These elements go towards giving the AER the necessary information and confidence to give effect to the early signalling and targeted review process.

3.2.3 What is the AER and CCP role in pre-lodgement engagement?

Pre-lodgement engagement is primarily a process between the network business and consumers. Our expectation is that networks will ensure their consumers are appropriately equipped and informed to meaningfully participate (see section 4 for further discussion).

AER staff involvement in pre-lodgement engagement will be focused on:

- providing support to consumers where appropriate to ensure they can meaningfully participate
- providing feedback, at the AER staff level, on the consumer engagement processes being undertaken
- providing feedback, at the AER staff level, to the network business where development of the capital expenditure, operating expenditure, depreciation and tariff structure statement proposals appears to deviate from, or be substantially inconsistent with, the expectations set out in this document
- providing feedback or guidance on, at the AER staff level, on the nature or type of information which a network business could provide to support a particular aspect of its proposal.

Any feedback or guidance provided to a network business will also be shared with consumers participating in the engagement process.

[6] Multiple independent consumer reports can be provided on different parts of the pre-lodgement engagement process if no one consumer advocate or group can provide a report covering all processes.

Importantly, at the pre-lodgement phase AER staff will not provide advice or guidance, implicitly or tacitly, on:

- whether an aspect of a draft proposal is likely to meet our expectations and/or qualify for targeted review
- how the AER Board would likely substantively decide on an issue.

We see the key role of the CCP in the pre-lodgement phase as assessing the quality and robustness of a network's consumer engagement processes and outcomes. This would be provided as an assurance report to the AER shortly after the proposal has been submitted. This would be separate to the independent consumer report. We would expect CCP advice to detail how well consumer preferences and desired outcomes have been incorporated into specific elements of the proposal (for example, how consumer preferences have influenced or been incorporated into the capital or operating expenditure forecast). However, the role undertaken by the CCP would depend on the specific circumstances of the reset, including the type and forms of consumer engagement being implemented by the network business.

3.2.4 Who will the Handbook apply to?

The expectations outlined in this Handbook generally apply to all regulated network businesses (electricity distribution, electricity transmission, gas distribution and gas transmission). However, certain expectations are specific to particular networks types, as specified.

We consider the targeted review stream could apply to both electricity and gas networks.

For electricity proposals, we would provide an early signal and indicate our intention to undertake a targeted and proportionate review at the issues paper stage.

For gas proposals, the Gas Rules do not include a prescribed issues paper stage. We consider, however, that the Gas Rules contain sufficient flexibility to allow an early signal to occur at a similar time. Gas network businesses seeking access to the targeted review stream should engage the AER at the start of their pre-lodgement engagement processes to discuss how we can manage our consultation on their proposals to incorporate an equivalent step within the shorter assessment timeframes available (8 to 10 months for gas compared to 15 months for electricity).

We consider the first full application of the targeted review stream process will apply to the proposals due in January 2023. This is because the pre-lodgement consumer engagement processes for proposals that are due earlier, have already commenced and are likely to be well-advanced.

3.2.4.1 What happens if there is a change in circumstances which materially impacts a proposal?

We recognise that between a proposal being submitted and the draft decision being published there may be changes in circumstances, beyond the control of the network business, which could materially impact our assessment of a proposal. Where this occurs, we would need to assess whether it is still possible to undertake a targeted stream review for some elements of the proposal, or whether the change in circumstances means such an approach is no longer possible.

If a network business wants to update its proposal in light of the changed circumstances which are beyond its control, we would expect it to engage with consumers on the proposed changes in accordance with our expectations for consumer engagement.

Changes in circumstances beyond the control of the network business could also occur late in the regulatory assessment process, such as after the draft decision or even after the revised proposal is submitted. If this occurs, we would similarly expect a network business to engage with its consumers on proposed changes in accordance with our expectations for consumer engagement.

However, if a network business wants to make material changes to a proposal which are not driven by circumstances beyond its control after it has been submitted to the AER, it will no longer be eligible for a targeted review of the elements of its proposal affected by the change.

4 Our expectations on consumer engagement

4.1 Overview

The networks we regulate are natural monopolies that supply an essential service. High quality consumer engagement is essential for ensuring that networks provide the services that meet the needs of their consumers, at a price that is affordable and efficient.

We have observed material improvements in consumer engagement as part of regulatory processes over the last five years. We acknowledge the significant commitment and progress that both network businesses and consumer representatives have made to date. We want to see this continue as the nature of the energy system evolves and the needs and preferences of consumers change over time.

Our expectations on consumer engagement outlined below are principles-based and build on our current learnings. They cover:

- the nature of engagement
- the breadth and depth of engagement
- clearly evidenced impact of this engagement.

Our expectations do not prescribe any particular form or model of consumer engagement and can be applied across all network types in developing their regulatory proposals. They are targeted at the outcomes we want to see from engagement. Importantly, we want networks to own their engagement approaches and tailor their engagement to best suit the needs and circumstances of their consumers.

Our expectations are a baseline that represents what we think is good practice under the Rules. Some networks are already exceeding these expectations. We expect this to continue and the learnings from new initiatives shared across the sector to "lift the bar" over time. We include case examples of good practice engagement that we have observed to illustrate these principles.

The onus for good consumer engagement ultimately rests with the network businesses. That being said, we will support consumers where necessary (where networks cannot provide this support themselves) in their engagement with a network business and commit resources to the development of regulatory proposals that we consider will bring a net consumer benefit. The support provided would be tailored to the network's engagement activities and the circumstances of the engagement. This may include the review of a networks' proposals, participation in consultation and the provision of written advice.

4.2 Nature of engagement

The nature of engagement is about *how* networks engage with their consumers. Our expectations are that network businesses will sincerely partner with consumers and equip them to effectively engage in the development of their proposals.

