Incentivising well-justified regulatory proposals that reflect consumer preferences

Report for the Australian Energy Regulator on insights from other jurisdictions

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farrierswier

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Abbreviations

Term	Definition
AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
CPP	Customised price-quality path for businesses regulated by the New Zealand Commerce Commission
DNSP	Distribution Network Service Provider
ESC	Essential Services Commission (Victoria)
NEL	National Electricity Law
NEM	The National Electricity Market, which covers New South Wales, Victoria, Queensland, South Australia, Tasmania and the ACT
NER	National Electricity Rules
NewReg	The AER-ENA-ECA trial of enhanced consumer engagement for AusNet Services
NGR	National Gas Rules
NT	Northern Territory
PREMO	The Performance, Risk, Engagement, Management and Outcomes model adopted by the ESC for Victorian water businesses
RIIO	The Regulation=Incentives+Innovation+Outputs model adopted by Ofgem for British electricity and gas networks
RIIO-ED1	Ofgem's determination process for electricity distribution network operators for the 2015-2023 regulatory period
RIIO-ED2	Ofgem's determination process for electricity distribution network operators for the 2023-2028 regulatory period
SOEN	Statement of expectations for networks
TNSP	Transmission Network Service Provider
WICS	Water Industry Commission for Scotland

Executive Summary

The AER's Strategic Plan 2020-2025 provides that one of the AER's priorities is to:

> ***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. New Reg).*

The AER intends to publish the Statement of Expectations for networks (SOEN) in September 2021.

Based on discussions with the AER board and staff, we expect the SOEN will cover three key topics:

1. The AER's expectations for consumer engagement by network businesses in the development of their regulatory proposals
2. The AER's expectations for how regulatory proposals are substantiated
3. How the AER will undertake its determination process if it receives a well-justified proposal that is supported by genuine consumer engagement.

This report has been prepared to help inform the development of the SOEN. It explores:

- how other regulators have sought to set expectations for the development of regulatory proposals and incentivise proposals that reflect consumer preferences and are 'capable of acceptance'
- whether these approaches could be applied by the AER within the existing National Electricity Rules (NER) framework and form part of the SOEN.

This report examines the following Australian and international regulatory regimes that we consider provide useful insights for how the AER regulates networks and the development of the SOEN:

- **Great Britain: Ofgem's regulation of electricity distribution networks** | We examine the experience of the Office of Gas and Electricity Markets (Ofgem) in regulating British electricity distribution networks under its RIIO (Regulation=Incentives+Innovation+Outputs) framework. Our focus is on Ofgem's guidance and incentives for well-justified business plans and consumer engagement, which included a formal fast-tracking process and explicit financial incentives.
- **Scotland: The Water Industry Commission for Scotland's (WICS) regulation of Scottish Water** | We explain the approach adopted by WICS in regulating Scottish Water. We focus on the model for consumer engagement, which is seen as a leading example of enhanced consumer engagement.
- **New Zealand: The Commerce Commission's regulation of electricity lines businesses** | We focus on the requirements of the Commission's Input Methodologies for customised price-quality path applications. A unique feature of this model is the requirement that businesses have their proposals (including their customer engagement) reviewed by an independent verifier.
- **Victoria: The Essential Services Commission's (ESC) regulation of water businesses** | We review the PREMO (Performance, Risk, Engagement, Management and Outcomes) model implemented by the ESC in its 2018 price determinations for Victorian water businesses. This model includes explicit financial incentives for ambitious proposals that represent 'best offers' and are based

on effective consumer engagement, and detailed guidance on how the ESC evaluated consumer engagement.

We set out below the key insights for the development of the SOEN from our review of regulatory approaches in these other jurisdictions and our analysis of the extent to which those approaches could be adopted by the AER under the current NER framework. Our insights are grouped by each of these three topics that are expected to be the focus of the SOEN.

Insights on the role of consumer engagement

1. **There are many different approaches to consumer engagement and no consensus that there is one 'right' model for engagement.**
2. **The AER should consider whether its aim is to 'shift the dial' on consumer engagement across all networks, or just incentivise poorer performing networks to follow current best practice.**
3. **To support effective consumer engagement, the AER should set out its expectations in a public document such as the SOEN and may need to have a greater role in the pre-engagement process.**
4. **There may be value in another body having a formal pre-engagement role and providing a report on the effectiveness of the network's engagement.**

Insights for incentivising well-justified proposals

5. **'Capable of acceptance' is unlikely to be a helpful concept under the current NER framework.**
6. **'Well-justified proposals' is likely to be a more useful concept.**
7. **The SOEN can create procedural and reputational incentives for well-justified proposals and effective engagement.**
8. **Material financial incentives for well-justified proposals are unlikely to be possible under the current NER framework.**
9. **The AER will need to develop and publish criteria for assessing whether proposals are 'well-justified'.**

Insights for the AER's review process if it receives a well-justified proposal supported by consumer engagement

10. **A 'proportionate and targeted review' is more appropriate under the current NER framework than a formal 'fast-tracking' process.**
11. **To achieve the desired process and reputational incentives for networks', the AER will need to explain what a 'proportionate and targeted' review will involve and the criteria for deciding which networks' proposals will be subject to such a review.**
12. **The requirements of the NEL, NER and the AER's current guidelines impose some constraints on the AER's ability to adopt approaches used in other jurisdictions, but are not likely to prevent a proportionate and targeted review process.**

13. In the longer term, there may be value in considering rule changes to increase the AER's regulatory flexibility.

14. In the medium to longer term, there may also be value in reviewing or consolidating some of the AER's guidelines, but that should be separate from the SOEN process and subject to resourcing issues.

1. Introduction

1.1 PURPOSE OF THIS REPORT

The AER's Strategic Plan 2020-2025 provides that one of the AER's tilt priorities to deliver the objective of 'efficient regulation of monopoly infrastructure while incentivising networks to become platforms for energy services' is to:[1]

> ***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. New Reg).*

The AER intends to publish the SOEN in September 2021.

Based on our discussions with the AER board and staff, we currently expect the SOEN will cover three key topics:

1. the AER's expectations for consumer engagement by network businesses in the development of their regulatory proposals
2. the AER's expectations for regulatory proposals
3. how the AER will undertake its determination process if it receives a well-justified proposal that is supported by genuine consumer engagement.

To help inform the development of the SOEN, the AER has requested farrierswier to provide a report that explores:

- how other regulators have sought to set expectations for the development of regulatory proposals and incentivise proposals that reflect consumer preferences and are 'capable of acceptance'
- whether these approaches could be applied by the AER within the existing NER framework and form part of the SOEN.

The focus of this report is on how the AER regulates electricity distribution network services providers (DNSPs) in the National Electricity Market (NEM) and the Northern Territory (NT).

Most of the insights from this report could also be applied to electricity transmission network service providers (TNSPs) and gas distribution and transmission pipelines regulated by the AER. Although there are many similarities between how the AER currently regulates these different types of businesses, there are some important differences that would need to be reflected in the SOEN if it applies to all electricity and gas transmission and distribution businesses. The AER also has greater discretion in how it regulates gas pipelines under the National Gas Rules (NGR) than it does for electricity networks under the NER.

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1 AER, *Strategic Plan 2020-2025*, p 18.

1.2 JURISDICTIONS AND REGULATORY REGIMES CONSIDERED

This report examines the following Australian and international regulatory regimes that we consider provide useful insights for how the AER regulates networks and the development of the SOEN.

- **Great Britain: Ofgem's regulation of electricity distribution networks** | We examine the experience of Ofgem in relating British electricity distribution networks under its RIIO (Regulation=Incentives+Innovation+Outputs) framework. The regulatory framework applied by Ofgem has many similarities to how the AER regulates electricity distribution networks, and RIIO introduced innovative processes and incentives for high quality business plans and customer engagement. We explain the approach taken by Ofgem in the current RIIO-ED1 price control period (2015-2023), lessons from reviews of those decisions, and Ofgem's proposed changes in RIIO-ED2 (2023-2028). Our focus is on Ofgem's guidance and incentives for well-justified business plans and consumer engagement, which for RIIO-ED1 included a formal fast-tracking process and explicit financial incentives.
- **Scotland: The Water Industry Commission for Scotland's (WICS) regulation of Scottish Water** | We explain the approach adopted by WICS in regulating Scottish Water for its 2015-2021 and 2021-2027 Strategic Review of Charges. We focus on the model for consumer engagement, which is seen as a leading example of enhanced consumer engagement and had a strong influence on the development of the AER-ENA-ECA NewReg model.
- **New Zealand: The Commerce Commission's regulation of electricity lines businesses** | We explore how the Commerce Commission regulates electricity lines businesses (i.e. distribution networks) though default price-quality paths and customised price-quality paths. We focus on the requirements of the Commission's Input Methodologies for customised price-quality path applications, using as an example Aurora Energy's application for a customised price-quality path for the 2021-2024 period. We focus on the requirements that businesses demonstrate compliance with customer engagement obligations and have their proposals (including customer engagement) reviewed by an independent verifier.
- **Victoria: The Essential Services Commission's (ESC) regulation of water businesses** | We review the PREMO (Performance, Risk, Engagement, Management and Outcomes) model implemented by the ESC for Victorian water businesses. This model includes explicit financial incentives for ambitious proposals that represent 'best offers' and are based on effective consumer engagement, and detailed guidance on how the ESC evaluated consumer engagement. We review the PREMO framework as explained in the papers published by the ESC, how it was applied by the ESC in its 2018 price determinations, and consultant reports reviewing the performance of the model.

For each regime, we:

- introduce the regime, focussing on the aspects that are relevant for the scope of our task
- explain what guidance and incentives the regulator provides for regulatory proposals that are capable of acceptance (or the equivalent concept in that jurisdiction)
- explain the role of consumer engagement under the regime and what guidance or incentives the regulator provides to promote effective consumer engagement.

We have focussed on regulators that operate under a regulatory model that is broadly similar to the AER but that also contain useful differences that could provide relevant lessons for the Australian regime. We have not undertaken a review of experience in other jurisdictions such as the United States where any lessons may be more difficult to apply in the Australian context.[2]

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[2] An interesting feature of the US regulatory model is that once the testimony of all parties is filed before the State Public Utility Commission (or even before), it is common for the parties to enter into settlement negotiations, with the

1.3 STRUCTURE OF THIS REPORT

The remainder of this report is structured as follows:

- **Section 2** sets out the key insights from our review of regulatory approaches in other jurisdictions and our analysis of the extent to which those approaches could be adopted by the AER under the current NER framework. Our insights are grouped by what we expect to be the three key topics that will be covered in the SOEN.
- **Appendices A to D** set out the findings of our review of each of the four jurisdictions.
- **Appendix E** examines the potential application of the approaches adopted in other jurisdictions under the current NEL/NER framework and discusses the current constraints on the AER adopting some of these approaches.
- **Appendix F** sets out a table of the AER's current guidelines and other guidance documents.
- **Appendix G** lists the constituent decisions the AER is required to make under the NER.

2. Key insights from other jurisdictions

2.1 INSIGHTS ON THE ROLE OF CONSUMER ENGAGEMENT

Insight 1: There are many different approaches to consumer engagement and no consensus that there is one 'right' model for engagement

Our review of the approaches to customer engagement in other jurisdictions supports the AER's current approach that there is no one right model for consumer engagement and networks should have flexibility to adopt engagement techniques that suit their circumstances.

Other regulators generally adopt a similar approach where they provide principles to guide engagement, including what types of issues businesses should engage on (i.e. material issues where stakeholders are best placed to help shape the proposal or regulatory decisions), but are not prescriptive in relation to the form of consumer engagement networks must adopt. For example:

- The ESC has provided guidance on its expectations for consumer engagement and how it will rate water business' engagement, including a customer engagement 'tool', but still gives businesses flexibility to decide on their own approach. The ESC's tool covers the form (based on the IAP2 spectrum), timing and content of engagement.
- Ofgem and the New Zealand Commerce Commission have imposed some high level process requirements for engagement, but businesses retain considerable flexibility.

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goal of presenting an agreed position on all issues (or a partial settlement on some issues) to the commission. This gives 'intervenors' including consumer representatives an opportunity to influence the final result. All parties normally participate in settlement negotiations. Having an all-party settlement is important because it increases the likelihood that the commission will approve the settlement and thereby put an end to the formal hearing process. This saves the parties the time and expense of the expert-witness hearings. It also typically gets the utility a decision sooner than going all the way through the 6-12 month hearing process. While elements of the regulatory process are similar to Australia (in particular a proposal is made by the business supported by evidence and there are procedures to enable the testing of evidence) the statutory role of the regulatory decision maker is fundamentally different to Australia. In the US, the commission makes decisions largely based on the evidence put before it, whereas in Australia the AER undertakes its own analysis based on rules specifying the criteria and factors that must be applied in its decision-making. In the US, the 'just and reasonable' standard for assessing rates proposed in a rate case is different from the standards in Australia's regulatory regime, which are much more prescriptive. Given these differences it is therefore difficult in our view to draw useful lessons from this experience about the role of a SOEN, incentives for consumer engagement, and the concept of 'capable of acceptance'. (See for example The Regulatory Assistance Project, *Electricity Regulation in the USA: A Guide*, for a description of the regulatory arrangements in the US).

- WICS adopted a negotiated settlement model for Scottish Water, but that model was developed collaboratively by WICS, Scottish Water and Consumer Focus Scotland.

Insight 2: The AER should consider whether its aim is to 'shift the dial' on consumer engagement across all networks, or just incentivise poorer performing networks to follow current best practice

An insight drawn from the ESC and Ofgem experience is that the appropriate approach will depend on the extent the AER wishes to 'shift the dial' on consumer engagement compared to retaining or refining the status quo. Both the ESC and Ofgem made a strategic decision to significantly strengthen incentives to improve customer engagement because they wanted to see a step change in engagement by businesses.

It could be considered that this step change has already occurred amongst some of the network businesses the AER regulates, with many network businesses having significantly expanded their consumer engagement in recent years. If consumer engagement is considered to be already evolving satisfactorily and on the right track, then significant changes across the sector may not be needed, with a focus more on refinement, more clearly expressing the AER's current thinking in a single document and bring up lagging performers.

The following table sets out options to improve consumer engagement in the regulation of network business drawing from the experience of other regulators. The options are presented in rough order of the extent of change and are limited to options that could be implemented under the current NER framework.

Table 2.1: Options to improve consumer engagement on network proposals

Option	Specific actions	Reference
Define what 'good' looks like for customer engagement	Recognise there has been significant progress. Updated customer engagement guidance in SOEN and potentially an updated consumer engagement guideline. Guidance would build on Table 7. Provide flexibility for choosing approaches that reflect a business's individual circumstances. Call out examples of good engagement.	CEPA's recommendations to Ofgem following its review of RIIO-ED1, ESC's PREMO consumer engagement tool and guidance
	Note expectation of possible need for changes to some businesses' internal cultures to enable effective engagement with customers and stakeholders.	Ofgem, Scottish Water, ESC PREMO
	Note that customer engagement should be a continuous business-as-usual process, not a one-off process only undertaken for regulatory purposes.	NZ requirement for annual publication for Asset Management Plan, ESC's PREMO guidance for 'leading' proposals

Option	Specific actions	Reference
Enhance reputational and procedural incentives	Draft SOEN with an eye to how to enhance reputational and procedural incentive effects for businesses undertaking good customer engagement: • explain that demonstrating effective consumer engagement will be a factor in the AER adopting a targeted and proportionate review • provide clear guidance on what evidence the AER expects to see with proposals to justify a more targeted and proportionate review by the AER.	Ofgem, ESC PREMO and NZ Commerce Commission approaches to proportionate assessment of proposals based on criteria defined up front
	An assessment and ranking system could be adopted. This could be explicit (as per PREMO) or an AER internal tool to enable more consistent evaluation of customer engagement and more targeted assessments focussed on certain issues or businesses.	ESC PREMO, Ofgem fast-tracking decisions
Consider whether there is a case for stronger expectations or mandating certain aspects of customer engagement arrangements	Needs detailed review of any gaps especially for worst performers. This could be done by mandating certain core requirements, or lifting up existing guidance materials into a document with broader application and requiring businesses to explain in their proposals the approach they have adopted based on that framework.	Ofgem Enhanced Stakeholder Engagement Guidance for RIIO-ED2, NZ Commerce Commission Input Methodologies, ESC's PREMO guidance on rating consumer engagement
Independent verifier/reviewer	A requirement for an independent party (which could be the CCP – see insight 4 below) to review the businesses' consumer engagement and prepare a public report on the effectiveness of the engagement process, whether it meets the regulator's guidance and any specific issues the regulator should focus on in its review.	NZ Commerce Commission independent verifier requirements

Insight 3: To support effective consumer engagement, the AER should set out its expectations in a public document such as the SOEN and may need to have a greater role in the pre-engagement process

There is likely to be value in the AER clearly setting out its expectations for consumer engagement prior to commencement of the regulatory determination process and the development of the business' proposal. The SOEN would be an ideal vehicle for doing so.

