MONASH BUSINESS SCHOOL

MONASH ENERGY INSTITUTE

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Dear Dr Funston

RESPONSE TO CONSULTATION ON THE DRAFT BETTER RESETS HANDBOOK

Thank you for the opportunity to provide comments on the Australian Energy Regulator's (AER) draft Better Resets handbook. The proposed reforms represent an important advancement in the way energy networks are regulated.

This submission describes some opportunities that will help mitigate against the risk that the handbook's worthwhile reforms become self-limiting. These opportunities include enabling stronger commitment devices from networks and clarifying the AER's role in the regulatory processes proposed in the handbook.

Given the matters covered by this review, I would be pleased to facilitate introductions to my colleagues in the Monash Business School, the Monash Energy Institute and the Monash Sustainable Development Institute (including BehaviourWorks).

The views expressed in this submission are those of the author and not the faculty or its staff.

There is no information in this submission subject of a confidentiality claim.

I am, of course, available to elaborate on any of the matters discussed below.

Yours sincerely

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SUMMARY & RECOMMENDATIONS

For some years, regulators have been exploring mechanisms to promote greater consumer participation in determining the value-for-money delivered by their regulated service providers. The draft handbook represents the AER's next step along that road. Two incentives are offered to motivate network participation – reputational reward and a streamlined regulatory process.

Section 3 of this submission suggests there are opportunities for the AER to examine how it can maximise the power of the proposed reputational incentive. It also contends that limiting access to streamlined reviews may prove counterproductive.

Recommendation1

The AER should explore opportunities to maximise the value of reputational incentives by gaining a better understanding of how networks earn their reputations with their other key stakeholders – for example: investors, rating agencies, governments and other regulators. (see section 3.1)

Recommendation 2

The handbook should not limit access to 'targeted reviews'. Access to a targeted review should be available to all networks that meet the required standard. (see section 3.2)

Section 4 discusses how a good *ex ante* consultation process does not guarantee improved *ex post* consumer outcomes. The section proposes a number of mechanisms that would create a feedback loop between consultation processes and delivered outcomes, while encouraging networks to compete in demonstrating their commitment to improved consumer outcomes.

Recommendation 3

The handbook should enable and encourage networks to competitively demonstrate their commitment to improved consumer outcomes by implementing *ex ante* commitment devices and/or *ex post* credibility mechanisms. (see section 4)

Section 5 of this submission examines the AER's evolving role when there is good engagement between networks and their consumers. Three thought experiments demonstrate the potential for conflict between the AER's expectations and consumers' preferences.

Recommendation 4

The handbook should clarify how price submissions should address situations where the revealed preferences of consumers are fully or partially at odds with the AER's expectations. (see section 5)

Section 6 highlights a practical example where the handbook risks sending a confused message to consumers and networks about the role of the AER.

Recommendation 5

AER staff should play no pre-lodgement role in providing feedback to networks about their consumer engagement activities. (see section 6)

RESPONSE TO CONSULTATION ON THE DRAFT BETTER RESETS HANDBOOK

1. Introduction

The *Draft Better Resets Handbook* (the handbook) reflects the evolving nature of the AER's approach to network regulation – specifically, its "increased focus on consumer engagement".[1] This is a worthy goal. Any changes to the regulatory framework to achieve a genuinely increased focus on customers should be pursued on a no regrets basis.

Of course, consumer engagement is only a means to an end. It is not an end in itself. The 'end' that matters is delivering network services that consumers consider reflects good value for money.

Section 2 of this submission provides a brief summary of the handbook's objectives and principles. Section 3 responds to the AER's questions about the sufficiency of the handbook's proposed incentive mechanisms. This leads to section 4 which highlights the opportunities to supplement these incentives with strong commitment mechanisms that seek to ensure good engagement leads to good outcomes.

Section 5 of this submission examines the evolving role of the AER when there is better engagement between networks and their consumers. The discussion uses three thought experiments to highlight the potential for conflict between consumers' preferences and the AER's expectations (as described in the handbook). Section 6 provides a practical example from the handbook that could lead to confusion.