4.2.1 Sincerity of engagement

We want network businesses to sincerely engage with consumers to understand and reflect their preferences in regulatory proposals. Sincerity of engagement relates to the intent of a network business and is not easily quantified. We can qualitatively assess sincerity by observing a network business' commitment to engagement through its actions.

Sincere engagement requires:

- high level 'buy-in' from network businesses extending from Board level

- openness to new ideas and a willingness to change
- ongoing conversation with consumers about outcomes that matter to them, which allows consumers to 'set the agenda'.

Case study 1: Jemena's 'People's Panel'

> Jemena's 'People's Panel' approach to engagement with its customers, which won the 2019 ENA / ECA consumer engagement award[1] exemplifies the principles outlined above, with good buy-in and attendance at engagement activities by senior executives and Board members. Jemena demonstrated it is customer-driven and open to new ideas and change, by adopting all recommendations made by the People's Panel.
>
> Jemena's approach provided us a good line of sight for issues which had been the subject of consultation with stakeholders and how consumer preferences had directly influenced the development of its regulatory proposal.

4.2.2 Consumers as partners

We want consumers to be partners in forming proposals rather than simply being asked for feedback on a proposal. Network businesses should collaborate with and, where appropriate, empower consumers in developing regulatory proposals.

In addition, consumer engagement should be a continuous business-as-usual process, not a one-off process only undertaken in preparing for regulatory proposals. Consumers should not have to wait for a once-in-five year reset to be heard.

4.2.3 Equipping consumers

Equipping consumers is about ensuring consumers are able to effectively engage with and provide informed feedback to network businesses. This principle ensures consumers, or committees/panels that represent them, are effective counterparties in the engagement process. Consumers cannot genuinely guide the development of a regulatory proposal unless they are appropriately qualified and supported to do so.

How consumers should be equipped depends on the engagement approach applied by the network business. It may include engaging with appropriately qualified consumer representatives, providing impartial support to consumers (including the ability to source independent expert advice), and ensuring consumers are appropriately remunerated for their contribution to the development of proposals.

We consider it is important that the network business and engagement parties are able to demonstrate independence through different metrics. This will allow us to place appropriate weight on any submissions and reports that consumers provide on proposals.

Case study 2: Demonstrating independence in the New Reg trial

A key characteristic of the New Reg trial was that the Customer Forum should be a credible counterparty, capable of independently and transparently acting on behalf of all consumers. This was demonstrated through:

- the recruitment of suitably qualified and experienced panel members
- the support and guidance we provided to the Customer Forum
- the ability of the Customer Forum to commission its own analysis
- the provision of independent funding arrangements
- the ability of the Customer Forum to meet independently of the Network.

These measures gave us confidence in the independence of AusNet Services' Customer Forum.

4.3 Breadth and depth

Breadth and depth is about the scope of engagement with consumers and the level of detail at which network businesses engage on issues. The breadth and depth of engagement also covers the variety of avenues used to engage with consumers.

4.3.1 Accessible, clear and transparent engagement

It is important that network businesses transparently set out their engagement plans. This includes outlining objectives, engagement issues/topics and the level of participation and influence consumers can expect on the regulatory proposal.

Consultation timeframes should have regard to the complexity of the issues in the regulatory proposal and provide consumers with adequate time to understand and assess the regulatory proposal. Engagement on different aspects of the same issue may require different engagement methods.

4.3.2 Consultation on outputs, then inputs

Our expectation is that consumers should guide, and be seen to guide, the development of proposals. This means that consumers should be consulted on the outcomes that they want from the proposal and how they would like network businesses to engage with them in the development of a proposal to give effect to those outcomes. This may then guide later consultation on the individual components of a proposal.

Consultation on a regulatory proposal should not end with the submission of that proposal. If circumstances change and it is necessary to update a proposal, we expect networks to engage with consumers on those changes.

Where consumers are consulted on their desired outcomes, engagement may go beyond the individual components of regulatory proposals and the usual considerations of reliability, affordability and sustainability, to explore a consumer's lived experience within the energy system – including customer services and interactions with the network. Outcomes from such engagement can then be reflected in the regulatory proposal.

Case study 3: AusNet's Customer Service Incentive Scheme

One successful example of a network business consulting on more than the building blocks of their proposal is from the New Reg Trial. The Customer Forum identified a 'blind spot' in the regulatory framework in relation to service standards and other 'outcomes' that customers would like their network to deliver. This resulted in the delivery of numerous customer service improvements, the development and implementation of a Customer Service Incentive Scheme, along with the introduction of an annual report to track progress of AusNet Services delivery against customer service commitments.

4.3.3 Multiple channels of engagement

No single avenue of engagement is perfect. Consumer panels, surveys, forums, direct meetings, workshops, focus groups and 'deep dives' are suited to certain types of issues and have their downsides. To gain a comprehensive understanding of consumer preferences multiple complimentary channels are necessary.

Different consumers will have different preferences in how they engage in the development of regulatory proposals. For example, a network business' approach to engaging with vulnerable consumers and culturally and linguistically diverse consumers would be quite different to its approach to engaging with commercial and industrial consumers.

A network business should aim to understand, represent and balance the interests of all its consumer cohorts. Where network businesses identify competing interests, they should seek to develop agreed positions with consumers. If this isn't possible, then network businesses should set out the competing interests in relation to elements of their proposals.

4.3.4 Consumers' influence on the proposal

Engagement should consider the IAP2 Spectrum of Public Participation, in particular the different levels of participation and range of influence (ranging from inform to collaborate) consumers have on the regulatory proposal. We consider that network businesses and consumers should consult with each other on the range of issues consumers can have influence over. Issues over which consumers will have more influence should be at the upper (collaborate) end of the IAP2 spectrum.

Network businesses should encourage consumers to test assumptions and processes that underpin the proposal. Where consumers aren't well equipped to do so, this may entail providing them with additional resources and supporting them to commission independent analysis.