The AER currently sets out its guidance on engagement in:

- the consumer engagement guideline for network service providers, but that guideline has not been reviewed since it was made in 2013 and does not reflect the AER's or networks' current views of best practice; and

- 'Table 7', but that table is currently only included in specific AER decisions and was not first used until the draft determination for the Victorian DNSPs.

Providing guidance before the regulatory process commences would be consistent with approaches taken by other regulators including Ofgem, the ESC and the Commerce Commission. For example, the ESC has published a customer engagement tool and guidance on how it will rate water business' engagement.

To support effective engagement and well-justified proposals, the AER's guidance and pre-lodgement role may need to be expanded beyond just providing guidance on its expectations and involve a more active role.

This may require the AER to not just set out high-level guidance for all networks in the SOEN, but to also set out more specific guidance at the outset of each determination process, for example by expanding and repurposing the current framework and approach paper.

For example, Ofgem's RIIO model includes several steps where Ofgem provides guidance on its expectations, including though a strategy decision document that:

- sets out priorities for the sector over the longer term, identifying the role network companies may play in delivering these, informed by enhanced engagement
- provides Ofgem's initial assessment of current network company performance
- sets out Ofgem's view, informed by enhanced engagement, on key elements of the price control
- sets out the criteria for a company to be fast tracked.

WICS has a considerable role in providing information and guidance to support effective engagement during the pre-lodgement process, similar to the NewReg trial approach. The AER may consider such a model may to be too resource-intensive to be applied to all networks. However, there would still likely be value in the AER having a role providing information that consumers and other stakeholders can use to assist with engagement, e.g. the AER's preliminary views on key issues and how the networks' expenditure is tacking under the AER's various tools and models.

There may also be value in the SOEN expressing certain minimum conditions for how engagement is conducted in order for the AER to rely on the outcomes of that engagement. For example, Ofgem's recent guidance on the enhanced stakeholder engagement it expects to be undertaken for RIIO-ED2 (released in April 2021)[3] has specified procedural requirements that the networks must meet for their customer engagement groups (CEG). These requirements are:

1. appoint an CEG independent chair (which must not represent any particular organisation or groups of stakeholders)
2. ensure the CEG is appropriately resourced (e.g. by providing the necessary secretariat support, training/induction for CEG members)
3. ensure the CEG has access to relevant data including information on past performance, totex forecasts and out-turn performance and reasons for the variation
4. provide the CEG with access to comparative data from other network companies and other background data to inform the CEG's decision making
5. ensure timely access to staff to enable the CEG to perform their role. The company's Board will be expected to be fully engaged with the CEG and this should be reflected in the governance arrangements

[3] Ofgem, *Enhanced Stakeholder Engagement Guidance for RIIO-ED2 - Version 2*, 30 April 2021.

6. ensure business plans are available to the CEG with a reasonable amount of time for the CEG to review and comment on.

We note that items 3 and 4 could be aided by augmenting the AER's framework and approach paper with additional information to inform customer pre-lodgement engagement (i.e. similar to Ofgem's strategy decision document).

Insight 4: There may be value in another body having a formal pre-engagement role and providing a report on the effectiveness of the network's engagement

There may also be value in another body having an increased role in the pre-lodgement process drawing on insights from the Commerce Commission's independent verifier model. This could be in addition to, or instead of, the AER having an increased pre-lodgement role.

A unique feature of the New Zealand customised price-quality path (CPP) model is the requirement that all CPP proposals must be verified by an independent verifier in accordance with the requirements of the Commission's Input Methodologies. The verifier provides a report to the Commission at the same time the CPP proposal is submitted. This report reviews whether the proposal meets the Commission's requirements, assesses the effectiveness of the business' customer engagement and comments on any areas the Commission should focus on in its assessment of the proposal. This requirement plays a key role in incentivising well-justified and efficient CPP proposals and enabling a proportionate and targeted review by the Commission.

The AER is unlikely to have the power to require regulatory proposals to be accompanied by a report from an independent verifier without a change to the NER.

However, this model could be adapted to fit within the current rules and the AER's context by having the CCP (or potentially a consumer body established and resourced by the network business if the AER considered it to be sufficiently independent and well-resourced – similar to the NewReg customer forum) prepare a report that is submitted to the AER at the same time as the business' regulatory proposal. Such as report could set out the CCP's views on the effectiveness of the business's engagement during proposal's development, its initial views on how well justified the proposal is and any key issues it considers the AER should focus on in its review process.

In some of the overseas models where a specific consumer body is tasked with engaging during the pre-lodgement process, the consumer body's comments focus on whether the proposal is aligned with consumers' preferences and interests. However, we think there is likely to be significant value in having a consumer body also scrutinise and comment on the level of evidence and justification included in the proposal. Such an approach is consistent with the current role of the CCP. It is also consistent with Ofgem's guidance for the role of the Consumer Engagement Groups, which Ofgem states should focus on matters including:[4]

- the company's overall priorities and approach
- proposed outputs and associated totex budgets, whether the company has demonstrated its proposals for expenditure efficiency or service quality improvement are sufficiently stretching, and what evidence the company has provided on how its proposals compare to historical levels of performance, other network companies and other industries
- the quality of stakeholder engagement the company has undertaken to inform its proposals, including whether the proposal demonstrates value for money by taking account of willingness to pay research

[4] Ofgem, Enhanced Stakeholder Engagement Guidance for RIIO-ED2, pp 14-15.

- the approach and support provided to vulnerable consumers
- the company's approach to innovation
- the range of scenarios the company has considered to anticipate future network requirements and the company's approach to managing uncertainty and associated risks.
- what alternatives to the investment proposals the company has considered
- any issues of particular relevance to a local region.

2.2 INSIGHTS FOR INCENTIVISING WELL-JUSTIFIED PROPOSALS

Insight 5: 'Capable of acceptance' is unlikely to be a helpful concept under the current NER framework

The AER's Strategic Plan refers to proposals that are 'capable of acceptance'. This term has become something of a term of art that has been used by some stakeholders, but it has no basis in the NER and does not have a clear meaning.

Other regulators do not use a term like 'capable of acceptance'. This type of concept is arguably implicit in regimes where a regulator has a formal fast-tracking process, such as the ESC's PREMO model or Ofgem's RIIO-ED1 decisions. However, even in those regimes, when the regulator fast-tracks its decisions on a proposal it does not 'accept' the entire proposal and it substitutes its views for aspects of the fast-tracked proposals.

We consider that this term is confusing and unlikely to be helpful given it is not defined; the AER can only accept a proposal if it complies with the NER; and in practice it is not a binary decision to accept or reject the entire proposal.

We do not consider that the 'capable of acceptance' concept is necessary to deliver the procedural and reputation incentives the AER is seeking to achieve through the SOEN process. As discussed in insights 6 and 7 below, those incentives can be delivered just as effectively by the AER setting out its expectations for proposals in the SOEN and explaining how it will adjust its determination process if it receives a proposal that meets those expectations. This is consistent with how other regulators such as the ESC and Ofgem create procedural and reputational incentives for high quality proposals without using a concept like 'capable of acceptance'.

Insight 6: 'Well-justified proposals' is likely to be a more useful concept

We consider that a more useful term for the concept that the AER is seeking to convey though its guidance in the SOEN is a 'well-justified proposal.

This terminology is used by Ofgem in its RIIO model, where it refers to 'well-justified business plans'. This term conveys what we understand to be the main objective of the SOEN, which is to incentivise proposals that are supported by robust evidence and genuine consumer engagement.

The ESC refers to incentives for businesses to submit their 'best offers' in their proposals, which is also a useful concept that could be mentioned in the SOEN, but 'well-justified' seems the most useful term.

Insight 7: The SOEN can create procedural and reputational incentives for well-justified proposals and effective engagement

The regimes we reviewed use a variety of types of incentives to encourage well-justified proposals that are supported by effective consumer engagement:

- All four regulators use procedural incentives:
  - Ofgem and the ESC create strong procedural incentives by offering the possibility of fast-tracking some proposals to an earlier final decision (although Ofgem ceased doing so for RIIO-ED2 after concerns about the results and costs of fast-tracking in RIIO-ED1)
  - Ofgem and the Commerce Commission expressly refer to undertaking a ‘proportionate review’ process that focusses on certain issues, with the extent of the review able to vary depending on the quality of the proposal. Similarly, the ESC’s PREMO model introduced a new ‘flexible assessment approach’ which tailors the scope of the ESC’s assessment to the quality of each proposal. The possibility of such a review creates a procedural incentive for better proposals.
  - WICS uses a negotiated settlement model that creates extremely strong procedural incentives by involving significantly less scrutiny by WICS for elements of the proposal that have been agreed with a Consumer Forum.
- Ofgem and the ESC aim to create strong reputational incentives by publicly rating and ranking different businesses’ proposals.
- Ofgem and the ESC also provide explicit financial incentives based on the quality of the proposal:
  - Ofgem provides various financial incentives under its Information Quality Incentive (for RIIO-ED1) or its Business Plan Incentive (for RIIO-ED2). These incentives aim to ‘encourage companies to submit more accurate expenditure forecasts to Ofgem’.
  - PREMO encouraged water businesses to submit price submissions that reflect their ‘best offers’ by the ESC setting the return on equity based on the level of ambition of the price submission. The business and the ESC both rate the proposal, with the highest return on equity being achieved when the ESC and the business align in their respective assessments.

The AER could use the SOEN to provide reputational and procedural incentives, although as discussed in insights 8 and 10, neither a formal fast-tracking process nor financial incentives are likely to be suitable under the NER.

Insight 8: Material financial incentives for well-justified proposals are unlikely to be possible under the current NER framework

The current NER requirements are likely to prevent the AER from providing material financial incentives for ambitious and well-justified regulatory proposals like under the Ofgem or the ESC models:

- The level of prescription in the building blocks clauses of the NER limit the AER’s ability to add an additional amount to its assessment of the efficient opex or capex allowances or other parts of the allowed revenue calculation based on an assessment of the quality of the proposal.
- The National Electricity Law (NEL) provisions related to the Rate of Return Instrument (RORI) would prohibit a PREMO style incentive tied to the rate of return. The NEL provides that the RORI must provide for the same rate of return methodology to apply to all network service providers automatically without the exercise of any discretion by the AER, and expressly prohibits the RORI including different methodologies or a band of values the AER could choose from.
- The NER permits the AER to develop small-scale incentive schemes, which are collectively limited to a maximum reward or penalty of 0.5% of revenue. Such a scheme must provide DNSPs ‘incentives to provide standard control services in a manner that contributes to the achievement of the national

electricity objective'. It is not clear whether this requirement would be met by a scheme that provided incentives based on the quality of a regulatory proposal. The AER's recently developed customer service incentive scheme is also a small-scale incentive scheme and has a maximum reward or penalty of 0.5% of revenue. The collective limit of 0.5% of revenue for all such schemes means the incentive power of the customer service incentive scheme would need to be reduced if another scheme was developed.

However, even without an explicit financial incentive like in the Ofgem and ESC models, networks may still consider that there are material financial benefits from meeting the AER's expectations. A proposal that meets the AER's SOEN expectations is more likely to be approved by the AER (or have more parts of it approved), particularly if the AER adopts the 'proportionate and targeted' review approach discussed below. This could have material financial benefits for the network compared with the outcome if it had submitted a proposal that does not meet the AER's expectations. For example, the AER is more likely to approve a larger amount of network's proposed revenue allowance, or approve proposals for changes such as accelerated depreciation or new tariff structures, if the network has provided a well-justified proposal that is supported by consumers.

Insight 9: The AER will need to develop and publish criteria for assessing whether proposals are 'well-justified'

If the AER wants to incentivise proposals that are well-justified, it will need to clearly and publicly explain to networks what it means by 'well-justified' and how it will assess whether a proposal meets that test.

Other regulators take various approaches to this issue.

- Ofgem issues a Strategy Decision at the start of each regulatory process, well before proposals are submitted. The Strategy Decision sets out the criteria for a company to be fast tracked. Ofgem's Strategy Decision for RIIO-ED1 also set out that Ofgem expected that all business plans would contain the following elements:[5]
    - *Justification of the DNO's proposed strategy for delivering their outputs against a thorough understanding of the long-term trends (and risks and uncertainties) they face. In addition, a demonstration that they understand their role, and are looking to be proactive, in contributing to the UK's carbon targets.*
    - *Clear links between expenditures, outputs and secondary deliverables.*
    - *Demonstration that the DNO has considered the views of stakeholders, and the opportunities to use innovative technologies, techniques or commercial arrangements to deliver their outputs at long-term value for money.*
    - *A holistic view of the package the DNO believes to be appropriate, including their view on financeability metrics (with evidence), against their view on expenditure and outputs.*
- The ESC (based on advice from KPMG) developed a PREMO Assessment Tool that provides the ESC's guidance to businesses for self-rating their proposals and the process the ESC will use for making its own ratings. This tool provides guidance on each of the Risk, Engagement, Management and Outcomes elements of PREMO.

5 Ofgem, *Strategy decision for the RIIO-ED1 electricity distribution price control, final decision overview*, p 32.

- The Commerce Commission sets out detailed requirements for the content of a customised price-quality path proposal in its Input Methodologies.

2.3 INSIGHTS FOR THE AER'S REVIEW PROCESS IF IT RECEIVES A WELL-JUSTIFIED PROPOSAL SUPPORTED BY CONSUMER ENGAGEMENT

Insight 10: A 'proportionate and targeted' review is more appropriate under the current NER framework than a formal 'fast-tracking' process

As discussed in relation to insight 7 above, the regimes we considered provide strong support for the regulator adopting a 'proportionate and targeted' review process, with the extent of the review varying depending on the quality of the proposal and the level of consumer engagement.

This concept would build on the 'proportionate review' process adopted by Ofgem and the Commerce Commission, the 'flexible assessment approach' adopted by the ESC, and potentially aspects of the negotiated settlement approach used by WICS.

Given the NER requirements, the AER will still be required to issue a draft and final determination for each network business that includes each of the 'constituent decisions' required by the NER (see Appendix G for a list of these).

However, within the current NER framework, we consider that there is scope for the level of assessment undertaken by the AER to vary:

- between issues; and
- between network businesses,

so that the AER devotes more resources to certain issues or networks based on the level of evidence and consumer support demonstrated in the proposal. For issues and networks where the AER's SOEN expectations are met and the networks' proposal has broad stakeholder support, the AER could adopt an approach more like that adopted by WICS and the Commerce Commission (and most US regulators) where it makes its decision largely based on the evidence before it rather than undertaking its own additional analysis of those issues.