Addressing these matters will mitigate against the risk that the handbook's worthwhile reforms become self-limiting. (See recommendations above)

2. The handbook's objectives and principles

In September, the Australian Energy Regulator (AER) published its *Draft Better Resets Handbook* (the handbook).[2] The handbook represents a significant and very positive development in the AER's approach to administering the regulatory framework. The objectives of the proposed new approach are outlined on page 5 of the handbook. They include:

- providing networks with incentives to "develop high quality proposals through genuine engagement"

[1] p.3

[2] AER (September 2021) *Draft Better Resets Handbook. Towards Consumer Centric Network Proposals*

- producing "regulatory outcomes that better reflect the long-term interests of consumers"
- putting consumers "further into the centre of the regulatory determination process"

Other priorities are found throughout the document. For example:

- not prescribing a particular model or format for consumer engagement (pp. 8 & 12)
- wanting networks to "own their engagement" (p.12)
- ensuing the "onus for good consumer engagement ultimately rests with the network businesses" (p.12)
- embedding "consumer engagement should be a continuous business-as-usual process, not a one-off process only undertaken in preparing for regulatory proposals" (p.13)
- promoting "consultation on outputs, then inputs" (p.14)

The draft handbook presents readers with a number of questions.[3] This submission is largely focussed on responding to:

- Question 1,2 4 & 5– on the sufficiency of the incentives the draft handbook is seeking to establish, and access to targeted reviews.
- Question 7 & 8 – the AER's expectations regarding particular components of a price submission, and whether any further clarifications or considerations are required

3. The incentive framework (questions 1, 2, 4 & 5)

The handbook is largely focussed on the process of preparing a price submission. As such, this process is seen as a mechanism for delivering better outcomes for consumers. The handbook's proposed incentives seek to reward good process. The AER offers two 'rewards' in return for a price submission produced in accordance with the processes outlined in the handbook. These rewards are:

(i) public recognition of the quality of the submission, and

(ii) streamlined or "targeted" review of the submission by the AER.

The following discussion examines the pwoer of these two mechanisms.

[3] pp. 1-2

3.1 Enhancing the value of reputational incentives

The offer of reputational rewards is a worthwhile addition to the regulatory framework, however, their power to influence the approach networks take when developing their price submission cannot be taken for granted. Different networks will attach different value to public recognition by the AER. Even within an individual network, different staff and board members will attach different value to the reward on offer. Conversely, different networks, staff and boards will attach different value to having their organisation's reputation diminished by the *absence* of public recognition (or receipt of negative recognition).

The power of a reputational incentive will depend on the internal value attached to public recognition and this, in turn, will determine a network's willingness to invest in earning that public recognition (or avoiding public admonishment).

Reputational incentives can work. For example, the Victorian framework for water pricing ('PREMO') has strongly and successfully leveraged reputational incentives. This was possible because of the particular circumstances of the industry. It was these features of the industry which enlivened the reputational incentives of the PREMO framework. These features include:

- The water businesses clearly value their individual reputations with their common owner (the Victorian government).
- There is a longstanding culture in the Victorian water industry of competition by comparison. The service providers demonstrably care about how they perform relative to their peers.
- The retail water businesses have a direct relationship with their customers and are deeply concerned about how they are perceived by those customers.
- All the urban water retailers have their price submissions reviewed at the same time (every five years).

The network sector regulated by the AER displays none of these characteristics.

The AER should consider how it might maximise the value of reputational incentives and the leverage that can be gained from them. This might include gaining better understanding of how networks earn their reputations with their other key stakeholders – for example: investors, rating agencies, governments and other regulators.

3.2 *Marking to a curve may weaken the value of a targeted review*

The handbook's approach to conducting targeted reviews also has the potential to limit their claimed incentive value. The handbook states:[4]

> "[O]ur preference would be to first apply the targeted review stream process to a limited number of network businesses process to a limited number of network businesses."

At first glance, limiting the opportunity to gain access to a targeted review might seem to enhance its perceived value by creating scarcity of opportunity. Unfortunately, it may have the opposite effect.

Across the sector there will already be a natural distribution of capabilities to meet the requirements for achieving a targeted review. As the handbook observes:[5]

> "Some networks are already exceeding [our] expectations."

If the AER signals it will limit access to targeted reviews, providers who are not already at the top end of that distribution curve may conclude they are unlikely to displace any of the front runners. As a result, the incumbent front runners benefit from the AER's approach even though they probably do not require the reward on offer, while the other network providers conclude it is not worth the effort investing in pursuing the reward.

The AER is urged not to 'mark to a curve' and rather, it should offer a targeted review to all service providers who are deserving of this reward.