4.4 Clearly evidenced impact

Clearly evidenced impact is about how a proposal represents and is shown to represent consumer views.

4.4.1 Proposals linked to consumer preferences

There needs to be a clear link between consumer research and engagement, a network business' representation of the outcomes desired by consumers, and how the proposal gives effect to those outcomes.

Where consumer views on an issue are diverse, network businesses need to set out those views and how they were balanced in developing their regulatory proposal. Network businesses should seek to find mutually acceptable solutions where divergent consumer views occur.

A network business won't be able to engage with all its consumers in the development of its proposal. To allow an opportunity for all stakeholders to comment, a network business should release a comprehensive draft regulatory proposal for stakeholder comment. The regulatory proposal submitted to the AER should set out how it has responded to submissions on the draft regulatory proposal.

Case study 4: ElectraNet's 'capable of acceptance' regulatory proposal

In March 2017, ElectraNet submitted a regulatory proposal that the AER accepted almost in its entirety – including the capex and opex forecasts.

ElectraNet's proposal reflected the preferences of its customers. ElectraNet undertook an open and collaborative consultation on its proposal in the 18 months prior to submission. ElectraNet also had a clear vision for its proposal that was linked to customer preferences – "it will deliver affordable and reliable power supplies that support customer choices for a sustainable future". ElectraNet's consumer engagement program won the inaugural ENA/ECA consumer engagement award.

ElectraNet's engagement wasn't without its challenges. On 28 September 2016, South Australia experienced a total loss of electricity supply (a system black event). This occurred four months prior to when ElectraNet was due to submit its proposal and when ElectraNet was well into its consultation on the proposal. In these circumstances we allowed ElectraNet extra time to develop, consult on and lodge its proposal. We assessed ElectraNet's proposed expenditure in response to the system black event as considered and proportionate.

We consider that ElectraNet's engagement demonstrates that, despite unexpected events, it is possible for networks to develop proposals that are largely capable of acceptance.

4.4.2 Independent consumer support for the proposal

We want consumers to express support for proposals developed by network businesses. This support may be demonstrated through submissions on a draft regulatory proposal or an independent report setting out consumer perspectives on a proposal as lodged to the AER. An independent report is mandatory if a network business is seeking a targeted review stream (see section 2).

Where consumers aren't supportive of areas of a draft regulatory proposal, we expect that network businesses will seek to improve these areas to align with consumer preferences, or have a feedback loop which explains to consumers why they can't.

Case study 5: Australian Gas Networks 2018-22 (Victoria and Albury) Access Arrangement - capable of acceptance

In January 2017, Australian Gas Networks (AGN) submitted an access arrangement proposal that the AER accepted almost in its entirety.

AGN exhibited a strong commitment to delivering for customers, consistent with the National Gas Objective, through an effective consumer engagement plan with the objective of developing a proposal that was 'capable of being accepted by the AER'. Submissions on AGN's proposal largely supported those outcomes, as well as the engagement process which led to its development. AGN also requested stakeholder submissions on its draft plan, which influenced development of the final plan.

5 Our expectations on capital expenditure proposals

5.1 Overview

Capital expenditure refers to the money required to build, maintain or improve the physical assets a network needs to provide standard control services.

We assess forecast capital expenditure which is one of the "building blocks" of a network business' total revenue. A network business recovers approved revenue from customers for using its network services through tariffs. Generally, a business will recover capital expenditure over several regulatory control periods as most capital assets have long lives.

The Rules set out the regulatory framework we apply when assessing capital expenditure forecasts. In electricity, we must decide whether or not we are satisfied that this forecast reasonably reflects prudent and efficient costs and a realistic expectation of future demand and cost inputs. In gas, capital expenditure must reflect what would be incurred by a prudent business, acting efficiently, in accordance with accepted good industry practice, to achieve the lowest sustainable cost of providing the network services.

Our assessment of forecast capital expenditure seeks to ensure that consumers are provided with safe, reliable and good quality services that meet their needs at an efficient price.

The AER provides guidance on its assessment approach to electricity distribution and transmission capital expenditure proposals in the following documents:

- Expenditure Forecast Assessment Guidelines[7]
- Regulatory Investment Test for Distribution and Transmission (RIT-D and RIT-T) Guidelines[8]
- Asset Replacement Industry Note[9]
- Information and Communication Technologies (ICT) Guidance Note[10]
- Regulation of Actionable Integrated System Plan Projects Guidance Note[11]
- AER outline of the replacement expenditure (repex) model[12]
- Guideline note (draft) on Distributed Energy Resources Integration Expenditure.[13]

7 https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/expenditure-forecast-assessment-guideline-2013.

8 https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/rit-t-and-rit-d-application-guidelines-minor-amendments-2017.

9 https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/industry-practice-application-note-for-asset-replacement-planning.

10 https://www.aer.gov.au/communication/aer-publishes-guidance-on-non-network-ict-capital-expenditure-assessment-approach.

11 https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/regulation-of-large-transmission-projects/final-decision.

12 https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/repex-model-outline-for-electricity-distribution-determinations.

13 https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/assessing-distributed-energy-resources-integration-expenditure/draft-decision

For electricity distribution proposals, the AER also:

- has regard to modelling outcomes from the AER's repex model when assessing an electricity business' proposed modelled replacement expenditure; and
- encourages the use of its standardised standard control services capex model when submitting its regulatory proposal. The model is currently out for consultation.[14]

5.2 Our expectations on capital expenditure

Having regard to the Rules and drawing from the comprehensive suite of guidance and tools, the AER has developed five expectations of a network business' capital expenditure proposal. A business that meets these five expectations will have the benefit of a targeted review of its capital expenditure proposal.