The prescriptive process and timeframe requirements under the NER would not allow the AER to adopt a formal fast-tracking process where it skips stages of the process. They would also make it challenging to adopt a fast-track process where the AER still undertakes all of the steps required by the NER, but issues a final determination for some businesses significantly earlier than for other businesses. In theory, the AER could adopt a limited fast-tracking process where it made its draft and final decisions for some businesses slightly earlier than for other businesses. However, the amount of time that can be saved is likely to be limited in practice, there could be significant resourcing implications from doing so, and the next regulatory period would still have to start at the same time for all businesses.

Accordingly, we consider that the concept of a 'targeted and proportionate' review process is likely to be more useful than a formal fast-tracking process. Doing so also acknowledges the precedent lessons from other regulatory models we have examined, including that:

- Ofgem removed the fast tracking element of its approach between RIIO-ED1 and RIIO-ED2; and
- the 'performance outcomes' element of the ESC's PREMO regulatory approach was not defined at the time of its inaugural application in 2018, and measurement of what that element and the ESC's fast tracking process achieved is arguably still in its relative infancy.

Under a 'targeted and proportionate' review, the AER's draft determination may be the same as or very similar to its final determination with very little work required by the network business or the AER between the draft and final determinations, and it could therefore have a similar procedural incentive to fast-tracking.

Insight 11: To achieve the desired process and reputational incentives for networks, the AER will need to explain what a 'proportionate and targeted' review will involve and the criteria for deciding which networks' proposals will be subject to such a review

If the AER wants the prospect of a targeted and proportionate review to be an effective incentive for networks to submit proposals that are well justified and supported by customers, it will need to clearly and publicly explain to networks what a 'proportionate and targeted' review will involve, and the criteria for deciding which networks' proposals, or which aspects of proposals, will be subject to such a review.

Ofgem summarises its proportionate treatment approach under RIIO-ED1 as follows:[6]

> *The RIIO model includes a proportionate approach to assessing the price control package. This means that the intensity and timescale of our assessment will reflect the quality of a company's business plan and the company's record for efficient output delivery. This approach is consistent with better regulation principles as it allows us to focus our attention where it is likely to produce greatest value.*
>
> *In cases where a DNO produces a particularly high quality business plan which reflects its track record, we will consider whether it is appropriate to conclude the DNO's review early, i.e. fast-track.*

As part of its initial assessment of business plans, Ofgem scores various aspects of them based on a traffic light system to help identify which businesses to fast-track and what issues to focus on for its assessment process. Each business is assessed against the following criteria:

- **Process:** Has the DNO followed a robust process, including stakeholder engagement?
- **Outputs:** Does the plan deliver the required outputs?
- **Resources (efficient expenditure):** Are the costs of delivering the outputs efficient?
- **Resources (efficient financing):** Are the proposed financing arrangements efficient?
- **Uncertainty and risk:** How well does the plan deal with uncertainty and risk?

Under PREMO, the ESC stated that it would introduce a new flexible assessment approach which:

- tailors the scope of the ESC's assessment to the quality of each price submission, which may include resubmission when businesses provide insufficient information
- 'fast-tracks' high quality price submissions through the assessment process to an early draft and final decision
- provides financial and reputational incentives linked to the ambition of a price submission through its overall PREMO rating.

The ESC publicly rates proposals against each element of the PREMO model: Performance, Risk, Engagement, Management and Outcomes. As noted above, the ESC published a PREMO Assessment Tool that provides guidance on how the ESC will rate proposals on each element.

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6 Ofgem, RIIO-ED1 Strategy Decision, p 32.

The ESC stated that the opportunity for a price submission to be fast-tracked was not directly linked to its PREMO rating. Instead, it was linked to the quality and clarity of the submission, its proposals, and the supporting information, which in turn enabled the ESC to complete its verification and assessment in a short timeframe. The ESC did not provide a check-list set of criteria for a business to qualify for fast-tracking.

The Commerce Commission uses the independent verifier's report to guide the scope of its proportionate review process. For example, following receipt of Aurora Energy's CPP proposal and farrierswier's verifier report on the proposal the Commission stated:[7]

> *We have critically reviewed the expert's report by Farrier Swier. We are satisfied by the rigour of their analysis and consider their review to be thorough and undertaken to a high standard. As a result, we are proposing to accept their opinion at a high level and do not intend to duplicate their analysis... We are seeking expert external advice on the projects not reviewed to ensure the spending is efficient... As a result, we intend to target our review primarily on the areas of Aurora's proposal that Farrier Swier suggested we scrutinise further, along with issues that were not identified by them, either because they were out of scope of their process or because we seek further assurance.*

The AER will also need to give careful thought to how and when it provides its initial views on whether a proposal has met its expectations and which networks and/or issues will be subject to the proportionate and targeted review process.

If the AER does not publicly signal this until the draft determination stage, the procedural and reputational benefits for the network may be reduced. However, the experience of other regulators shows the risks of making this decision too early based on limited information. In particular, reviews of Ofgem's RIIO-ED1 decisions indicated that, in hindsight, Ofgem fast tracked the wrong business and its views of the relative efficiency of the businesses changed markedly during the determination process.

Insight 12: The requirements of the NEL, NER and the AER's current guidelines impose some constraints on the AER's ability to adopt approaches used in other jurisdictions, but are not likely to prevent a proportionate and targeted review process

There are several important unique features of the NEL/NER regime compared with the 4 other regimes we examined that are likely to limit the AER's ability to adopt some of the approaches used by other regulators without rule changes. In particular:

- **More layers of instruments** | The regulatory framework governing how the AER regulates DNSPs in the NEM and NT is unusual in that it relies on a greater number of different types of instruments with a clear legal hierarchy between them. The AER's approach in the SOEN must be consistent with detailed requirements set out in the NEL, NER, RORI and the numerous existing AER guidelines that are required under the NER. In contrast, the regimes in other jurisdictions have fewer layers and much less prescription regarding what guidance materials or other instruments the regulator may make.
- **More prescriptive process and content requirements set by other bodies** | The framework under which the AER regulates is also unique in terms of the level of prescription that is set out in documents that are made by other bodies. The provisions of the NEL and NER that govern how the AER regulates electricity DNSPs are more than 3 times the length of the equivalent instruments set by other bodies in any other jurisdictions we considered, and are 10 times the length of the equivalent

[7] Commerce Commission, *Have your say on Aurora Energy's investment plan: Consumer Summary key issues paper*, June 2020, p 3.

instruments governing how Ofgem and the ESC regulate similar businesses. In other jurisdictions, these documents are generally limited to principles, objectives and high-level process requirements. In contrast, chapter 6 of the NER regulates in detail both the process and content of the AER's determinations. This limits the AER's discretion compared with other regulators. Combined with the above point regarding the clear legal hierarchy, this prescription also limits what the AER can include in its formal guidelines or in a SOEN or other informal guidance document.

- **More network determination processes** | The AER is also unique amongst these regulators in not having a single network determination /price review process that covers almost all regulated businesses and not having regulatory periods that are aligned for almost all regulated businesses. This is likely to increase the resources required by the AER per regulated business and will make it harder to adopt some of the approaches used by other regulators to encourage ambitious and well-justified regulatory proposals though measures like competition by comparison, competition for financial incentives, proportionate assessment and fast-tracking.

The key implications of the NER requirements for the AER's ability to adopt some of the approaches utilised by other regulators in the examples in this report are:

- **Limited ability to adopt a formal fast-tracking process** |As noted above, the process and timeframe requirements under the NER will limit the AER's ability to adopt a formal fast-tracking process. However, there is still likely to be scope for the AER to adopt a 'proportionate assessment' approach like Ofgem, the ESC and the Commerce Commission where more effort is directed to certain businesses and/or issues.
- **Explicit financial incentives for well-justified proposals are unlikely to be permitted** | As discussed above, incentives for proposals that are capable of acceptance are more likely to need to be reputational and procedural due to several limitations in the NER that would prevent the AER providing explicit financial incentives based on the quality of a proposal. However, even without *explicit* financial incentives, networks may consider that there are important *implicit* financial incentives from meeting the AER's expectations and having a larger amount of their proposal approved under a targeted and proportionate review approach.
- **The concept of 'capable of acceptance' needs to be grounded in the NER requirements and may be unhelpful**| These legal requirements will need to inform what is meant by the concept of 'capable of acceptance', as the NEL and NER impose much greater constraints than in other regimes on what proposals the regulator is legally permitted to accept. 'Capable of acceptance' is likely to be a confusing term and the concept of a 'well-justified' proposal is likely to be more useful.
- **A greater focus on inputs rather than outputs may be unavoidable** | The level of prescription in the constituent decision and building blocks clauses of the NER are likely to make it harder for the AER to move to a model where it has increased focus on outputs or outcomes for consumers like Ofgem, the ESC and WICS have done, rather than decisions that address each key input to the elements of the building blocks model.
- **There may be limitations on the role of enhanced consumer engagement** | The AER can place weight on consumers' views when making its decisions. However, consumer engagement can never be a complete substitute for the AER's review role – the preferences of current consumers can meaningfully guide many issues but cannot answer all questions in a determination such as complex technical issues like the rate of return or inter-generational issues related to tariffs and depreciation. In addition, the level of prescription in the NER (including the constituent decisions and building blocks requirements model, the detailed opex and capex objectives, factors and criteria) and the existence of state and territory reliability requirements may mean the AER has less ability to use enhanced consumer engagement to decide on price-quality or price-reliability trade-offs than other regulators. The AER can use incentive schemes to encourage improved reliability or customer service over-and-

above what is required in jurisdictional requirements, but consumers cannot negotiate to pay less for reduced reliability and there may be less ability to agree on trade-offs between different building blocks.

Insight 13: In the longer term, there may be value in considering rule changes to increase the AER's regulatory flexibility

The AER wishes to issue the SOEN in September 2021. This means that it must comply with the current requirements of the NEL, NER and AER guidelines. We also understand that the AER does not want to consider rule changes in relation to these issues in the short term.

We consider that the AER is able to develop a SOEN that provides material procedural and reputational incentives while complying with the current NEL, NER and AER guidelines. However, the AER should monitor whether the SOEN delivers on its objectives and whether those incentives are effective.

In the longer term, the AER may want to consider whether the current NER framework is overly prescriptive and whether the AER should have greater flexibility in how it regulates networks.

As noted in insight 12, the current regulatory framework is much more prescriptive than any of the other regulatory models we examined. This level of prescription may have been appropriate when the network regulation rules were first implemented in the mid-2000s as part of the transfer of regulatory responsibilities from state and territory governments and local regulators to the national framework and a Commonwealth regulatory body, but could be overly restrictive today.

Insight 14: In the medium to longer term, there may also be value in reviewing or consolidating some of the AER's guidelines, but that should be separate from the SOEN process and subject to resourcing issues

The AER has published 27 formal or informal guidance documents relating to how it regulates electricity distribution networks, excluding rate of return issues. This includes:

- **Customer engagement:** one guideline that provides informal guidance only and is not required by the NER.
- **Expenditure assessment:** 16 documents, including 10 guidelines, schemes or models that are required by the NER and 6 other guidance documents.
- **Other issues:** 10 documents, including 6 guidelines or schemes that are required by the NER, one scheme that is optional under the NER and 3 other guidance documents.

The AER also provides significant guidance on its approach to regulation in individual determinations for network businesses. While this guidance has no legal status for other determination processes, it often gives the best explanation of the AER's approach to certain issues as the AER applies the same or very similar approaches across multiple determinations.

We note that several key guidelines including the consumer engagement guideline and the expenditure forecast assessment guideline have not been updated since 2013.

Given that many of these published guidance materials have a legal status under the NER and the AER and network businesses are required to comply with them, the SOEN will need to be consistent with them, at least in the short term.

The key short term question for the development of the SOEN will be the impact on the current consumer engagement guideline. The SOEN will set out the AER's current guidance on consumer engagement by networks and there would be risks in retaining the current guideline if it is not consistent with the SOEN. This guideline has no legal status so the SOEN could announce that it no longer applies, or announce that the AER will commence a consultation on amendments to the guideline.

A further short term consideration for the development of the SOEN will be the form and extent of any guidance on tariffs, noting that the AEMC's draft determination for the access and pricing rule change includes a requirement for the AER to develop and export tariff guideline for electricity DNSPs.

In the longer term, the AER could undertake a process to consult on changes to relevant guidelines if necessary, and if resourcing constraints allow it. There may also be merit in consolidating and simplifying the multiple expenditure assessment guidelines.

Appendix A Ofgem: British electricity distribution networks

A.1 INTRODUCTION

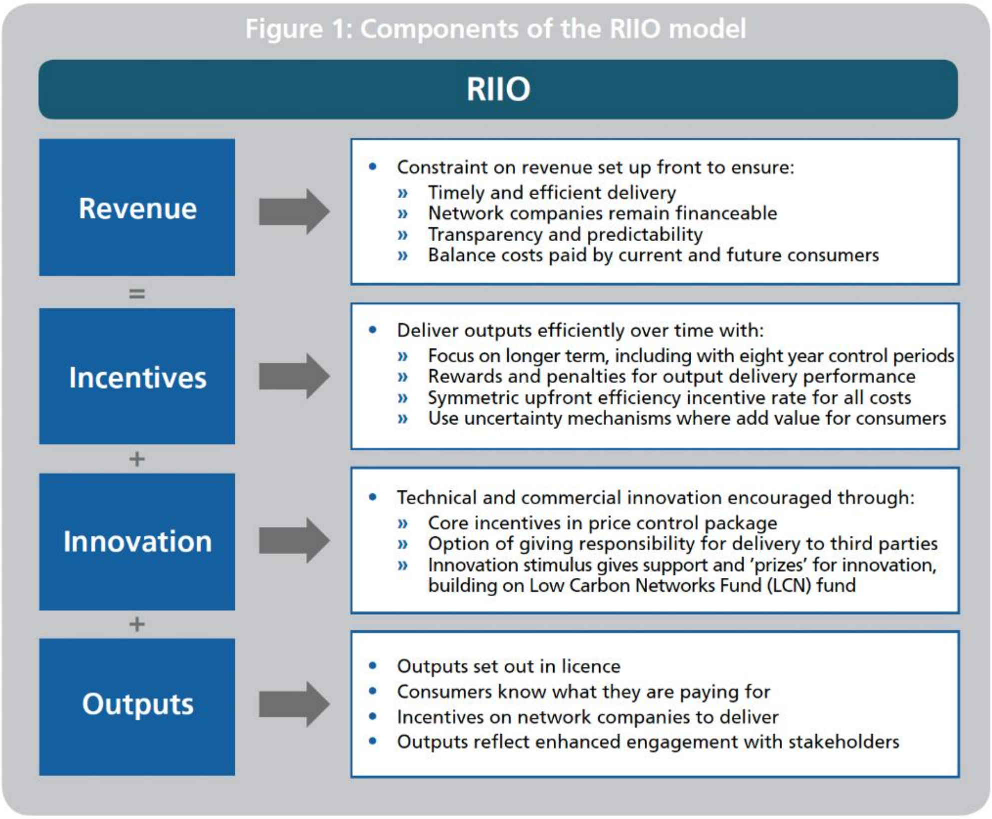
Ofgem regulates electricity and gas transmission and distribution networks in England, Scotland and Wales, including 14 licensed electricity distribution network operators (DNOs).

Ofgem has considerable discretion as to how it regulates DNOs, with just high-level requirements set out in legislation. Ofgem also sets licence conditions for DNOs and embeds its price control decisions in licence conditions.

The building blocks incentive-based form of regulation applied by the AER has its origins in the 'RPI-X' model of regulation developed in Great Britain and applied by several British regulators including Ofgem. As a result, there are many similarities between how the AER and Ofgem regulate electricity distribution networks.