If the AER is concerned that its resources will be over-run by a highly ambitious sector,[6] it is encouraged to consider developing a more effective 'sorting mechanism' than is currently described by the handbook. Some important opportunities are discussed in the next section.

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[4] p.1
[5] p.12
[6] As noted on p.1 of the handbook

4. Creating a feedback loop between process and outcomes (questions 4 & 8)

The framework proposed in the handbook pursues improved outcomes from the regulatory process via networks implementing a better consultative process when developing a price submission. The handbook explains:[7]

- an improved outcome is one where "customer preferences drive outcomes"
- a better consultative process is one reflecting "genuine engagement with consumers".

The quality assurance mechanism proposed by the handbook involves networks submitting an independent consumer report.[8]

> "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 AER may also consider:[9]

> "commissioning the [Consumer Challenge Panel] to provide an assurance report on the network business' consumer engagement process."

While these measures are worthwhile, they are limited in at least two ways. First, a better process is only ever a proxy for an improved outcome. The most a better process can deliver is the *promise* of an improved outcome. Whether that promise will be realised in the lived experience of consumers during the regulatory period remains unknown at the time at which the AER must make its regulatory assessment and decision.

Second, the two quality assurance mechanisms discussed in the handbook both rely on largely subjective assessments. No matter the expertise of the parties making these assessments, there is no universal or objective measure of good consultation. Moreover, the quality assurers do not know what they do not know. In other words, if they don't know a piece of information exists and is relevant to a decision, they cannot assess whether a network has genuinely supported its customers during the engagement process. All they can judge is how a network *appears* to have supported its customers.

The handbook recognises the proxy and subjective nature of what it is seeking to achieve.[10]

> "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." [emphasis added]

[7] pp.4 and 5, respectively.
[8] p.9
[9] p.9
[10] p.12

As things stand, it is entirely possible that a network's engagement could be rated highly in reset after reset, even if it fails to deliver on its commitments during each regulatory period.

The handbook does not create a dynamic feedback-loop between *ex ante* processes and *ex post* outcomes within, and between, regulatory periods. There appears to be no material consequences for a network if it fails to deliver its promised outcomes.

Given the potentially tenuous relationship between process and outcomes, and the subjective and highly qualified nature of the proposed quality assurance mechanisms, consumers would be well served by the AER enabling and encouraging supplementary measures to boost the likely efficacy proposed framework.

One or both of two broad approaches could be taken. These are:

- ***ex ante* commitment devices** whereby a network agrees to compensate consumers in some manner if it fails to deliver a promised outcome. There is no limit on how such schemes might be designed or the range of outcomes they might address. Such schemes could resemble Guaranteed Service Level payment schemes, though they differ in their purpose.[11]
- ***ex post* credibility mechanisms** whereby if a network fails to deliver promised outcomes in one regulatory period, it is burdened by a default setting in the next reset that presumes it will also under-achieve in that subsequent regulatory period. In other words, to achieve the same level of financial return out of the regulatory framework, the network would need to work harder than would have been necessary had it delivered on its promises in the earlier regulatory period. One potential mechanism available to the AER may lie in allowing adjustments to be made to the sharing arrangements under its current efficiency incentive schemes.

A regulator's natural tendency will be to start solving how such schemes could or should be designed. That would be the wrong approach.

Instead, the challenge for designing such schemes – and volunteering to commit to them – should lie with the networks (in consultation with consumers). By going to the effort of designing such schemes and then committing to them in a price submission, each network would be transparently and objectively signalling its commitment to the consumer outcomes it has promised in its price submission. **Networks should be encouraged to compete** on the breadth and depth of the commitment devices and credibility mechanisms to which they are prepared to commit.

These measures would not only require networks to put "skin in the game" it would also provide consumers and the AER with a quantifiable measure of a network's commitment to consumer

[11] A *ex ante* commitment device seeks to promote delivery of a promised consumer outcome whereas a GSL scheme seeks to promote efficient investment. The two mechanisms are not in conflict.

outcomes. Among other things, such objective measures would complement the subjective quality assurance mechanisms proposed in the handbook. In effect, networks would use commitment devices and credibility mechanisms to 'bid' for access to a targeted review.

5. Clarifying who is at the centre of the regulatory process (questions 7 & 8)

While the handbook is clearly focussed on promoting better engagement between networks and their consumers, it does not appear to contemplate how improving this relationship might shift the AER's role within the regulatory process.