5.2.1 Top-down testing of the total capital expenditure forecast and at the category level

5.2.1.1 Total capex forecast

Comparing a network business' total capital expenditure forecast against actual spend over the current regulatory period can be a reasonable starting point for a top-down test. This is generally the case where an electricity or gas business has been responding to the incentives created by the capital efficiency sharing scheme. In those circumstances:

- we expect businesses to demonstrate that forecast total capital expenditure is not materially above current period actual spend. In particular, we would question whether a step up in forecast capex is required if network performance metrics like SAIDI[15] show that it is able to maintain its network well on its efficient revealed spending levels
- where there is material underspend in the current period as well as a forecasted step up in total capital expenditure, we would question why a forecasting a step up is required from its revealed efficient level
- if material incentive benefits are being claimed, there is well-justified reasons for this and these have been explained to customer groups.

There are circumstances where a business' actual total capital expenditure is a less useful top-down test of the forecast. For instance, this may be the case where capital expenditure is predominately made up of large non-recurrent projects or where a capital efficiency sharing scheme is not in place. Where this is the case, we expect businesses to provide quantitative cost benefit analysis to demonstrate that the major project/programs driving the total forecast maximises net benefits.

5.2.1.2 Capital Expenditure category level

Capital expenditure categories generally include replacement expenditure, augmentation, connections, ICT, property and fleet. Replacement expenditure is largely recurrent and some categories like ICT have both a recurrent and non-recurrent component. Generally, we can rely on revealed actual spend over the current period to undertake a top-down test of forecast recurrent expenditure. We expect network businesses to

[14] https://www.aer.gov.au/communication/aer-invites-submissions-on-the-preliminary-standardised-scs-capex-model.

[15] System Average Interruption Duration Index (SAIDI) is commonly used as a reliability indicator.

demonstrate to us and consumer groups that the recurrent components of its forecast are not materially different from its current spend levels and if so, the reasons for it. For non-recurrent capital expenditure categories, we expect businesses to support the forecast with cost benefit analysis.

For electricity distribution, the AER's repex model also allows us to undertake a top-down assessment of recurrent expenditure by comparing the business' forecast modelled replacement expenditure against other businesses. **Box 1** provides a short description of the AER’s repex model. We expect businesses to demonstrate that the modelled forecast replacement expenditure is not materially higher than the replacement expenditure model threshold or provide reasons if it is above the threshold.

We are also cognisant that a business’ capital expenditure make up can evolve over time, such that new capital expenditure categories are introduced. For instance, DER-related expenditure has been included in capital expenditure proposals in the recent electricity revenue determinations. We expect businesses to explain to us and consumers why the new capital expenditure category is required.

Box 1: The AER’s replacement expenditure (repex) model in electricity distribution revenue reviews

> The AER's repex model is a statistical predictive modelling tool that informs us where to target a more detailed bottom-up review. There are six broad asset groups modelled: poles, overhead conductors, underground cables, service lines, transformers and switchgears.
>
> The model analyses the age of asset already in commission and calculates the time at which a distributor will replace them based on historical replacement practices.
>
> The repex model sets a threshold against which we compare the electricity distribution business’ forecast repex. Where a DNSP's forecast exceeds the threshold, we will seek further information to understand the difference.

5.2.2 Evidence of prudent and efficient decision-making on key projects and programs

For capital expenditure categories that are a material proportion of the total forecast, we expect businesses to demonstrate prudency and efficiency in its decision-making by providing the following for key recurrent and non-recurrent projects and programs:

1. Identification and evidence of the network’s need (prudency of the proposal). For electricity distribution and transmission, businesses are expected to provide evidence that the expenditure is needed to achieve the capital expenditure objectives, for example, to meet and manage expected demand, comply with regulatory obligations, maintain quality, safety, reliability and security of supply.

2. Quantitative cost benefit analysis assessing all feasible options to show that the preferred option maximises net benefits. This includes consideration of non-network options.

3. Where relevant, evidence of fully accounted for trade-offs between capital expenditure and operating expenditure to show that the preferred option is prudent and efficient. For instance, we have accepted ICT capex proposals as delivering a maximum net benefit because the business provided evidence of corresponding savings (offsetting reductions) in operating maintenance.

4. For electricity businesses, compliant Regulatory Investment Tests for eligible capital expenditure projects submitted in its regulatory proposal.

5.2.3 Evidence of alignment with asset and risk management standards

We consider alignment with industry standards on good asset and risk management demonstrates prudent and efficient decision-making. We expect network businesses to provide evidence that their asset and risk management are consistent with well-established relevant Australian industry standards (such as ISO 55000 and ISO 31000).

5.2.4 A steady and stable regulatory asset base (RAB)

We expect network businesses to provide reasons for increases in the business' RAB in the forecast period and over time, especially if the RAB has been stable. Consumer groups must be provided with those reasons and their implications.

5.2.5 Genuine consumer engagement on capital expenditure proposals

We expect evidence of genuine customer engagement as set out in this Handbook. For capital expenditure proposals, we expect businesses to engage with consumers on why the expenditure is required over the forecast period and what other options are available to consumers. For instance, in electricity proposals, we expect businesses to explain why a proposed capital expenditure program is required to meet service level outcomes like maintaining reliability of supply, and the cost to consumers to fund this program compared to other viable options available to address the service level outcome.

There may be circumstances where outcomes from our capital expenditure assessment do not appear to align with what businesses state their customers want. In these circumstances, we would expect to see clear evidence that businesses have fully-informed affected consumers about any implications of the proposed capex including trade-offs in the short and long term.

Recently, there have been considerable efforts undertaken by businesses to better understand their customers' preferences on capital expenditure. Case study 6 provides a recent example of a business bringing customer preferences into its capital expenditure decision making.

Case study 6: Aligning customer preferences with a business' capital expenditure proposal - AusNet Transmission Services

AusNet Services Transmission undertook a deep dive in August 2020 with its stakeholders on its forecast capex addressing deliverability risk as well as the impact of deferrals.