To coincide with the 20th anniversary of the RPI-X model, Ofgem initiated a major review of how it regulates electricity and gas networks called 'RPI-X@20'. This review led to Ofgem introducing significant changes to how it regulates energy networks and a new model known as RIIO, which is summarised in Figure A.1 below.[8]

Figure A.1: Overview of Ofgem's RIIO model



8 Ofgem, *RIIO: A new way to regulate energy networks, final decision,* October 2010, p 3.

The RIIO model is explained in various Ofgem reports that are available on its website, including its final decision on the RPI-X@20 review and its *Handbook for implementing the RIIO model*.[9]

Ofgem first applied the RIIO model to electricity DNOs in its decisions for the RIIO-ED1 price control period from 2015-2023. Ofgem undertook a review of lessons from those decisions and made changes to how it proposes to apply the RIIO model for the upcoming RIIO-ED2 price control period from 2023-2028.

The features of RIIO that are most relevant to setting expectations for the development of regulatory proposals and incentivising proposals that reflect consumer preferences and are capable of acceptance are:

- **Proportionate assessment and fast-tracking**: For RIIO-ED1, Ofgem committed to adopting 'a transparent and proportionate approach' to assessing business plans including the ability to conclude the process early for some companies.
- **Information quality incentive (IQI) / Business Plan Incentive (BPI)**: For RIIO-ED1, Ofgem maintained and refined the IQI that it had applied in previous price control decisions. The IQI is used to set the strength of the upfront efficiency incentives each company faces according to differences between its forecasts and Ofgem's assessment of its efficient expenditure requirements and aims to 'encourage companies to submit more accurate expenditure forecasts to Ofgem'.[10] For RIIO-ED2, the IQI was replaced by the new BPI discussed below.
- **Enhanced engagement:** RIIO sought to provide stakeholders greater opportunities to influence decision making by Ofgem and network companies.

Each of these issues are explained below.

A.2 INCENTIVES FOR WELL-JUSTIFIED BUSINESS PLANS

Ofgem's statements of its expectations for business plans

RIIO contains several explicit incentives for what Ofgem describes as 'well-justified business plans'.[11]

The RIIO model also includes several steps where Ofgem provides guidance on its expectations, including though the documents mentioned above and a Strategy Decision document that:[12]

- sets out priorities for the sector over the longer term, identifying the role network companies may play in delivering these, informed by enhanced engagement
- provides Ofgem's initial assessment of current network company performance
- sets out Ofgem's view, informed by enhanced engagement, on key elements of the price control
- sets out the criteria for a company to be fast tracked.

Ofgem's Strategy Decision for RIIO-ED1 set out that Ofgem expected that all business plans would contain the following elements:[13]

- *Justification of the DNO's proposed strategy for delivering their outputs against a thorough understanding of the long-term trends (and risks and uncertainties) they*

9 Ofgem, *Handbook for implementing the RIIO model*, October 2010.

10 Ofgem, RIIO Handbook p 66.

11 'Business plans' are the British equivalent of 'regulatory proposals' for DNSPs in Australia.

12 Ofgem, RIIO Handbook, p 9.

13 Ofgem, *Strategy decision for the RIIO-ED1 electricity distribution price control, final decision overview*, p 32.

face. In addition, a demonstration that they understand their role, and are looking to be proactive, in contributing to the UK's carbon targets.

- *Clear links between expenditures, outputs and secondary deliverables.*
- *Demonstration that the DNO has considered the views of stakeholders, and the opportunities to use innovative technologies, techniques or commercial arrangements to deliver their outputs at long-term value for money.*
- *A holistic view of the package the DNO believes to be appropriate, including their view on financeability metrics (with evidence), against their view on expenditure and outputs.*

Proportionate assessment and fast-tracking under RIIO-ED1

Ofgem summarises its proportionate treatment approach under RIIO-ED1 as follows:[14]

> *The RIIO model includes a proportionate approach to assessing the price control package. This means that the intensity and timescale of our assessment will reflect the quality of a company's business plan and the company's record for efficient output delivery. This approach is consistent with better regulation principles as it allows us to focus our attention where it is likely to produce greatest value.*
>
> *In cases where a DNO produces a particularly high quality business plan which reflects its track record, we will consider whether it is appropriate to conclude the DNO's review early, i.e. fast-track...*
>
> *The scope for proportionate treatment and, to a greater degree fast-tracking, incentivises companies to submit realistic and well-justified business plans. This is because these approaches will allow DNOs to:*
>
> - *get on with business as usual without focussing as much resource on the price control process*
> - *plan with greater certainty earlier in the process*
> - *be a significant driver of its own review outcome*
> - *gain a reputational advantage.*
>
> *As a result DNOs may reveal information that would not be available otherwise that assists with the assessment of other companies.*

As part of its initial assessment of business plans, Ofgem scores various aspects of them based on a traffic light system to help identify which businesses to fast-track and what issues to focus on for its assessment process. Each business is assessed against the following criteria:[15]

- **Process:** Has the DNO followed a robust process, including stakeholder engagement?
- **Outputs:** Does the plan deliver the required outputs?
- **Resources (efficient expenditure):** Are the costs of delivering the outputs efficient?

[14] Ofgem, RIIO-ED1 Strategy Decision, p 32.

[15] See the Strategy Decision for more details on each criterion.

- **Resources (efficient financing):** Are the proposed financing arrangements efficient?
- **Uncertainty and risk:** How well does the plan deal with uncertainty and risk?

For RIIO-ED1, the only businesses fast-tracked were the 4 DNOs owned by Western Power Distribution (WPD). All aspects of WPD's determination were finalised 10 months before other businesses.

Financial incentives under RIIO-ED1

In addition to the process and reputation benefits of being fast-tracked, RIIO-ED1 contained powerful financial incentives for all businesses to submit well-justified business plans through the information quality incentive (IQI).

In its final decision on the slow-tracked businesses for RIIO-ED1, Ofgem explains:[16]

> *We use the IQI to encourage slow-track DNOs to create business plans that reflect the best available information about their future efficient expenditure requirements. The IQI provides additional financial motivation for companies to spend the time and resources to produce high-quality and well-justified business plans. It also deters DNOs from submitting inflated expenditure forecasts.*
>
> *The IQI has three core elements:*
>
> - *DNOs receive an up-front financial reward or penalty depending on their forecast relative to our assessment of efficient expenditure.*
> - *DNOs that submit better forecasts (i.e. closer to our view of efficient cost) receive a higher efficiency incentive rate (sharing factor).*
> - *Allowed expenditure is based 75% on our benchmark view and 25% on the DNOs' forecasts (called interpolation).*

In contrast, the AER's approach to each of these elements is as follows:

- There is no explicit financial incentive based on how the DNSP's regulatory proposal compares to the AER's assessment of efficient expenditure.
- The sharing factor under the AER's CESS and EBSS is fixed for all DNSPs. It is fixed at 70:30 for the CESS and approximately[17] 70:30 for the EBSS.
- If the AER does not accept the aspects of the DNSP's forecast of expenditure, the allowed expenditure for those aspects can be entirely based on the AER's assessment of efficient expenditure.

WPD also obtained additional financial incentives from being fast-tracked, including the maximum possible sharing factor under the IQI and an ex-ante reward of 2.5% of total expenditure (totex) in lieu of the up-front reward element of the IQI.

Lessons from RIIO-ED1 and changes for RIIO-ED2

Ofgem undertook a review of the RIIO model part-way thought RIIO-ED1, including commissioning an independent report into its effectiveness by CEPA. CEPA found that RIIO 'has succeeded at incentivising network companies to better deliver outputs for customers', but that several implementation

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16 Ofgem, *RIIO-ED1, Final determinations for the slow-track electricity distribution companies, overview,* November 2014, p 37.

17 We note this is only approximately because the EBSS sharing outcome will vary depending on the discount rate. A 70:30 sharing factor would be achieved where the discount rate was 6%.

issues had 'resulted in added returns for network companies' and that networks' 'overall risk profile is likely to have been lower than would justify the available returns'.[18]

CEPA concluded that the fast-track incentive resulted in an increase in WPD's allowed revenues of £678 million, but that the resulting incentives for better proposals by all DNOs are likely to have resulted in a net benefit to customers across RIIO-ED1.[19] CEPA recommended changes to the proportionate assessment and fast-tracking process and the IQI.

Some other stakeholders' analysis of the effectiveness of the fast-tracking process and associated incentives for well-justified business plans was less positive than CEPA's. For example, NERA has expressed the view that, although RIIO was successful in incentivising companies to develop more comprehensive business plans that demonstrate a greater level of engagement with users, the costs of doing so were very high:[20]

> *Agreeing to plans in full has led to increased bills for consumers of the fast-tracked company, relative to the outcome where the company was subject to the slow-track process. For example, Ofgem's own analysis shows that WPD's allowances are around £600 million higher relative to the allowance it would have received if it had not been fast-tracked or around 10% of its total expenditure (totex). By contrast, the benefits of fast-tracking are less tangible, and stem from a general improvement in companies' business plans. Higher quality business plans ought to bring benefits through companies tailoring their proposed outputs to better meet customers 'needs, greater use of innovation, etc.*
>
> *In addition to uncertainty over whether the costs of fast tracking justify the benefits, another downside is the subjectivity of the fast-tracking process. In particular, success in the fast-tracking competition involves performing well under inexact benchmarking techniques that may favour the same set of companies over time.*

NERA and other consultancies have published analysis that indicates that, with hindsight, Ofgem fast-tracked the wrong businesses, primarily due to making its fast-tracking decision too early in the process with limited information. NERA states:

> *Ofgem's own analysis shows that WPD is no longer the most efficient company (and indeed relatively poorly ranked) using the more developed slow-track models.*

In its Framework Decision for RIIO-ED2, Ofgem made several key changes to its approach, including:[21]

- removing the fast-tracking process
- setting incentive rates via a new 'confidence-dependent incentive rate' approach (CDIR) rather than the IQI
- introducing a new Business Plan Incentive (BPI) instead of the IQI to incentivise high-quality business plans.

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18 CEPA, *Review of the RIIO framework and RIIO-1 performance, final report,* March 2018, pp 2-7.

19 CEPA, Review of RIIO, p 64.

20 NERA, *Energy Regulation Insights: Reflections on the successes of RIIO and the scope for future improvement,* January 2016.

21 Ofgem, *RIIO-ED2 Framework Decision, December 2019*, p 37

The purpose of the new BPI is 'to drive benefits for consumers by rewarding companies for plans that offer consumers additional benefits and value for money'.[22] The BPI is proposed to involve a 4 stage process:[23]

- **Stage 1: Minimum requirements |** Ofgem assesses whether business plans meet its stated minimum requirements, including providing appropriate evidence and demonstrating enhanced consumer engagement. A penalty of 0.5% of totex applies for business plans that do not meet these requirements.
- **Stage 2: Customer value proposition (CVP) reward |** Ofgem assesses what additional value the business plan offers 'beyond the functions typically undertaken by an energy network company as business as usual' and provides rewards based on the CVP.
- **Stage 3: Incentive for ambitious costs proposals |** Incentive payments are made under the new CDIR for cost proposals that are judged to be ambitious against an independent benchmark.
- **Stage 4: Penalty for poorly justified costs proposals |** A penalty of up to 10% applies to poorly-justified costs.

Issues to consider before applying these approaches in Australia

In our view, a lesson from the RIIO-ED1 process is that fast-tracking processes and financial incentives for the 'best' proposals are likely to involve greater risks of poor outcomes if they are applied when the regulatory regime or the regulator's approach to assessment of expenditure are undergoing material change. Applying these types of incentives is likely to be more appropriate when the regime and the regulator's assessment tools are well-established so that the regulator and other stakeholders can be confident that the proposals that are fast-tracked and receive financial incentives are indeed the proposals that best promote the long term interests of customers. That would reduce the risk of material changes in the regulator's assessment between the decision to fast-track some proposals and its final decision on the slow-track proposals.

It is also important to note that the regulatory periods for all DNOs in Great Britain are aligned and Ofgem makes its determinations for all DNOs at the same time (subject to the ability to fast-track businesses). This gives Ofgem greater ability to compare and benchmark businesses and to create incentives for network businesses to compete with each other for incentives or reputational benefits.[24] It may also mean that Ofgem has an increased incentive to develop methods that allow it to undertake more focussed and proportionate review processes given that it has to review 14 DNOs at the same time.

Ofgem's fast-tracking process may be more difficult to apply in Australia, given that regulatory periods are not aligned and the AER is unable to compare all DNSPs' proposals at the same time and have them all compete for incentives. However, there would still be scope for a 'proportionate assessment' process, potentially including some type of less formal fast-tracking processes, noting that the AER undertakes determinations for up to six DNSPs at the same time.

As discussed in Appendix E, there are also considerable constraints under the current NEL/NER framework on the AER' ability to provide financial incentives for well-justified proposals.

22 Ofgem, *RIIO-ED2 Draft Business Plan Guidance*, August 2020, p 51.

23 Ofgem, RIIO-ED2 Draft Business Plan Guidance, pp 51-57.

24 A key rationale for fast-tracking is that it incentivises all business to provide better proposals in the hope they will be fast-tracked, with the costs of any rewards to fast-tracked businesses being offset by lower cost proposals from all businesses. This is likely to result in lower network costs for all customers in the longer term. However, we note that one problem of this approach is it could create short-term subsidies between customers in different network areas, with customers of the fast-tracked business paying higher network charges to incentivise better proposals and reduced network costs for customers in other network areas.

A.3 THE ROLE OF CONSUMER ENGAGEMENT

Ofgem's approach to stakeholder engagement in RIIO-ED1

Consumer engagement requirements are part of the broader business plan requirements and fast-tracking incentives established through RIIO described above and are not given any particular emphasis over other features.

CEPA's review of RIIO found that 'the "enhanced engagement" model in RIIO-1 has been a positive step. There is evidence that network companies are learning by doing: stakeholder engagement in both developing the RIIO-ED1 business plans and on an ongoing basis has been notably more effective than in RIIO-T1 and GD1.'[25] CEPA recommended: [26]

> *In order to make more effective use of 'enhanced engagement', Ofgem should specify the areas of the price control where stakeholders are best placed to shape the settlement, and the forms of engagement that would be most effective. More can also be done to define what 'good' looks like for engagement during price control reviews.*

Ofgem's stakeholder engagement guidance for RIIO-ED2

It is useful to consider the most recent Ofgem guidance on enhanced stakeholder engagement it expects to be undertaken for RIIO-ED2 (released in April 2021).[27] This guidance is summarised in Box 1 followed by a discussion of how this compares to current AER consultation processes, including the NewReg model.

Box 1: Enhanced Stakeholder Engagement Guidance for RIIO-ED2

- Ofgem's stakeholder engagement guidance aims to 'strengthen the voice of consumers both in setting the price control and in the day to day operation of the network companies'.
- Ofgem considered that a strong emphasis on stakeholder engagement in RIIO-ED1 led to an improvement in the range of stakeholders involved in the process and the quality of engagement.
- Further enhancement is required however due to the scale and pace of change taking place across the energy system – for example the growth in electric vehicles, electrification of heating and rooftop solar. This is expected to bring about new business models which will require much deeper engagement than previously.
- Stakeholder engagement is broader than just consumers and includes 'individuals, companies, organisations or communities that are impacted directly and indirectly by the activities of the network companies'. It also includes existing and future consumers.
- For RIIO-ED2, DNOs are required to establish Customer Engagement Groups (CEGs) and Ofgem sets up a Challenge Group (CG). These Groups will provide challenge on whether the company's business plan addresses the needs and preferences of consumers.

[25] CEPA, Review of the RIIO framework, p 4.

[26] CEPA, Review of the RIIO framework, pp 6-7.

[27] Ofgem, *Enhanced Stakeholder Engagement Guidance for RIIO-ED2 - Version 2*, 30 April 2021.