A search of the handbook for the term "our expectation/s" results in 45 hits. In a document focussed on putting consumers at the centre of the regulatory process, these references risk sending a confused message (to consumers and networks) about the priority network submissions should place on consumer preferences relative to the AER's expectations.

The following simplified examples are intended merely as **thought experiments** to test whose views would prevail in event of a conflict between the revealed preferences of consumers and the AER's stated expectations.

5.1 Repex and risk

Replacement capital expenditure (repex) is discussed in chapter 5 of the handbook. This chapter frames capital expenditure within a broader discussion about asset and risk management practices and standards.

It is not completely beyond the realms of possibility that if given the option, consumers might reveal a preference for something approaching real time repex – that is, a much greater tolerance for outages in return for lower prices. In the extreme case, pre-emptive repex might not be required, with all repex channelled to reactive expenditures (ie. once an outage occurs). Such an approach would clearly be at odds with the AER's expectations, as reflected in its repex model described in the handbook.[12]

Despite its expectations, would the AER permit a network to take such an approach to repex even if the consequences were demonstrably understood and preferred by its consumers?

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[12] Box 1, p.19

5.2 Regulatory depreciation and price stability

Chapter 7 of the handbook discusses regulatory depreciation, which is the most wondrous element in the regulatory revenue model. The only true constraint on the application of regulatory depreciation is that:[13]

> "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."

Beyond this constraint, there are only general and non-binding propositions to inform the application of regulatory depreciation. As the handbook notes:[14]

> "As a general proposition, economic theory suggests sunk costs be recovered in the least distortionary way."

There is a reasonable body of evidence that consumers value price stability.[15] Regulatory depreciation could be used as a 'swing' instrument to help smooth price movements in, and between, regulatory periods. Despite this, the handbook makes the AER's expectations clear.[16]

> "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 broad changes to the depreciation approach that would bring forward costs to consumers."

While it is unlikely consumers would care how improved price stability was achieved (and whether pulling forward regulatory depreciation means they are paying for assets in advance of their use[17]), it is conceivable a network could strike a bargain with its consumers involving smoother prices through a dynamic approach to regulatory depreciation.

Despite its expectations, would the AER permit a network to take such an approach to regulatory depreciation if greater price stability was demonstrably preferred by its consumers?

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[13] p.27
[14] p.27
[15] AER Consumer Reference Group (2021) *CRG Response to the AER's July 2021 Draft Working Papers: The Overall rate of return, Debt omnibus and Equity omnibus papers Volume 2: Engagement.* September
[16] p.27-28
[17] And vice versa if regulatory depreciation is deferred to reduce or prevent price increases.

5.3 Tariffs and simplicity

Over the past decade, the AER has been strongly committed to tariff reform that leads to improved cost reflectivity in network prices – as envisaged by the Network Pricing Principles.[18] As the Handbook explains in chapter 8:[19]

> "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."

Tariff structure statements set out electricity (distribution) networks' tariffs for an upcoming regulatory period. These statements are submitted to the AER for assessment as part of a network's broader revenue proposal. Networks are required to consult with consumers before submitting their tariff structure statements. The handbook describes the AER's expectation about tariff structure statements.[20]

> "Tariff structure statements are the means by which distributors progressively reform their tariffs to better signal to customers the cost of providing network services."

> "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."

> "Accounting for customer impacts drives networks to model the effect of new tariffs. Networks then design strategies to introduce tariffs progressively…"

The handbook also notes electricity distribution networks may "provide a choice from which customers may select a tariff that best suits them."[21]

When assessing how networks have consulted consumers in the preparation of their tariff structure statements, the handbook draws particular attention to the AER's expectations that networks will play an educative role.[22]

> "We assign weight to engagement that enhances customer insight and builds customers' capacity to understand tariff reform's objectives and considerations."

When read in their entirety, these statements clearly outline the AER's expectations that tariffs *must* be reformed, and networks are responsible for facilitating the pace of reform by enhancing customer's capacity to understand the merits of these reforms.