In light of stakeholder feedback on the high value placed on both reliability and affordability, AusNet smoothed the forecast to prioritise supply risk (the risk of supply being lost to customers due to an asset failure) and market impact risk (the risk that due to an outage the lowest cost generators cannot supply the National Electricity Market) over other risks to reflect customers' views. Projects were ranked to minimise supply risk and market impact risk. Having regard to customer views and other factors, AusNet Services Transmission capital expenditure proposal deferred 5 major station projects to address deliverability risk without compromising the reliability and safety of the network.

Reference: AusNet Transmission Group, 29 October 2020, Revenue Proposal, 2023-27 Transmission Revenue Reset, pp.128-9

5.2.6 Targeted review of capital expenditure

We anticipate a targeted review means that we would focus our assessment on a specific capital expenditure category or projects and programs:

- that are driving the forecast
- has strategic significance in the proposal
- that relates to a change from business-as-usual practices, and
- that are a new category or program of works.

6 Our expectations on operating expenditure proposals

6.1 Overview

The AER also assesses the business' forecast operating expenditure which is another of the "building blocks" of a network business' total revenue. Operating expenditure includes a wide range of non-capital costs incurred by a network business serving its customers, such as vegetation management, maintenance, emergency response, network support and corporate overheads. In contrast to capital expenditure, which is recovered over the life of the asset, a network business will recover operating costs as and when they are incurred. In this way operating expenditure has a more immediate impact on network revenues than capital expenditure.

The Rules set out the regulatory framework the AER applies when assessing operating expenditure forecasts. Broadly, we must decide whether or not we are satisfied that the operating expenditure forecast proposed reasonably reflects prudent and efficient costs required by a network business to deliver the current levels of service to customers.

Our general approach is to assess the efficiency of a business' proposed operating expenditure forecast at a total level, rather than to assess individual operating expenditure projects or programs. To do so, we develop an alternative estimate of total operating expenditure using the top down 'base-step-trend' approach set out in the Expenditure Forecast Assessment Guideline[16]. We compare our alternative estimate to the network business' operating expenditure forecast to determine whether we can accept that forecast. Where we are not satisfied a business' forecast reasonably reflects the criteria, e.g. if our alternative estimate is materially lower than the network businesses, then we will substitute our alternative estimate.

The 'base-step-trend' forecasting approach consists of the following elements:

- Forecasting an operating expenditure base using a recent year as a starting point. Operating expenditure is largely stable and recurrent, making past expenditure an appropriate starting point if it is efficient. We use various assessment techniques, including benchmarking (see **Box 2** further down below in this section), to confirm a base year is not materially inefficient and can be used as a starting point. Where historical operating expenditure is not efficient, we will use a base year opex only after making an efficiency adjustment.
- Forecasting trend to escalate base year operating expenditure annually over the forecast period to account for any required changes in efficient costs. Typically we will adjust for changes to services provided by businesses (output growth), real changes in input prices (price growth) and improvements in productivity (productivity growth).
- Forecasting step changes in costs which are not compensated by base operating expenditure and trend, and are required to ensure the operating expenditure forecast meets the criteria in the Rules. Examples include cost increases associated with new regulatory obligations and trade-offs between capital expenditure and operating expenditure.
- In addition to base, trend and step, we independently forecast costs specific categories of operating expenditure. We only include costs in this category where required to be consistent with our decision on

16 https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/expenditure-forecast-assessment-guideline-2013.

other parts of a proposal (such as debt raising costs) or where it would make total operating expenditure forecast using 'base-step-trend' too volatile.

Under the regulatory framework, network businesses have incentives to continuously reduce costs below their operating expenditure forecast each year by making efficiency gains over time. This reflects that network businesses are generally subject to incentive schemes, known as the efficiency benefit sharing scheme in electricity and efficiency carryover mechanism in gas. These efficiency gains are shared with consumers.

6.2 Our expectations on operating expenditure

Drawing from the Rules, our guidelines and previous decisions, the AER's expectations for a business' operating expenditure proposal, which we will assess a proposal against to determine whether to apply a targeted review, are set out below.

6.2.1 Opex forecasting approach

Operating expenditure is forecast using the 'base-step-trend' approach set out in the Expenditure Forecast Assessment Guideline.

We expect the inputs and assumptions used to forecast opex are consistent with those used to calculate opex incentive scheme (Efficiency Benefits Sharing Scheme in electricity and the Efficiency Carryover Mechanism in gas) carryover amounts.

6.2.2 Base opex

Forecast opex uses a base year for which audited actual opex is available and which a network business can demonstrate is not materially inefficient. In electricity, this should be based on analysis in the latest available Annual benchmarking report.

- For electricity distribution, a business should show that it has efficiency scores greater than 0.75 (see **Box 2** below). If its average efficiency score is less than 0.75, then a more detailed efficiency assessment will be required as part of the proposal. This should involve the use of the AER's benchmarking roll-forward model (available on our website), to either demonstrate the efficiency of its base year opex or inform the size of any proposed efficiency adjustment. As part of this more detailed assessment, the business should identify and quantify any operating environment factors it considers would impact (both negatively and positively) its benchmarking performance. In these situations, the business should consult with the AER prior to submitting.
- For gas distribution, we will rely on the benchmarking studies undertaken by consultants.
- We expect that a network business would use the equation in the AER's Expenditure forecast assessment guideline to estimate opex in the final year of the current control period.
- Where a business seeks to make further adjustments to base opex (e.g. to reflect the impact of a change in accordance with its cost allocation or capitalisation method), it should consult with the AER prior to submitting.