Customer Engagement Groups

- DNOs remain responsible for the engagement approach. Ofgem does not prescribe which stakeholders a company should engage with, nor the format or frequency used for engagement.
- However, DNOs are required to adopt the following 'CEG procedural requirements':
  - appoint an CEG independent chair (which must not represent any particular organisation or groups of stakeholders)
  - ensure the CEG is appropriately resourced (e.g. by providing the necessary secretariat support, training/induction for CEG members)
  - ensure the CEG has access to relevant data including information on past performance, totex forecasts and out-turn performance and reasons for the variation
  - provide the CEG with access to comparative data from other network companies and other background data to inform the CEG's decision making
  - ensure timely access to staff to enable the CEG to perform their role. The company's Board will be expected to be fully engaged with the CEG and this should be reflected in the governance arrangements
  - ensure business plans are available to the CEG with a reasonable amount of time for the CEG to review and comment on.
- The role of the CEGs includes:
  - identifying key concerns of all stakeholders and determine how well these have been accommodated in the company's business plan
  - providing scrutiny of individual company business plans through monitoring development of these plans
  - indirectly driving culture change towards stronger and more effective stakeholder engagement within the companies through continued interrogation of company's approaches and assumptions
  - influencing company decisions earlier in the process of business plan development.
- The focus of the CEGs is to challenge the company on:
  - the company's overall priorities and approach (e.g. at a strategic level does the company understand the range of changes happening within and to the energy system that could impact its activities)
  - proposed outputs and associated expenditure budgets (including level of cost efficiency improvements)
  - the quality of stakeholder engagement the company has undertaken to inform its proposals
  - the company's approach to innovation
  - the range of scenarios the company has considered to anticipate future network requirements and the company's approach to managing uncertainty and risks
  - what alternatives to the investment proposals has the company considered, including from parties offering alternative and non-network based solutions
  - any issues of particular relevance to a local region.

- Matters that are out of scope for the CEGs are specific financial topics, such as the cost of capital, treatment of debt or gearing. CEGs are however expected to develop views on the approach companies have taken in relation to key financial decision tools, such as cost benefit analyses.

Challenge Group

- An independently chaired RIIO-ED2 CG will assess the business plan proposals and provide a report to Ofgem on their findings.

Open hearings

- The enhanced engagement process will involve open hearings for Ofgem to hear submissions and evidence on various aspects of the business plans. 'These would … allow us to listen to arguments from the companies, the enhanced engagement Groups and from other interested stakeholders in favour of, or against company proposals. This will enable us to gain a better understanding of the issues in an open and transparent way.'

Comparison with current approaches adopted by Australian DNSPs

This section compares and contrasts the RIIO-ED2 stakeholder engagement model (including incentives), and the consumer engagement approach currently adopted by Australian DNSPs and the AER, including the NewReg model.

The CEG compared to the NewReg trial Customer Forum

- The CEG model (including its membership, role, procedures, focus and out-of-scope matters) are similar to the Customer Forum established for the AusNet NewReg trial.
- However, unlike the NewReg model there is no expectation or requirement of agreement being reached between the DNOs and the CEG on any components of the business plan.
- In contrast to the more structured NewReg trial process, it is open to the DNO to decide:
  - the format and frequency of engagement (provided the CEG procedural requirements are adopted); and
  - to what extent their final business plans reflect feedback received through stakeholder engagement (including whether it seeks to reach agreement on any aspect of the business plan).

Incentives

- Unlike the more flexible AER customer engagement arrangements, there is a mandated requirement on a DNO to establish a CEG according to mandated procedural requirements. As it is mandated, there is no need to rely on financial, reputational, or other incentives for a DNO to establish a consumer engagement entity which meets minimum procedural requirements.
- The extent to which the DNO reflects consumer preferences and other stakeholders' views in its business plan depends on how the DNO responds to the incentives included in the regulator's determination decision-making process – as described in section A.2 above.

Resourcing implications for the regulator

- The Ofgem stakeholder engagement model appears to be less demanding on the resources of the regulator compared to the NewReg model:
  - Most of the onus for resourcing is placed on the DNO.

- We are aware that the focus on reaching agreement in the NewReg model required considerable commitment of resources by the AER.
- The Open Hearings proposed for Ofgem to hear submissions and evidence from stakeholders on various aspects of the business plans may have benefits in promoting efficient use of the regulator's resources. The AER currently undertakes some open stakeholder forums as part of its determination process, e.g. a public forum following publication of its issues paper on the regulatory proposal.

Focus on stakeholder engagement

- The Ofgem guidelines refer to 'stakeholder engagement' which is a broader focus than just consumers.
  - This is in contrast to the AER's current reference to 'consumer engagement' in its guidelines[28] and recent network determinations including 'Table 7' of the recent Victorian draft determinations.
  - We understand this focus addresses the emergence of companies (e.g. DER service providers) interested in providing services that depend in some way on new types of services expected to be offered by network companies.
  - It also may reflect different specific regional issues that affect people in affected communities in ways that are different than their interest as consumers. Ofgem's statutory objectives are also broader than the AER's objectives under the NEO and extend to matters such as environmental issues and sustainable development.

Culture change

- The expectation of the CEGs 'indirectly driving culture change towards stronger and more effective stakeholder engagement within the companies' is similar to the positive outcome observed for culture change for the AusNet NewReg trial.

28 AER, *Better Regulation Consumer Engagement Guideline for Network Service Providers*, November 2013.

Appendix B WICS: Scottish Water

B.1.1 Introduction

WICS is the economic regulator of Scottish Water, which is the sole water network business in Scotland. WICS's approach to economic regulation is governed by high level requirements set out in legislation plus a Commissioning Letter that is issued by the Minister setting out the timetable, objectives and principles for each price review process.

Regulation of charges is based on a building block model that has many similarities to how the AER regulates DNSPs.

At the heart of WICS's approach to its 2015-2021 and 2021-2027 Strategic Reviews of Charges (SRC) for Scottish Water is a 'Customer Forum' that is discussed below.

Rather than WICS providing detailed guidance and financial incentives for well-justified proposals, WICS seeks to empower Scottish Water and its customers to reach agreement on prices and service levels. This is backed up by what WICS describes as a 'seek trust but expect verification' approach.

In contrast to Ofgem, the fact that WICS only regulates one water network also means that there is no scope for competition for incentives and fast-tracking based on a comparison of different networks' business plans.

B.1.2 The form and role of the customer forum

A Customer Forum for Water in Scotland was established in September 2011 as part of the process to determine the 2015-2021 SRC. Price setting for the 2021-27 period was finalised in late 2020, and we have not reviewed the most recent experience.

The Customer Forum's membership, role, procedures and focus had a significant influence on the design of the NewReg model and so are well understood by the AER. Its key features are summarised in Box 2.

Box 2: Customer Forum for Water in Scotland[29, 30]

Appointment of Customer Forum Members

- The Customer Forum for Water in Scotland was created under a cooperation agreement between WICS, Consumer Focus Scotland (CFS)[31] and Scottish Water.
- Finance was provided by WICS, while CFS provided administrative support. All parties agreed to support the work of the Forum.
- Customer Forum members were appointed jointly. They were appointed in a personal capacity and not as 'stakeholders' representing an organisation or a group of customers.

29 Energy Consumers Australia, *Negotiated Settlement and Consumer Engagement UK Experience and lessons for Australia, ECA Research Report No. 2*, 2016.

30 Customer Forum, *Legacy report: Lessons learned from customer involvement in the 2015-2021 Strategic Review of Charges*, February 2015.

31 Consumer Focus Scotland is an independent statutory entity established to champion consumer interests.

Role

- The Customer Forum's role was to:
  - work with Scottish Water on a program of quantitative and qualitative research to establish customers' priorities for service level improvement and expectations in terms of the level of charges;
  - understand and represent to the Commission and to Scottish Water the priorities and preferences of customers as a whole in the SRC 2015-2021 process as identified through the customer research; and
  - seek to secure, through its participation in that process, the most appropriate outcome for customers as a whole based on those priorities and preferences.
- Initially the agreement establishing the Customer Forum implied the work of the Forum would be just another input to WICS's determination process although at the working level there was an emphasis on trying to reach some kind of negotiated outcome with Scottish Water. This latter view was formalised in October 2012 when WICS asked the Forum to seek to reach agreement with Scottish Water on its business plan.
- WICS did not delegate its decision making powers to the Customer Forum but said it would be 'mindful to accept' an agreed plan.

Guidance

- Similar to the NewReg trial, WICS provided guidance notes to the parties indicating its expectations including a set of financial parameters within which it expected Sottish Water to stay. In addition, the Minister specified a range of matters including price structures through the Commissioning Letter.

Assessments of the success of the engagement approach for the 2015-2021 SRC

Outcomes

The process that was adopted has been widely regarded as successful. A 14-month process of engagement between the Customer Forum and Scottish Water was followed by a negotiation which resulted in the signing of a Minute of Agreement which outlined the modifications to the draft business plan that both parties agreed to, and several outstanding workstreams that Scottish Water committed to carry out. The Customer Forum worked to February 2015 to provide insight to Scottish Water into these various workstreams and to sign off progress.[32] There were material changes agreed to the draft business plan.

The Customer Forum's legacy report comments that:

> *Instead of a duel between the service provider and the regulator, which can sometimes turn into a cat and-mouse game, if not serious tension and dispute, the process amounted to a constructive challenge, whereby all energies were focused on finding acceptable compromises rather than debunking the other party's positions. This created the right*

[32] Customer Forum, Legacy report, p 5.

conditions for Scottish Water to willingly stretch itself and make the best possible offer of prices and service.

Incentives

Sottish Water voluntarily agreed with WICS to participate in the process. There were no financial incentives or mandated requirements imposed by WICS.

It appears that Scottish Water's incentives for agreeing to enter into this process and working to reach agreement were mainly reputational. Scottish Water's strategic goal going into the process was 'being Scotland's most valued and trusted business, one we can all be proud of.' Duncan Millican, CEO of Scottish Water, was 'perceived to be keen to change the culture of his organisation in support of this goal'.[33]

In our view it is possible that ownership also played a role. Scottish Water is publicly owned and Scottish Water's goal of increasing public trust was likely supported by the Scottish government.

The regulator's rationale for change

From WICS's perspective there was a view that the approaches it had used in the previous periods would find their limits since Scottish Water had all but closed the gap with similar companies in England (making meaningful benchmarking harder to obtain) and potential efficiency gains are dwindling.[34] A different approach was therefore needed to push Scottish Water to find new sources of efficiency that would benefit customers.

Insights for the AER

The Scottish Water customer engagement model was closely reflected in the design of the NewReg model and its benefits and challenges in the context of Australian energy network regulation are well understood by the AER.

There would be some value in the AER and regulated businesses continuing to monitor the Scottish Water model, in particular the experience from the strong cultural and strategic focus of Scottish Water on its customers, as well as detailed insights about agreements reached between Scottish Water and the Customer Forum.

33 ECA, Research Report No. 2, p 9.

34 Customer Forum, Legacy report, p 6.

Appendix C Commerce Commission: NZ electricity lines businesses

C.1 INTRODUCTION

The Commerce Commission is the economic regulator of electricity and gas distribution and transmission businesses in New Zealand. The Commission regulates 17 electricity lines businesses[35] under a form of 'price-quality path' regulation.

Regulation of the 'price' aspect of the price-quality path is based on a building block model that has many similarities to how the AER regulates DNSPs. However, a key difference under the New Zealand model is that rather than making a separate determination for each DNSP with DNSPs' having different regulatory periods as is the case in Australia, the Commission:

- initially regulates all 17 lines businesses under a single five-year 'default price-quality path' (DPP); and
- individual lines businesses can apply for a 'customised price-quality' (CPP) path to apply instead of the DPP in certain circumstances.

Under a DPP, the Commission sets for each lines business:

- the maximum prices/revenues that are allowed at the start of the regulatory period
- the annual rate at which the businesses' maximum allowed prices can increase (in the form of CPI-X)
- the minimum service quality standards that must be met.

The default and customised price-quality path approach can be thought of as an alternative approach to an Ofgem-style 'proportionate assessment' model as it allows a large number of businesses to be regulated in a relatively low cost way. A key reason why the government introduced this model was to reduce the resources required by the Commission and avoid the need for it to undertake 17 separate electricity distribution determination processes (in addition to its electricity transmission and gas determinations).

The Commission is currently in its fourth round of DPPs, with the current DPP applying for the 2020-2025 period.

DPPs do not involve the lines business making a regulatory proposal in the same way as Australian DNSPs and they have traditionally involved limited consumer engagement. We therefore focus on the requirements for CPP, which are more similar to DNSPs' regulatory proposals in Australia.

A CPP is usually only used where the business can demonstrate that there are special circumstances requiring it to invest more in its network than provided for under the default price-quality path or it has been affected by an event outside its control. To date, the Commission has only made price-quality path decisions for 3 lines businesses. The Commission is currently assessing a price-quality path application for Aurora Energy, which we use as an example below.

The Commission regulates lines businesses in accordance with the requirements of Part 4 of the Commerce Act, which is not specific to the energy sector and can apply to any goods or services where regulation is imposed in accordance with the Act.[36] The Act provides relatively high-level content and process requirements for the default and customised price-quality path processes.

35 The New Zealand term for DNSPs.

36 Part 4 currently applies to electricity networks, gas networks and three international airports.

The Act requires the Commission to develop Input Methodologies (IMs) addressing certain aspects of how it will regulate particular goods and services. The Act states that the purpose of IMs is to 'promote certainty for suppliers and consumers in relation to the rules, requirements, and processes applying to the regulation, or proposed regulation, of goods or services under this Part'.[37]

The electricity distribution IMs cover most of the matters that in Australia are governed by a combination of the NER, the Rate of Return Instrument and the AER's guidelines, schemes and models. The requirements for CPP proposals are set out in the IMs.

C.1.1 The role of the independent verifier

A unique feature of the New Zealand CPP model is the requirement for an independent verifier. All CPP proposals must be verified by an independent verifier in accordance with the requirements of the IMs. This requirement plays a key role in incentivising well-justified and efficient CPP proposals and enabling a proportionate and targeted review by the Commission.

The independence requirements, required qualifications, and appointment process for the verifier are set out in a schedule to the IMs. The verifier must be approved by the Commission and enter into a deed with the Commission regarding its appointment and duties to the Commission.

The verifier's role is governed by a detailed terms of reference set out in a schedule to the IMs. Key provisions that explain the role are set out in Box 3.

Box 3: Key IM provisions relating to the verifier's role

'The verifier's role, purpose and obligations include:

(a) engaging with the CPP applicant in an independent manner in accordance with this Terms of Reference;

(b) assessing the extent to which the CPP applicant's policies allow the CPP applicant to meet the expenditure objective;

(c) assessing the extent to which the CPP applicant's policies have been implemented;

(d) prior to the Commission's assessment of the CPP proposal, assessing whether the CPP applicant has provided the verifier with the information specified in clause 5.5.2(3);

(e) prior to the Commission's assessment of the CPP proposal, providing an opinion to the CPP applicant on whether the CPP applicant's capex forecasts, opex forecasts and key assumptions meet the expenditure objective;

(f) prior to the Commission's assessment of the CPP proposal, assessing the extent to which the CPP applicant is able to deliver its capex forecast and opex forecast during the CPP regulatory period;

(g) prior to the Commission's assessment of the CPP proposal, providing an opinion on the extent and effectiveness of the CPP applicant's consultation with its consumers; and

(h) providing a list of the key issues which it considers the Commission should focus on when assessing the CPP proposal.'

[37] *Commerce Act 1986* (NZ), section 52R.

'Based on its assessment, the verifier must, in the verification report:

(a) provide a list of the key issues that it considers the Commission should focus on when undertaking its own assessment of the information to which the assessment related;

(b) specify information identified in the CPP proposal that, were it to be provided, would assist the Commission's assessment of the CPP proposal; and

(c) identify any other information it reasonably believes would:

 (i) be held by the CPP applicant; and

 (ii) assist the Commission's assessment of the CPP proposal.'