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[18] National Electricity Rules clause 6.18.5
[19] p.30
[20] p.30
[21] p.30
[22] p.31

The Australian Energy Market Commission (AEMC) recently re-emphasised a somewhat more open-ended conclusion it reached in 2014 about cases where the consumer impact principle and the cost reflectivity principles produce outcomes that are inconsistent:[23]

> "To allow [Distribution Network Service Providers] to make the necessary trade-offs, DNSPs can set network tariffs that vary from the cost reflectivity principles to the minimum extent possible to comply with the consumer impact principle. DNSPs cannot disregard the cost reflectivity principles to reduce consumer impacts or provide simpler tariffs. However, where consumers face tariffs which **they cannot relate their usage decisions to**, or that send inconsistent price signals, the gains from efficient pricing which the cost reflectivity principles are designed to achieve will not be realised." [highlight added]

It is conceivable that consumers may conclude – after considering all the relevant information and their network's educative efforts about the merits of tariff reform – that "they cannot relate their usage decisions" to cost reflective prices (as noted by the AEMC). In these circumstances, they could conclude their interests lie in having simple, but not cost-reflective, tariff structures.

Despite its expectations, would the AER permit a network to take such an approach to structuring its tariffs if simplicity was demonstrably preferred by its consumers?

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The handbook articulates the AER's expectations in clear terms. In doing so, it signals it will require network submissions to comply with those expectations.

The above thought experiments seek to demonstrate it is not beyond the realm of possibility that the AER's expectations could be fully or partially at odds with consumers' preferences or the opportunities available to networks to satisfy those preferences. In which case which prevails: the expectations of the AER or the preferences of consumers?

Whereas the above discussion relied on thought experiments, the following section provides a concrete example of the confused messages the handbook is potentially sending to networks and their consumers about who is at the centre of the regulatory process.

[23] AEMC (2021), *Access, pricing and incentive arrangements for distributed energy resources, Draft rule determination*, 25 March 2021, p.122

6. The role of AER staff (question 8)

The greatest risk posed by the handbook is that it sends confused and mixed messages about meaningful consumer engagement, who it involves and who is accountable for it.

As noted in the handbook, the AER's priorities include having networks:[24]

> "own their engagement"
>
> "sincerely engage with consumers"

Elsewhere, the handbook describes the involvement AER staff will have in pre-lodgement engagement with networks and consumers.[25] Three of the four types of involvement are entirely appropriate, however, one form of staff involvement described in the handbook risks sending a confused message – namely:[26]

> "AER staff involvement in pre-lodgement engagement will be focused on … providing feedback, at the AER staff level, on the consumer engagement processes being undertaken"

This is a practical example of the concern raised in section 5 of this submission – that is, confusion about who is at the centre of the regulatory process.

Having AER staff involved in providing feedback on a network's consumer engagement processes is problematic on various levels, including:

- Involving AER staff in this way will send a signal (whether intended or not) to networks that they should seek to satisfy, and potentially seek the approval of, AER staff in relation to their consumer engagement activities.
- If AER staff become involved, it blurs the lines of responsibility and accountability for the decisions a network makes in relation to its consumer engagement activities.
- AER staff cannot know with certainty the concerns of a network's consumers and may inadvertently misdirect a network's engagement efforts.
- Involving AER staff could undermine the role of the networks' consumer consultative committees who should be fully and solely charged with providing feedback to networks on the adequacy of their engagement processes.
- If AER staff become involved, it potentially places staff in a position of conflict when, later in the regulatory process, they must assess submissions and advise the AER Board on the adequacy of the networks' proposals.

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[24] p.12
[25] p.9
[26] p.9

Involving AER staff in providing pre-lodgement feedback on networks' consumer engagement activities sends mixed and confused messages to networks and their consumers.

For these reasons, AER staff should play no pre-lodgement role in providing feedback on the consumer engagement processes being undertaken by a network.

About the author

Dr Ron Ben-David currently holds a Professorial Fellowship with the Monash Business School and Monash Sustainable Development Institute. He is also the principal of Solrose Consulting providing policy and regulatory advice across various (utility) sectors.

Between 2008 and 2019, he served as full-time chair of the Essential Service Commission (Vic) where he led far-reaching reforms in many areas of regulation administered by the commission. Prior to his appointment to the commission, Ron was a Deputy Secretary in the Department of Premier and Cabinet (Vic) and headed the secretariat for the Garnaut Climate Change Review.

Ron is a board member at Climate Works Australia, the Consumer Policy and Research Centre, and the Regulatory Policy Institute (A-NZ). He is an advisory board member for the Centre for Market Design and Customer Stewardship Australia. Ron is a member of the AER's Consumer Reference Group and the Consumer Challenge Panel.