Box 2: How we benchmark to assess the efficiency of electricity distribution operating expenditure

> In our electricity distribution operating expenditure decisions, we draw on efficiency scores from our econometric operating expenditure cost function modelling (set out in our annual Benchmarking Report) to assess the efficiency of historical opex and base year opex and determine any efficiency adjustments. We do this by comparing the efficiency scores of individual electricity distribution networks against a benchmark comparison score of 0.75 (rather than 1.0), which reflects the upper quartile of possible efficiency scores by electricity distribution networks. In our efficiency assessment, we adjust the benchmarking comparison scores further to take account of operating environment factors not already captured in the modelling.

6.2.3 Trend

Forecast opex incorporates a trend that adopts our approach to output, price and productivity growth. We expect that a reasonable trend forecast would be consistent with:

- output growth forecast:
  - for electricity distribution and transmission networks, using the AER's preferred output specification, including output weights, as set out in our latest Annual benchmarking report
  - for gas distribution, output growth net of productivity growth should be no greater than mid-point of the reasonable range based on econometric analysis
  - adopting AEMO's forecasts of consumption and demand
  - forecasting customer number growth consistent with the historic trend
- price growth forecast:
  - for electricity distribution and transmission networks, using the AER's input price weights, as set out in our latest Annual benchmarking report
  - forecasting zero real non-labour price growth
  - using an average of two state-specific utilities industry wage price index growth forecasts for forecast real labour price growth, including one engaged by the AER.
- productivity growth forecast:
  - for electricity, using a forecast no less than the AER's preferred productivity growth forecast, which is currently:
    - the industry average opex productivity growth for electricity transmission[17]

[17] We provide updated productivity growth figures each year when we publish our Annual Benchmarking Report. The relevant productivity growth figure is the industry average opex multilateral partial factor productivity growth over the longest possible period, which is usually found in the consultant’s report accompanying our Annual Benchmarking Report.

    - 0.5 per cent per year for electricity distribution.[18]
- for gas distribution, see output growth forecast.

6.2.4 Step changes

The number of forecast step changes is limited to a few well justified ones, or none at all. Our expectations for step change by category proposals is set out **Box 3** below and **Case study 7** provides an example of a step change which has been well justified.

Box 3: Expectations for step changes by category and examples from previous AER decisions

New regulatory obligation step change

- It is clearly linked to the new regulatory obligation and represents a major upward step to comply with it
- It will have an overall material impact on the costs of providing prescribed network services
- No double counting of costs
- Clearly demonstrates the change is not otherwise capable of being managed under forecast opex including through inbuilt provisions under output, price and productivity growth.

Capex/opex substitution step change

- It is supported by thorough cost benefit analysis
- The avoided capex is estimated accurately and it more than offsets the increase in opex in net present value terms (ie efficient substitution)
- No double counting of costs

Step change driven by major external factor(s) outside the control of a business

- It will have a material impact on the costs of providing prescribed network services
- Where it involves incurring costs in complex areas or markets, it is accompanied by an expert report (including analysis of options, market outlook, opinion on the reasonableness of the proposed step change)
- No double counting of costs
- Clear demonstration the impact is not capable of being managed under allowed opex including through inbuilt provisions under output, price and productivity growth

[18] https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/review-of-our-approach-to-forecasting-opex-productivity-growth-for-electricity-distributors.

Case study 7: Example of a previous step change we have included which would meet our expectations of being well-justified – increasing insurance premiums

In recent years insurance premiums have increased due to the withdrawal of capacity in the global bushfire insurance market. A number of network businesses have included step changes for insurance premium increases. In the 2021–2026 Victorian electricity distribution determinations, we included step changes for insurance premium costs for Jemena, AusNet Services distribution, Powercor and United Energy. These businesses were able to provide expert reports detailing the magnitude of forecast increases. This provided sufficient information for us to verify the magnitude of forecast increases and the drivers of them with our consultant. In these circumstances, we were satisfied the magnitude of these increases, relative to total opex, could not be otherwise managed with the opex

6.2.5 Category specific forecasts

Category specific forecasts should only include cost categories which have been included as category specific costs in previous AER decisions.

6.2.6 Consumer engagement

There should be evidence of genuine consumer engagement, consistent with the expectations set out in this Handbook, on the proposed forecast of operating expenditure. This includes:

- detailing how the proposed forecast operating expenditure is consistent with, or takes into account consumer preferences and outcomes identified in the course of consumer engagement.
- where the proposed forecast is developed in a way which departs from our base-step-trend approach and/or the expectations set out above, there should be evidence that the deviation in approach has been discussed with consumers, and how consumer views have been taken into account. This includes where a network business proposes a smaller efficiency adjustment (including no adjustment) than suggested by the AER's latest benchmarking analysis.

6.2.7 A targeted review of operating expenditure

We anticipate a targeted review means we will focus our operating expenditure assessment on select issues taking into account factors such as whether an issue:

- has strategic significance (either within the context of the proposal or which there would otherwise be value in having the AER address)
- has been identified by consumers as an issue which would benefit from detailed AER assessment
- could have a material impact on our alternative estimate of total opex
- deviates from the base-step-trend approach and/or expectations set out above. In particular for electricity distribution, where the base year proposed has an efficiency score less than 0.75 and the efficiency adjustment (including no adjustment) is less than suggested by the AER's latest benchmarking analysis.