In June 2020, Aurora Energy lodged a CPP application for the 2021-2024 period. The CPP application proposed a significant increase in expenditure compared with the default price-quality path. Aurora stated that this investment was needed to address historical under-investment that has resulted in a gradual deterioration of its equipment, a higher number of safety incidents and an increasing number of unplanned outages.

Farrierswier acted as verifier of Aurora's CPP proposal, with technical input from GHD. Farrierswier prepared an extensive verification report (140 pages plus 400 pages of appendices) covering the matters required by the IMs.[38]

The verification report enabled the Commission to focus its review on a narrower set of issues, as explained by the Commission in its issues paper at the start of its review process:[39]

We have critically reviewed the expert's report by Farrier Swier. We are satisfied by the rigour of their analysis and consider their review to be thorough and undertaken to a high standard. As a result, we are proposing to accept their opinion at a high level and do not intend to duplicate their analysis. In summary, they found that for the three year proposed investment period 64% of Aurora's capital expenditure and 89% of its operating expenditure meets our expenditure objective. The expert's sample review covered 66% of Aurora's capital expenditure plans as they are limited to reviewing up to 20 projects and Aurora had many more projects than previous applications. We are seeking expert external advice on the projects not reviewed to ensure the spending is efficient. The expert came to a similar conclusion when examining the proposed expenditure over the alternative five year investment period. As a result, we intend to target our review primarily on the areas of Aurora's proposal that Farrier Swier suggested we scrutinise further, along with issues that were not identified by them, either because they were out of scope of their process or because we seek further assurance.

The verification process also increases the incentives for the lines business to develop a realistic and well-reasoned proposal, as it knows its proposal will be subject to extensive independent scrutiny before it is submitted. The fact that the verification process occurs before the CPP is submitted also creates an incentive for the business to refine its final proposal to address any material issues that are identified by the verifier.

38 Farrierswier, *Verification report: Aurora Energy CPP Application*, June 2020, pp 6-7.

39 Commerce Commission, *Have your say on Aurora Energy's investment plan: Consumer Summary key issues paper*, June 2020, p 3.

For example, in its issues paper for the Aurora CPP, the Commission stated:

> *As a result of feedback from its customers and Farrier Swier, Aurora's final proposal has been narrowed to primarily focus on safety. Growth-related projects have been deferred due to COVID-19 and the total expenditure Aurora is seeking has been reduced by around $20 million. This has had the effect of reducing proposed price increases for Aurora's customers, though increases to lines charges from April 2021 are still significant.*

A CPP application must also include a report by an auditor that covers the financial and quantitative historical and forecast information contained in the CPP proposal. Two directors of the CPP applicant must also provide a certification that complies with the requirements of the Input Methodologies.

Potential insights for the AER

The Commerce Commission's experience demonstrates that an independent verifier process can be useful as part of a regulator's toolkit to incentivise well-justified proposals that are 'capable of acceptance' and to enable the regulator to undertake a more targeted and proportionate review process.

The AER currently imposes certification requirements that are similar to those required by the Commerce Commission, but there is no equivalent independent verifier process.

There are likely to be limitations on the AER's ability to impose an independent verifier requirement under the NER without a rule change.

There is also likely to be a regulatory philosophy question for regulators about whether the most useful approach is to:

- implement mechanisms like this that aim to give the regulator greater assurance as to the accuracy of the business' cost proposals and the regulator's reviews of those proposed costs; or
- focus instead on enhanced consumer engagement approaches like NewReg or the WICS approach for Scottish Water that put greater weight on consumer engagement rather than a detailed bottom-up analysis of costs.

However, there would be scope for the AER to adapt aspects of the verifier approach to help it undertake a proportionate and targeted review. In particular, there may be value in a body such as the CPP (or potentially a consumer body established and resourced by the network business) preparing a report that is submitted to the AER at the same time as the business's regulatory proposal. Such as report could set out the body's views on the effectiveness of the business's engagement on the development of the proposal, its initial views on how well justified the proposal is and any key issues it considers the AER should focus on in its review process.

C.1.2 The role of consumer engagement

The Input Methodologies set out the consumer engagement obligations that a business must meet as part of preparing a CPP proposal.

Box 4 summarises these requirements. The requirements are only of a procedural nature and do not address the substantive nature of consumer engagement expected, e.g. the nature, breadth or depth of the engagement.

Box 4: Consumer consultation for CPP proposal

Consumer consultation obligations on the lines business intending to propose a CPP set out in the Input Methodologies are as follows:

- **Consumer consultation processes:**[40] Includes notification requirements (e.g. customers must be notified of the intention to develop a CPP no later than 40 working days prior to submission of the CPP proposal); information on the expected effect on the revenue and quality of its electricity distribution services if the proposal were accepted; what price versus quality trade-offs are made in the expenditure alternatives considered in the intended CPP proposal; whether quality standards are to be varied; where and how further information in respect of the intended CPP proposal may be obtained; the process for making submissions on the proposal; and how information is to be provided.
- **Evidence of consumer consultation to be provided:**[41] Includes evidence that the required process was followed (see above); which parties were consulted; a description of all issues raised by consumers on the draft CPP proposal; a summary of the arguments raised in respect of each issue; and whether and how the CPP proposal accommodates those arguments.

The verifier must provide an opinion on the extent and effectiveness of the CPP applicant's consultation with its consumers and provide a list of the key issues which it considers the Commission should focus on when assessing the CPP proposal.[42]

Potential insights for the AER

There appear to be strong incentives for lines companies to undertake high quality consumer engagement in developing their CPP applications due to the New Zealand regulatory context, which is significantly different to Australia in several key ways.

- The Act only provides relatively high-level content and process requirements for the CPP process meaning the Commission has a high level of discretion in how it assesses a CPP application. A lines company therefore knows that it must provide a high quality proposal to have a good chance of the Commission accepting it.
- CPPs are the exception rather than the norm. As a result, lines businesses know they need strong evidence and consumer support to justify a CPP proposal.
- As a result, CPP proposals are higher profile events than most Australian DNSPs' proposals because they are unusual and likely to involve significant proposed price increases above the default price path. This means the lines companies know the local community and consumers will be well aware of the intention to make a CPP proposal and are likely be engaged with it; and the Commission can, and is likely to, devote considerable resources to closely reviewing the CPP application.

The Commission has provided very little guidance as to what it expects for consumer engagement. We are aware that for two of the CPP proposals (Powerco and Aurora Energy) the businesses looked to Australian practice to guide the design of consumer engagement process. For the Aurora Energy CPP proposal, farrierswier as the verifier found that much of its customer consultation was in line with best

40 Clause 5.5.1, *Electricity Distribution Services Input Methodologies Determination 2012*

41 Clause 5.1.2, *Electricity Distribution Services Input Methodologies Determination 2012*

42 Schedule G, clause G2(g), *Electricity Distribution Services Input Methodologies Determination 2012*

industry practice in New Zealand and other jurisdictions such as Australia.[43] As a result, these processes provide little in the way of new insights for the AER in terms of the nature of consumer engagement.

43 Farrierswier, *Verification report: Aurora Energy CPP Application*, June 2020, p 21.

Appendix D ESC: Victorian water businesses

D.1 INTRODUCTION

The ESC is the economic regulator for 19 Victorian water businesses, all of which are government-owned.

The ESC regulates Victorian water business under the *Essential Services Commission Act 2001* (Vic) and the *Water Industry Act 1994* (Vic). The Water Industry Regulatory Order 2014 (WIRO) prescribes the water services that are subject to economic regulation, specifies the objectives for regulation and sets out high-level process requirements for the ESC's price determinations.

In 2016, the ESC worked closely with stakeholders to develop and implement a new regulatory model known as PREMO: Performance, Risk, Engagement, Management and Outcomes. Prior to PREMO, the ESC regulated Victorian water businesses using a building block incentive-based model that is similar to how the AER regulates DNSPs.

The development of PREMO was preceded by the Victorian Government engaging Professor Graeme Samuel to conduct a 2014 independent review of regulation, governance and efficiency in the Victorian water sector. Three key themes emerged from the review that influenced the regulatory changes implemented by the government and the ESC's thinking that led to the development of PREMO:

- government needed a more 'active' approach to managing the performance of its water businesses
- the WIRO as then in force unnecessarily limited regulatory flexibility
- there was an opportunity for a more flexible assessment approach by the ESC.

The Victorian Government amended the WIRO in 2014, which in turn gave the ESC the flexibility to undertake a far-reaching review of economic regulation for the water sector in 2015 and 2016.

The ESC developed its new pricing approach with four high level objectives:

- to pivot water businesses' attention squarely towards their customers
- to provide greater autonomy for water businesses, in consultation with customers, to decide on the services to be delivered and the prices to be paid, and the risk to assume on behalf of customers
- to provide new incentives for water businesses to demonstrate ambition in the delivery of services and outcomes that matter most to customers, and to deliver these as efficiently as possible
- to avoid focusing on matters that make little difference to the outcomes experienced by customers by choosing simplicity whenever possible.

Under the PREMO approach, water businesses' revenue requirements are still derived using the building block method, as under the previous pricing approach. However, the key changes under PREMO are:

1. a stronger emphasis on the role of customer engagement to inform and influence water businesses' price submissions

2. a set of outcomes focused on what each water business will deliver to its customers effectively replaces the previous core service standards under the ESC's Customer Service Code

3. a water business' return on regulated equity is linked to the outcomes it delivers to customers though:

- the return on equity varying according to the level of ambition shown in a price submission
- a price submission being rated as 'leading', 'advanced', 'standard' or 'basic', and being assessed against the five PREMO elements of Performance, Risk, Engagement, Management and Outcomes

4. water businesses are incentivised to submit price submissions that reflect their 'best offers'
5. a more flexible assessment approach tailoring the scope of the ESC's assessment to the quality of a price submission, with potential 'fast-tracking' of high-quality submissions through the assessment process to an early draft and final decision
6. a requirement for water business boards to attest to the quality and accuracy of the information included in price submissions, and the submissions' compliance with the ESC's guidance.

Items 1, 3, 4 and 5 above are most relevant to the scope of our report and we discuss each of these features in more detail below.

The ESC made determinations under its PREMO framework for 16 water businesses in its 2018 price review. The price review period for all of these businesses was 2018-2023, except for one business that had a longer period (2018-2026) and one that had a shorter period (2018-2020).[44]

The WIRO requires the ESC to provide guidance to the water industry on various aspects of how it will undertake its price determinations, which the ESC set out in its Water Pricing Framework and Approach document for its 2018 price determinations.

D.1.1 Incentives for ambitious price submissions that reflect 'best offers'

The PREMO model contains three measures that are designed to incentivise water businesses to submit 'price submissions'[45] that are ambitious, accurate and deliver tangible outcomes for customers:

- a revised approach to setting the return on equity
- incentives to submit 'best offers'
- a new 'flexible assessment approach' by the ESC.

Return on equity

Under PREMO, a single regulated weighted average cost of capital no longer applies to every water business. Instead, PREMO links a water business' return on equity to the outcomes it delivers to customers.

This was achieved by allowing the return on equity to vary according to the level of ambition shown in a price submission. Ambition is assessed against each of the five PREMO elements:[46]

- **Performance:** Have the performance outcomes to which the business committed in its price submission been met or exceeded?
- **Risk:** Has the business sought to allocate risk to the party best positioned to manage that risk?

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44 Three businesses were not subject to PREMO in the 2018 price review: Melbourne Water (which had its prices reviewed in 2016 for the 2016-2021 period), Western Water (which was excluded from the PREMO framework for the 2018 review but the ESC applied PREMO to its 2020 price review for Western Water's 2020-2023 regulatory period) and Goulburn-Murray Water (which is partly regulated under different legislation including the Commonwealth government's Water Charge (Infrastructure) Rules).

45 'Price submissions' are the equivalent of regulatory proposals for DNSPs.

46 ESC, *Water Pricing Framework and Approach, final paper*, October 2016, p 10.

- **Engagement:** How effective was the business' customer engagement?
- **Management:** Is there a strong focus on efficiency? Are controllable costs increasing, staying the same, or decreasing?
- **Outcomes:** Do proposed service outcomes represent an improvement, the status quo, or a withdrawal of service standards?

Prior to each round of price reviews under the new framework, the ESC's guidance to water businesses will set out an assessment methodology to inform the rating of a price submission by a water business and the ESC as 'Leading', 'Advanced', 'Standard' or 'Basic':[47]

- A Basic submission reflects stagnating or declining performance for customers in terms of service outcomes, operating efficiencies or both. The return on equity for Basic price submissions will be set at a level commensurate with the benchmark real cost of debt.
- A Standard price submission will reflect a good value proposition for customers, although it would generally reflect proposals representing a continuation of current outcomes and targets for cost efficiency. The allowed return on equity would be largely unchanged from under the previous framework.
- Advanced or Leading price submissions will demonstrate better value for customers than the commitments given in a Standard submission. Generally, they will commit to improved outcomes for customers in terms of services, prices, or both. Leading price submissions will demonstrate that the business' proposals place it as a sector leader on key aspects of performance.

In its 2018 price review, the ESC rated only 1 business as Leading, 9 as Advanced, 5 as Standard and 1 as Basic.

Best offers

PREMO encouraged water businesses to submit price submissions that reflect their 'best offers' by providing incentives for businesses to assess their price submissions accurately and honestly. This mechanism is linked to the new approach to setting the return on equity discussed above.

Each business is required to self-assess the level of ambition of its price submission, with the self-assessments provided in the business' price submission. The ESC then conducts its own independent assessment.

The best outcomes for a water business in terms of the return on equity are achieved when the ESC and the business align in their respective assessments. Water businesses were incentivised not to overstate their level of ambition. If the Commission found that a water business had overstated its ambition, then the return on equity was lower than if the water business had accurately assessed itself.

This model is illustrated in Figure D.1 below from the ESC using an indicative regulated return on equity.[48]

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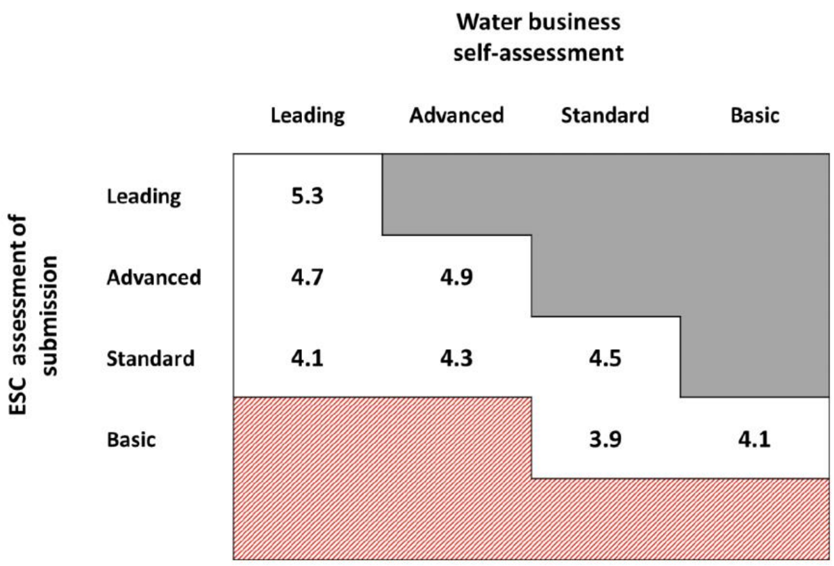
47 ESC Water Pricing Framework and Approach, pp 10-11.

48 ESC Water Pricing Framework and Approach, p 13.

Figure D.1: Incentives for best offers and impact on regulated return on equity



Flexible assessment approach

The ESC introduced a new flexible assessment approach which:

- tailors the scope of the ESC's assessment to the quality of each price submission, which may include resubmission when businesses provide insufficient information
- 'fast-tracks' high quality price submissions through the assessment process to an early draft and final decision
- provides financial and reputational incentives linked to the ambition of a price submission through its overall PREMO rating as discussed above.