7 Regulatory depreciation

7.1 Overview

Network businesses invest in costly sunk assets. The regulatory regime under the Rules supports the recovery of sunk costs as regulatory depreciation. No more or less than the real value of the asset should be recovered through regulatory depreciation over the economic life of the asset in net present value terms.[19]

We generally employ an approach where regulatory depreciation is recovered evenly over an asset's useful life.[20] As a general proposition, economic theory suggests sunk costs be recovered in the least distortionary way. An even profile of recovery over the life of the asset supports this idea, as it does not encourage consumers/businesses to either bring forward or delay consumption/replacement simply due to the depreciation profile.[21]

The networks we regulate are generally mature businesses. They do not typically face factors that might justify front or back loaded depreciation profiles, such as significant and persistent trends in expected demand or real replacement costs.[22] Demand is typically relatively stable in mature industries, although there have been exceptions in the area of gas, which is discussed further below. There is also often little reason to expect real replacement costs will change dramatically in a particular direction, in part due to the traditional slow rate of technology change in these industries. While new technological opportunities and challenges are arising, in particular in electricity distribution networks, given existing connections it is still likely to be some time before most networks change in a fundamental way. Much of the network replacement will therefore continue to occur using existing technologies with relatively stable unit costs.[23]

7.2 Our expectations on regulatory depreciation

The asset bases of the network businesses we regulate are large with a broad mix of old and new assets. In itself, this characteristic provides a certain stability to the regulatory depreciation profile (and to a network business' revenues) over time. To adjust the regulatory depreciation in a broad way would potentially distort replacement and consumption incentives in both the short and long run. Accordingly, we have not accepted

[19] This condition is referred to as NPV neutrality. However, NPV neutrality and efficiency are not necessarily synonymous. There are essentially limitless recovery profiles of regulatory depreciation that achieve NPV neutrality, but only a limited number of profiles that may be considered efficient in given circumstances. Accordingly, NPV neutrality is not sufficient for determining an efficient recovery profile. Other factors need to be considered.

[20] The use of straight-line depreciation, and the use of a combination of an indexed regulatory asset base with a nominal rate of return and offsetting indexation adjustment, promote a relatively even recovery profile.

[21] For the same reason, we consider that regulatory depreciation should not be used to offset other cost trends, for example, a lower rate of return on capital. To do so, notwithstanding the difficulties in forecasting such trends, would distort the market signal that those costs are sending to consumers/businesses.

[22] For example, if it is expected that real replacement costs will continuously rise, a backload depreciation profile may be efficient to reduce the potential for price shocks when assets are replaced. The rising depreciation charges in a back loaded profile then reflect the expected rising trend in real replacement costs, and prices based on this profile would provide a consistent signal on the direction of future costs.

[23] There is also no reason to expect new technologies would necessarily be cheaper or more expensive than existing technologies in the long run. The nature of the service that customers receive may also change in time.

broad changes to the depreciation approach that would bring forward costs to consumers.[24] However, we have accepted more targeted approaches to determine changes in the economic lives of assets.

7.2.1 Asset lives

Determining an asset's economic life can be a challenge. It is typically associated with the technical life of the asset. In approving capital expenditure, we usually expect the assets to provide a service until they are eventually replaced. In this regard, demand considerations often "sit in the background" in determining the economic life of an asset.

We review expected technical lives and sometimes make adjustments to the remaining asset lives of existing assets if new information warrants such a change. Otherwise, we encourage consistency in technical lives across regulatory periods and businesses, again because the technology is relatively stable and proven. If it becomes likely that an asset will stop being used before the end of its technical life due to falling demand (and therefore not replaced), the economic life could be changed to reflect these circumstances. However, in such circumstances, more significant questions beyond the depreciation profile are likely to become relevant.[25] **Case study 8** provides a recent example of a change to economic lives.

Case study 8: Evoenergy final decision

> In the AER's 2021 Evoenergy final decision we accepted that new pipeline assets in the ACT would have shorter economic lives than their technical lives due to the ACT Government's policies to move away from gas use, despite uncertainties about the ACT Government's path to net zero emissions. At the same time, we accepted the proposal for no new connection capex in this decision which also reflected the ACT Government's position on this matter.
>
> As a result of the information provided by Evoenergy on the elevated risk of network closure and a substantial reduction in demand, we considered our decision was a reasonable assessment of the economic life of the network as a whole.

Other factors can also unexpectedly cut short an asset's remaining life. In cases where assets have been destroyed, say by a cyclone or bushfire, it is clear that both an asset's technical and economic life have come to an end, and it would be inappropriate for the residual value of these assets to distort consumption decisions well into the future. In these circumstances, removing the residual value of these assets from the asset base by way of accelerated depreciation is appropriate and consistent with the requirements in the Rules.

We have observed a trend towards more targeted accelerated depreciation proposals by network businesses. While we see targeted approaches as generally preferable to broader ones, these proposals need to be well justified. Proposals to separate existing assets from a broader asset class require detailed assessments. We would expect to see a spreadsheet provided with the proposal which would include (but is not limited to):

- Volumes and commissioning date/age of the assets in question.

[24] The AER has not supported other forms of accelerated depreciation such as un-indexing of the regulatory asset base or the adoption of a diminishing value approach for calculating depreciation.

[25] For example, should new capex be approved if demand is expected to cease before the technical life of the asset expires? The cost-benefit balance of such an investment is likely to be significantly affected in such circumstances.

- Calculation of the residual cost of asset – ideally this value would be based on actual historical costs. However, proxies that use discounted replacement unit costs may also be possible. The unit costs should be well justified and consistent with the capex proposal.

In other cases, proposals for accelerated depreciation flow from decisions to replace or decommission assets before the end of their technical lives. For assets which will be replaced early, there should be a reconciliation with the volume of forecast replacement capex being proposed. In such a case, the amount of accelerated depreciation being accepted is likely to be proportional to our decision on the future replacement capex program. When asset decommissioning occurs in a particular area, we expect the business to consider the possibility of reusing some of the assets in other areas of the network.

Until recently, network businesses have typically not consulted with customers on proposals for accelerated depreciation. However, in a number of cases, the price impacts of proposed changes have been significant and this should be discussed with customers in pre-lodgement engagement. There is scope for consumers to challenge a business' motivation for selecting certain assets for accelerated depreciation including whether the proposal naturally fits with other aspects (such as replacement considerations) or has been motivated by perceived problems with the regulatory regime (such as a desire for greater cash flow). **Case study 9** provides a recent example of engagement with consumers by a business on its changes to depreciation.