The opportunity for a price submission to be fast-tracked was not directly linked to its PREMO rating. Instead, it was linked to the quality and clarity of the submission, its proposals, and the supporting information, which in turn enabled the ESC to complete its verification and assessment in a short timeframe. The ESC did not provide a check-list set of criteria for a business to qualify for fast-tracking.

The ESC fast-tracked 4 businesses' price submissions. Box 5 provides an example of how the fast-tracking process operated.

Box 5: Example of fast-tracking process for South East Water

- The ESC released an early draft decision (in December 2017, rather than the scheduled time of March 2018) to provide an opportunity for it to test its preliminary views with stakeholders before making a final decision around June 2018.
- The ESC explained the rationale for releasing the early decision. For South East Water, the ESC stated that the price submission:

  > *provided clear and comprehensive information supporting its proposals and … also provided evidence that its engagement captured the main priorities and concerns of customers and [had] taken this feedback into account. This enabled us to quickly assess South East Water's price submission against the legal framework that governs our role.*

- The ESC's draft decision was to accept South East Water's proposal. Although the ESC indicated it would seek further information to inform its final decision, it considered the additional information did not involve matters that materially impact customer prices or outcomes.
- The ESC then considered submissions on its draft decision and held a public meeting with stakeholders.
- The ESC then made a final decision for South East Water and retained the ability to change its position between its draft and final decisions. In its final decision:
  - where a particular aspect of a final decision was unchanged from a draft decision, it did not detail the supporting reasons
  - where it reached a different decision to that proposed in the draft decision, or where new information required its consideration, it set out its reasons in full in the final decision
  - the final decision therefore had to be read in conjunction with the draft decision.

2019 post-implementation review of PREMO

In late 2018, the ESC engaged farrierswier to conduct an independent post implementation review of PREMO, including an early assessment of how well PREMO delivered on its intended outcomes.[49]

Our review involved a desktop review of documents; an online survey of water businesses; interviews with a selected sample of water businesses, customer and government representatives; and analysis of data provided by the ESC. Our review had a number of limitations, including that it occurred only six months after the relevant PREMO decisions.

We concluded that there is strong evidence that the design of PREMO contributed significantly to the overall objective of economic regulation of water businesses, being to promote the best long-term outcomes for Victorian water customers.

Other key findings of our assessment were:

- There is clear evidence that the PREMO approach provided incentives for the water businesses to have greater ambition. There was significant divergence in business ambition and strategies – some water businesses did 'break from the pack' as intended by the ESC.
- There is clear evidence that PREMO was successful in giving stronger emphasis to customer engagement for most water businesses.
- There is some evidence supporting the proposition that PREMO provides greater autonomy to water businesses, and that this can produce better outcomes, but a mixed picture on whether the benefits of autonomy were achieved across all water businesses.
- There is mixed evidence on the extent to which the objective of greater focus and simplicity in the price review process was achieved.

Our assessment of the impact of PREMO on the water businesses' approach to planning and developing their 2018 price submissions was:

- There is reasonably clear evidence that the design of the PREMO incentive mechanism encouraged the businesses to put forward their best offers.

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[49] Farrierswier, *Victoria's water sector: The PREMO model for economic regulation*, March 2019.

- There are diverse views in the sector about the real incentives that drive water businesses. Reputational incentives are considered the most important.
- There is reasonably clear evidence supporting the value of the board attestation requirement.
- There are mixed views on the impact of the PREMO approach on water businesses' effort and resourcing requirements.

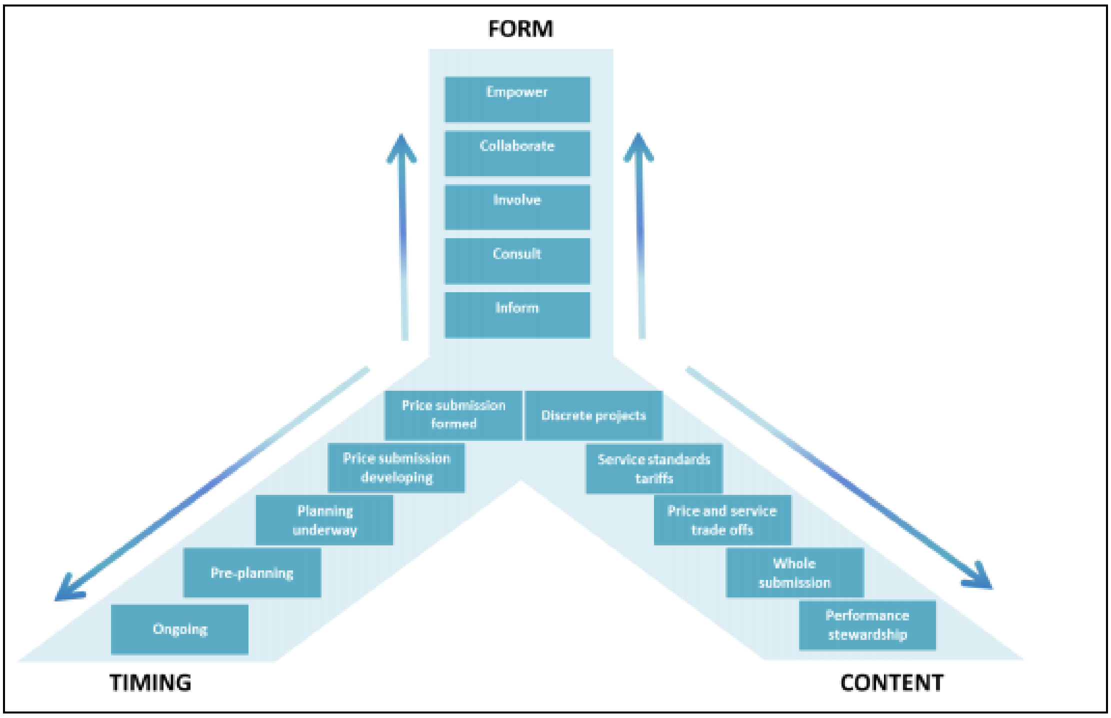
D.1.2 The role of consumer engagement

The key features of the ESC's approach on consumer engagement were to:

- strongly focus on the importance of customer engagement to shift industry practices significantly
- focus attention of boards and management on the rating of a water business' customer engagement approach as 'leading', 'advanced', 'standard' or 'basic'
- provide a financial, procedural and reputational incentive to aim for higher ratings
- not be prescriptive on how customer engagement was undertaken so as to provide scope for innovation.

Figure D.1 sets out the customer engagement 'tool' published by the ESC and Table D.1 sets out the guidance provided for ratings on consumer engagement.[50] The ESC worked closely with the businesses to assist them to interpret this guidance.

Figure D.1: ESC's PREMO customer engagement tool



50 KPMG, *Essential Services Commission PREMO Assessment Tool,* p 10.

Table D.1: ESC Guidance of rating consumer engagement

<table>
<tr><th>Guiding questions</th><th>1) Expectations of a standard submission</th><th>2) Additional requirements to 1) for an Ambitious rating</th><th>3) Additional requirements to 2) for a Leading rating</th><th>4) Risk of downgrade to Basic</th></tr>
<tr><td rowspan="5">Has the business detailed and justified alignment of its customer engagement process with the IAP2 Public Participation Spectrum?
Has the business demonstrated that it has engaged with a broad range of customers in developing its submission (Form)?
Has the business demonstrated that it has engaged with its customers about a range of issues relating to its submission (Content)?
Has the business explained how it decided when to engage with its customers (Timing)?
Has the business explained how its engagement with customers has influenced its submission?</td><td>The business demonstrates that engagement has occurred on matters that customers reveal are the most important to them.</td><td rowspan="5">The business is able to demonstrate that the engagement significantly extends beyond the expectations of a standard submission and reflects meaningful progression towards a longer term objective of meeting the requirements of leading rating.</td><td rowspan="5">The business is able to demonstrate that the engagement reaches all of the outer boundaries of the Commission's engagement tool by:
empowering customer participation;
being ongoing; and
conducts meaningful consultation with customers on price and service trade-offs and/or the entire submission.</td><td>Engagement has not occurred on matters that are important to customers or significant to the outcomes they receive and prices they are charged.</td></tr>
<tr><td>A business demonstrates that engagement was undertaken early, prior to locking in key strategies and priorities.</td><td>Engagement was undertaken late, after the business had developed its key strategies and priorities.</td></tr>
<tr><td>A business demonstrates that the business re-tested its position and proposals with customers as it developed its price submission.</td><td>The business has not retested its position and proposals with customers as it developed its price submission.</td></tr>
<tr><td>The form of customer engagement is justified as being fit for purpose given the content and circumstances facing the business and its customers.</td><td>The business has failed to demonstrate that its engagement program elicited information that it could use to shape the strategic direction and priorities in its price submission.</td></tr>
<tr><td>The business can demonstrate that the information provided to customers was appropriate given the purpose, form and content of customer engagement.</td><td>Information provided to customers was written in technical jargon, and/ or was not appropriate for customer use.</td></tr>
<tr><td></td><td>The price submission describes what was learned from customer engagement, and how this influenced its proposed outcomes, expenditure (composition and level) and prices.</td><td>The outcomes proposed reflect a significant improvement in customer value delivered, consistent with customer priorities.</td><td>The outcomes proposed reflect a step change improvement in customer value delivered, consistent with customer priorities.
The business proposes outcomes that lead the industry.</td><td>The price submission does not clearly link the outcomes of engagement to the outcomes proposed, and the alignment of outcomes to expenditure and prices.</td></tr>
</table>

In our view, the primary insight from the ESC's approach to customer engagement was that it decided to provide very strong impetus to 'shift the dial' on customer engagement in the Victorian water industry from past practice.

The approach forced boards and management to give customer engagement strong attention knowing they would need to publicly self-rate their approach, with this rating tested by the ESC, and also knowing that businesses would inevitably consider how they ranked compared to their peers. This was made easier by the ESC undertaking its price reviews of 16 water business under the PREMO framework at the same time.

The farrierswier review of PREMO showed that while there was a financial incentive, the reputational incentives had the greatest influence for the state-owned firms.

The ESC also provided clear guidance on what it considered good consumer engagement looked like, without being prescriptive in terms of the engagement techniques used by each business.

The AER may wish to consider the following questions based on the ESC's experience:

- How much does the AER wish to 'shift the dial' on customer engagement from past practice, noting that there has already been significant progress by many energy businesses in recent years?
- If the AER does wish to shift the dial, then how can it strengthen incentives? Reputational incentives based on more explicitly rating and comparing customer engagement are one mechanism that can be powerful in changing behaviour.
- Is it possible to undertake a comparative rating of customer engagement approaches without prescribing how it is undertaken, thereby enabling innovation and choice?
- Is there value in the AER providing additional guidance on what it expects effective consumer engagement to look like, including by drawing together its various existing guidance documents and comments from past determinations into a single document containing simple tools like the ESC's diagrams and tables set out above?

Appendix E Potential constraints on the application of these examples under the current NER framework

E.1 COMPARISON OF THE NEL/NER REGULATORY FRAMEWORK WITH THE OTHER JURISDICTIONS EXAMINED

In considering the extent to which the AER could learn from and potentially adopt aspects of the approaches used by other regulators, it is critical to situate those examples within the broader regulatory framework within with each regulator operates.

The examples above highlight a number of important differences between the regulatory regime under which the AER regulates electricity DNSPs and the regulatory regimes applying to the other regulators we examined.

The broad regulatory framework and key regulatory instruments applying to each regime are summarised in Figure E.1 and Figure E.2 below.

Figure E.1: Regulatory instruments governing how the AER regulates DNSPs

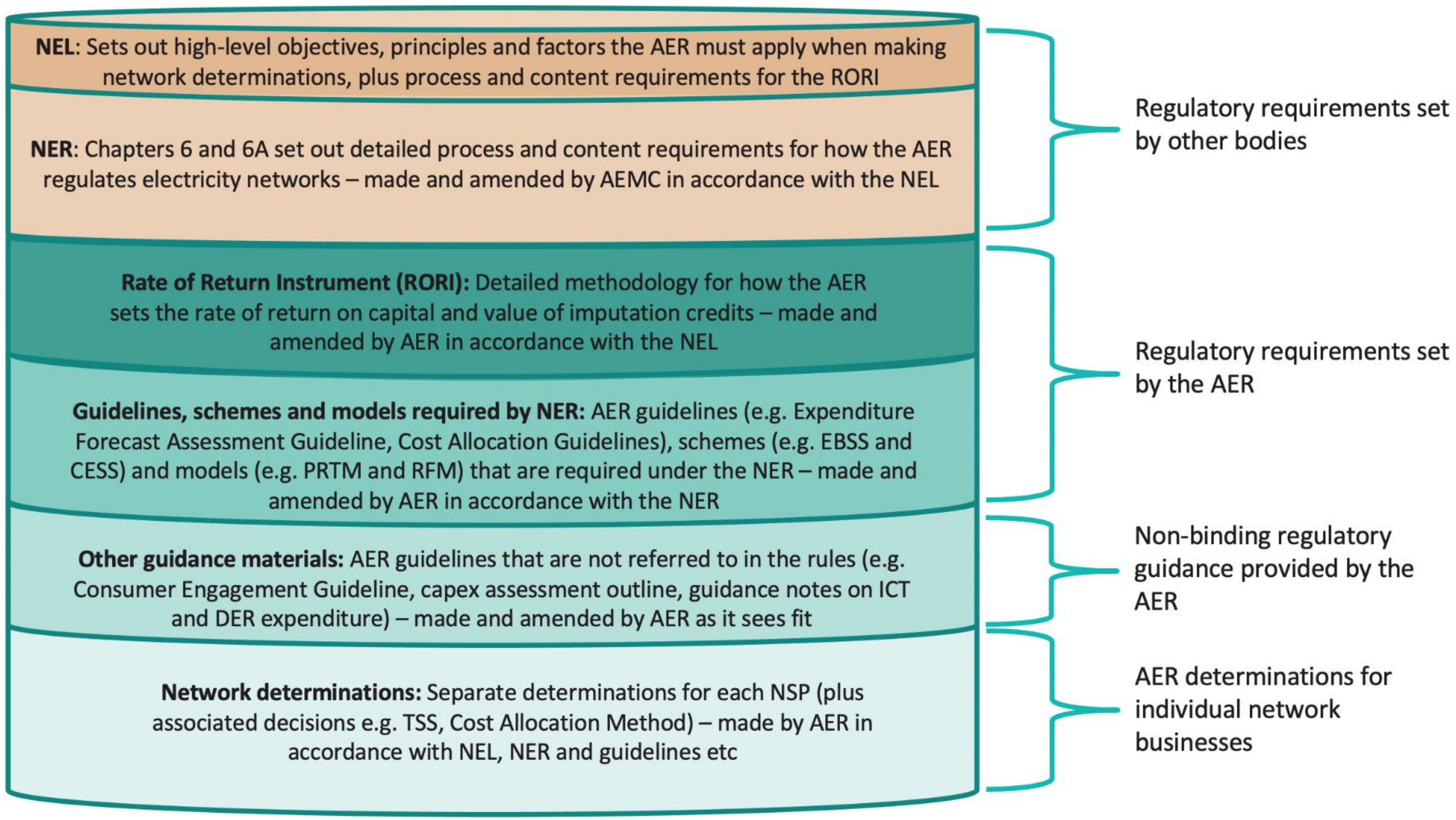
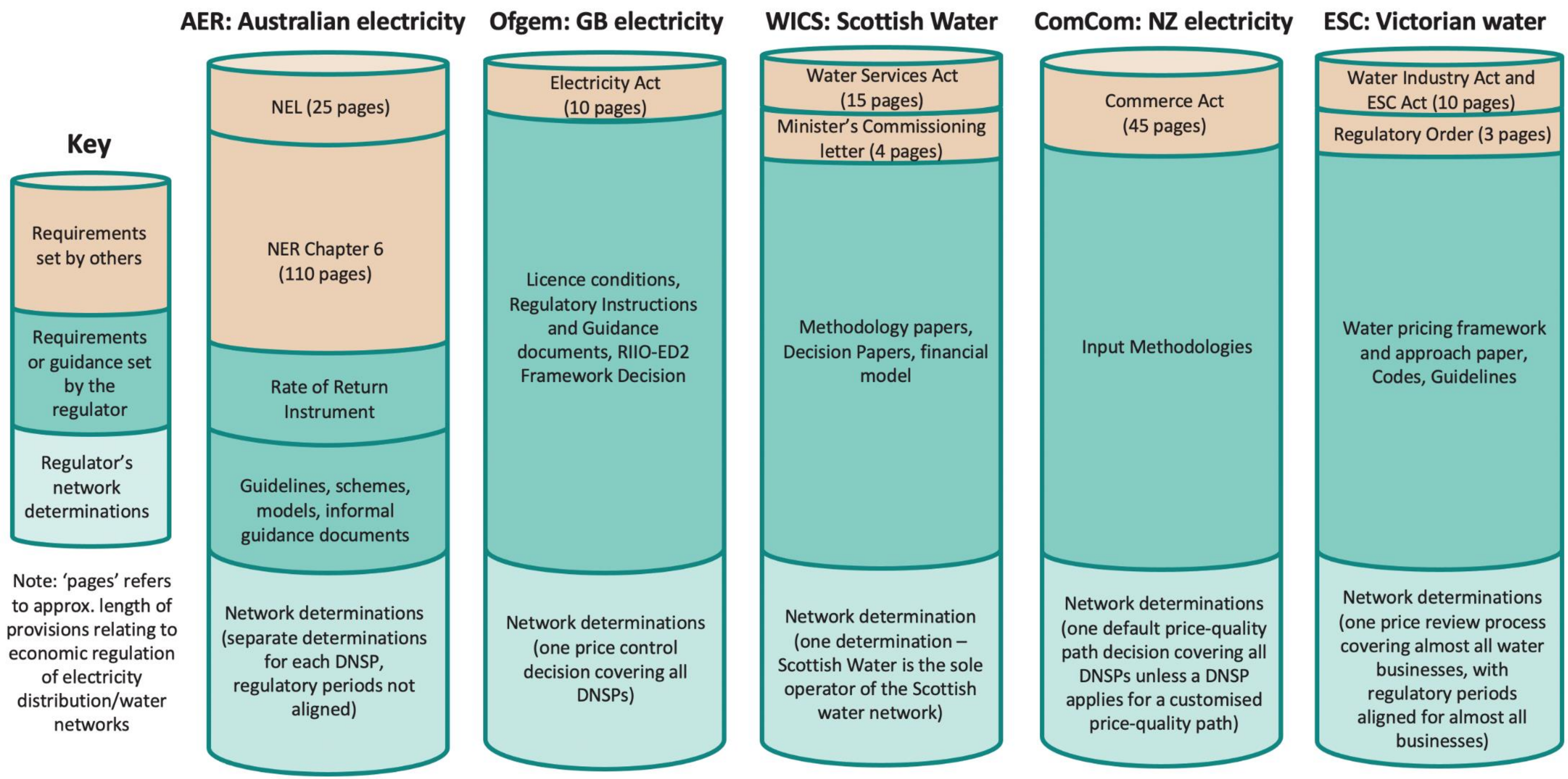