Case study 9: Powerlink's year-by-year tracking depreciation approach

Powerlink's proposal in 2021 to move to year-by-year tracking depreciation would have raised prices in the near term, which concerned customers during its engagement with them. Powerlink contacted the AER to discuss the feasibility of a possible response to this concern. Powerlink reviewed its asset base and found an asset class where it was reasonable to extend its remaining asset life, which mitigated the price impact of the move to year-by-year tracking. We agreed that the extension was reasonable under the Rules. Powerlink then presented this to customers who were supportive. Long run refinements to the depreciation schedules were thereby achieved with limited short run impact on customers.

7.2.2 Targeted review of regulatory depreciation

In determining whether we will undertake a targeted review of a network business' regulatory depreciation proposal, we would expect:

- that the business would use the AER's post-tax revenue model, roll forward model, and depreciation tracking module (where relevant) without amendments[26]
- the asset classes would be unchanged from the last reset and the asset lives would also reflect those approved in previous decisions.

This means any changes to the models, asset classes, asset lives and/or proposals for accelerated depreciation of assets would require us to conduct a more targeted and detailed assessment. We would also expect the network business to discuss these changes with consumers.

[26] The regulatory depreciation amount ultimately approved will also depend on other decisions regarding the regulatory asset base, expected inflation, and capex.

8 Tariff structure statements (electricity distribution only)

8.1 Overview

Tariff structure statements set out electricity distribution network tariffs for a given five year regulatory control period. They are submitted to the AER for assessment by distribution networks as an element of their broader revenue proposals. Once approved, a tariff structure statement becomes a compliance document against which annual tariff proposals submitted to the AER by a network are assessed.

Tariff structure statements are the means by which distributors progressively reform their tariffs to better signal to customers the cost of providing network services. By better aligning tariffs to their costs, networks allow customers to minimise their bills at the same time as reducing network investment pressures by moderating their network use. Reforming network tariffs is an incremental process, whereby we expect ongoing improvements in tariff structures across successive tariff structure statements.

8.2 Our expectations on tariff structure statements

In determining whether we will undertake a targeted and proportionate review of a network business' tariff structure statement, the AER would expect the network business to demonstrate:

1. progression of tariff reform consistent with the network pricing objective and pricing principles set out in the Electricity Rules
2. demonstration of significant stakeholder engagement and broad stakeholder support
3. insight into and management of any adverse customer impacts.

8.2.1 Progressing tariff reform

An electricity distributor's tariff structure statements should progressively improve the cost reflectivity of its tariffs over time, accounting for the network's circumstances and customers' ability to respond. Tariffs must be based on long run marginal cost and balance efficiency against the need to manage customer impacts.

Case study 10: Tariff reform's network pricing principles

The pricing principles set out in the Electricity Rules are foundational to tariff reform and guide both tariff structure statement development by distributors and AER assessment. The most important pricing principles require tariffs to be based on the long run marginal cost of providing services and require customer impacts to be taken into account.

Long run marginal cost is the forward looking additional cost of providing network services in response to network use. So tariffs should signal future network investment costs in the event that network use doesn't change. For example, tariffs should make energy use more expensive during times of the week when networks are congested, to signal that further use during those times will drive future network investment. Conversely, tariffs should be low when networks are not congested to incentivise network use during those periods.

Accounting for customer impacts drives networks to model the effect of new tariffs. Networks then design strategies to introduce tariffs progressively, or provide a choice from which customers may select a tariff that best suits them. The customer impact principle also drives networks to tightly target peak charging periods at times when network investment pressures are greatest, allowing customers to lower their bills by shifting network use away from those peak periods.

8.2.2 Stakeholder engagement and support

In assessing tariff structure statement proposals we place significant weight on stakeholder views and on the nature of a network business' stakeholder consultation. Where network businesses can demonstrate broad understanding of, and support for, their tariff structure statement proposal amongst stakeholders, we will recognise that achievement in our assessment. We assign weight to engagement that enhances customer insight and builds customers' capacity to understand tariff reform's objectives and considerations.

8.2.3 Managing customer impacts

Adverse customer impacts may be managed through transitional arrangements or through complementary measures by state and territory governments. In particular, we see customer impact modelling as a critical tool for network businesses to demonstrate they understand those impacts and are managing them appropriately. It is also key to effective stakeholder engagement by allowing customers to understand how network tariff proposals may translate to retail bills. Customer impact modelling can also guide governments in developing or redesigning existing subsidy programs to assist customers in managing their energy use by making energy efficiency initiatives more affordable.

Case study 11: An example of good customer engagement in tariff reform

In assessing SA Power Networks' tariff structure proposal for the 2020–25 regulatory period we learned that it was supported by a wide range of stakeholders.

Based on written submissions to the AER from stakeholders and our bilateral discussions with many of them, it became clear that SA Power Networks had effectively explained its objectives, convinced people of the merits of its approach, and succeeded in harnessing significant support.

While we undertook our standard technical assessment of the proposal, including reviewing tariff structures, levels and options in light of the pricing principles, stakeholder support contributed to the AER's decision to approve the proposal at the earliest opportunity (the draft decision stage of our assessment process).

We consider SA Power Networks' tariff structure proposal is a good example of how networks may explain to stakeholders the challenges networks face, how those challenges may be addressed and how customer interests can be safeguarded.

8.2.4 Targeted review of a tariff structure proposal

We anticipate that a targeted review means we will focus our tariff structure assessment on select issues, taking into account factors such as whether an issue:

- fails to progress the cost reflectivity of network price signals
- elicited significant stakeholder objections in written submissions or other representations to the AER
- reduces customer choice in the network tariff customers are assigned to
- would lead to significant customer impacts which have not been otherwise addressed
- means that the tariff structure proposal is incomplete in terms of meeting the rules' requirements.