Figure E.2: Summary of the hierarchy of key economic regulatory instruments in each jurisdiction



Figures E.1 and E.2 illustrate several important unique features of the NEL/NER regime compared with the 4 other regimes we examined:

- **More layers of instruments |** The regulatory framework for DNSPs in the NEM and NT is unusual in that it relies on a greater number of different types of instruments with a clear legal hierarchy between them. For example:
  - The NEL sets out high-level objectives, principles and factors and governs how the NER and RORI are made by the AEMC and AER respectively; the NER and RORI then set out very detailed requirements; the NER requires the AER to make a large number of specific formal guidelines, schemes and models that must be consistent with the NEL and NER and made in accordance with a prescribed process (see section E.2 below), and the AER also publishes various other informal guidance documents that must be consistent with all of the above instruments.
  - In contrast, the regimes in other jurisdictions have fewer layers and much less prescription regarding what guidance materials or other instruments the regulator may make. For example, in New Zealand the Commerce Commission's Input Methodologies essentially perform the same function as the NER, RORI, AER schemes, guidelines and models collectively perform in Australia.
- **More prescriptive process and content requirements set by other bodies |** The framework under which the AER regulates is also unique in terms of the level of prescription that is set out in documents that are made by other bodies. The provisions of the NEL and NER that govern how the AER regulates electricity DNSPs are more than 3 times the length of the equivalent instruments set by other bodies in any other jurisdiction we considered, and are 10 times the length of the equivalent instruments governing how Ofgem and the ESC regulate similar businesses. In other jurisdictions, these documents are generally limited to principles, objectives and high-level process requirements. In contrast, chapter 6 of the NER regulates in detail both the process and content of the AER's determinations. This limits the AER's discretion compared with other regulators. Combined with the above point regarding the clear legal hierarchy, this prescription also limits what the AER can include in its formal guidelines or in a SOEN or other informal guidance document.
- **More network determination processes |** The AER is also unique amongst these regulators in not having a single network determination/price review process that covers almost all DNSPs/water businesses and not having regulatory periods that are aligned for almost all regulated businesses. This is likely to increase the resources required by the AER per regulated business and will make it harder to adopt some of the approaches used by other regulators to encourage ambitious and well-justified regulatory proposals though measures like competition for financial incentives, proportionate assessment and fast-tracking. For example:
  - The AER regulates 14 DNSPs, with each DNSP having a separate distribution determination and the regulatory periods not being aligned. In practice, the AER effectively undertakes 3 separate determination processes for different groups of DNSPs: the 5 Victorian DNSPs (2021-2026), the 6 NSW, ACT, NT and TAS DNSPs (2024-2029), and the 3 SA and QLD DNSPs (2025-2030).
  - In contrast, Ofgem undertakes one price review process for all 14 DNOs (subject to fast-tracking), the Commerce Commission makes one default-price quality path decision for all 17 lines businesses, and the ESC undertook one price review process for 17 of the 19 water businesses it regulates. In the Ofgem and ESC examples, the regulator still ultimately makes separate determinations for each business, but those decisions are made and consulted on as part of a single process and regulatory periods are aligned (subject to some exceptions under the ESC's approach).[51]

[51] Ofgem also regulates other businesses, so runs a series of separate processes for different types of businesses all based on the RIIO model (e.g. RIIO-T2 covers all gas and electricity transmission businesses and RIIO-GD2 covers all gas distribution businesses).

E.2 EXISTING AER GUIDANCE MATERIALS

The AER has published a large number of existing guidance materials explaining how it regulates electricity distribution networks. As shown in Figure E.1, some of these documents are required by the NER and have a legal status under the NER, while others are informal guidance documents explaining the AER's approach on specific issues.

A key question for the design of the SOEN will be how to best use it to complement these existing guidance materials.

Table F.1 in Appendix A lists the AER's current guidelines, schemes, models and other guidance materials that are relevant to the economic regulation of electricity distribution networks.

In summary, the AER has published 27 formal or informal guidance documents relating to how it regulates electricity distribution networks (excluding rate of return issues). This includes:

- **Customer engagement:** one document, which is a guideline that provides informal guidance only and is not required by the NER.
- **Expenditure assessment:** 16 documents, including 10 guidelines, schemes or models that are required by the NER and 6 other guidance documents.
- **Other issues:** 10 documents, including 6 guidelines or schemes that are required by the NER, one scheme that is optional under the NER and 3 other guidance documents.

The AER also provides significant guidance on its approach to regulation in individual determinations for network businesses. While this guidance has no legal status for other determination processes, it often gives the best explanation of the AER's approach to certain issues as the AER applies the same or very similar approaches across multiple determinations. Notable examples are:

- The AER's current expectations for effective consumer engagement are best explained in 'Table 7' of the recent draft determinations for the Victorian DNSPs, which the AER has subsequently applied in other determinations.
- The AER's approach to capex and opex assessment is explained in detail in its recent determinations, for example its recent determinations for the Victorian DNSPs.

Given that many of these published guidance materials have a legal status under the NER and the AER and network businesses are required to comply with them, the SOEN will need to be consistent with them, at least in the short term.

In the longer term, the AER could undertake a process to consult on changes to relevant guidelines if necessary and if resourcing constraints allow it. We note that several key guidelines including the Consumer engagement guideline and the Expenditure forecast assessment guideline have not been updated since 2013. There may also be merit in consolidating and simplifying the multiple expenditure assessment guidelines.

For those 17 guidelines, schemes and models that have legal status under the NER, any changes must be made in accordance with the requirements of the NER. In most cases, this means any amendments must be consulted on and made in accordance with the distribution consultation procedures in clause 6.16 of the NER.

E.3 KEY CONSTRAINTS UNDER THE NER FRAMEWORK

As noted in section E.1, the NER is relatively prescriptive in relation to the content of the AER's distribution determinations, the approaches and tests the AER must apply in making those determinations and the process the AER must follow. This prescription imposes a number of constrains on the AER's freedom to provide guidance on its approach through a SOEN or other guidance materials, and limits the AER's ability to adopt some of the approaches used by other regulators that are discussed in the examples in this report.

Key aspects of Chapter 6 of the NER that regulate the AER's approach and that will influence the meaning of 'capable of acceptance', the potential role of enhanced consumer engagement and the AER's ability to adopt a proportionate assessment or fast-tracking process include the following requirements:

- **Constituent decisions |** Although it is commonly said that the AER only determines a total maximum revenue allowance for the regulatory period (sometimes called a 'bucket of money'), the NER sets out considerable detail on how that total revenue allowance must be calculated. The AER is required to make numerous 'constituent decisions' as part of its distribution determination, each of which must comply with the relevant parts of the NER. A draft and final distribution determination must contain 28 constituent decisions by the AER that are listed in clause 6.12.1 of the NER. The matters that must be covered by these constituent decisions are summarised in Appendix G. In our experience, this level of prescription is unprecedented in any other equivalent regulatory model in other jurisdictions.
- **Building blocks approach |** The NER require the AER to adopt a building blocks approach. The NER specify the 8 required building blocks and set out requirements for how each building block is determined.
- **Opex and capex objectives, criteria and factors |** Clauses 6.5.6 and 6.5.7 of the NER set out 7 pages of detailed requirements for how the AER calculates the opex and capex building blocks. These clauses include a detailed hierarchy of objectives, criteria and factors the AER must have regard to when determining its forecasts of efficient opex and capex.
- **Process requirements for distribution determinations |** The NER set out a prescriptive process and timetable for the regulatory proposal and distribution determination process. The process required by the rules takes 32 months and requires the AER and DNSPs to publish or submit a range of documents at different stages of the process, including dates by which the AER must publish a Framework and Approach Paper, Issues Paper, Draft Determination and Final Determination and the required contents of each document.

It is also relevant to note that most reliability and customer service standards for DNSPs are set by jurisdictional governments or jurisdictional regulators rather than by the AER. The capex and opex objectives give considerable weight to the need to allow sufficient forecast capex and opex to comply with any jurisdictional regulatory obligations or requirements. This contrasts with other regimes where the economic regulator also sets some of these requirements.

The key implications of these NER requirements for the AER's ability to adopt some of the approaches of other regulators in the examples in this report are:

- **Limited ability to adopt a formal fast-tracking process |** The process and timeframe requirements under the NER will not allow the AER to adopt a formal fast-tracking process where it skips stages of the process and issues a final determination for some businesses significantly earlier than for other businesses, e.g. like adopted by Ofgem and the ESC. However, there is still likely to be scope for the AER to adopt a 'proportionate assessment' approach like Ofgem, the ESC and the Commerce Commission where more effort is directed to certain businesses and issues. For example, the AER could potentially signal earlier in the process that it expects to accept all or most of a DNSP's regulatory proposal, but it would still need to publish complete draft and final determinations containing all required constituent decisions. In theory, the AER could adopt a limited fast-tracking process where it made its draft and final decisions for some businesses slightly earlier than for other businesses, but in practice the amount of time that can be saved is likely to be limited, there could be significant resourcing implications of doing so, and the next regulatory period would still have to start at the same time for all businesses.

- **Material financial incentives for well-justified or ambitious proposals are unlikely to be permitted |** Incentives for proposals that are capable of acceptance are more likely to need to be reputation or process based due to several limitations in the NER:
  - The level of prescription in the building blocks clauses of the NER are likely to limit the AER's ability to provide material financial incentives for ambitious and well-reasoned regulatory proposals like Ofgem or the ESC.
  - The NEL provisions related to the RORI would prohibit a PREMO style incentive tied to the rate of return.[52]
  - The NER permits the AER to develop small-scale incentive schemes, which are collectively limited to a maximum reward or penalty of 0.5% of revenue. Such a scheme must provide DNSPs 'incentives to provide standard control services in a manner that contributes to the achievement of the national electricity objective'.[53] It is not clear whether this requirement would be met by a scheme that provided incentives based on the quality of a regulatory proposal. The AER's recently developed customer service incentive scheme is also a small-scale incentive scheme and has a maximum reward or penalty of 0.5% of revenue. The collective limit of 0.5% of revenue for all such schemes means the incentive power of the customer service incentive scheme would need to be reduced if another scheme was developed.
- **The concept of 'capable of acceptance' needs to be grounded in the NER requirements and may be unhelpful |** These legal requirements will need to inform what is meant by the concept of 'capable of acceptance', as the NEL and NER impose much greater constraints than in other regimes on what proposals the regulator is legally permitted to accept. 'Capable of acceptance' is likely to be a confusing term and the Ofgem concept of a 'well-justified' proposal is likely to be more useful terminology.
- **A greater focus on inputs rather than outputs may be unavoidable |** The level of prescription in the constituent decision and building blocks clauses of the NER is likely to make it harder for the AER to move to a model where it has increased focus on outputs or outcomes for consumers like Ofgem, the ESC and WICS have done, rather than decisions that are focussed on the inputs to the elements of the building blocks model.
- **There may be limitations on the role of enhanced consumer engagement |** The AER can place weight on consumers' views when making its decisions. However, the level of prescription in the NER including the constituent decisions and building blocks requirements model, the detailed opex and capex objectives, factors and criteria, and the existence of state and territory reliability requirements may mean the AER has less ability to use enhanced consumer engagement to decide on price-quality or price-reliability trade-offs than other regulators. The AER can use incentive schemes to incentivise improved reliability or customer service over-and-above what is required in jurisdictional requirements, but consumers cannot negotiate to pay less for reduced reliability and there may be less ability to agree on trade-offs between different building blocks.

52 Under section 18J of the NEL, the RORI must provide for the same rate of return methodology to apply to all network service providers automatically without the exercise of any discretion by the AER. This section expressly prohibits the RORI including different methodologies or a band of values the AER could choose from.

53 NER clause 6.6.4(a).

Appendix F Current AER guidance materials

Table F.1 lists the AER's current guidelines, schemes, models and other guidance materials that are relevant to the economic regulation of electricity distribution networks.

In the 'legal status' column, documents listed as 'Required by NER' must be made, consulted on and amended by the AER in accordance with the distribution consultation procedures in the NER, and the AER and/or DNSPs may be required by the NER to comply with them. Documents listed as 'Guidance only' are not referred to in the NER and have no specific legal status.

This table does not include documents related to rate of return issues.

Table F.1: Current AER guidance materials for electricity distribution networks

Topic	Instrument	Last amended	Legal status
Consumer engagement	Consumer engagement guideline for network service providers	2013	Guidance only
	Guidance in individual distribution determinations (e.g. 'Table 7' of the recent Victorian draft determinations)	N/A	Applies to those decisions only
Expenditure assessment	Expenditure forecast assessment guideline	2013	Required by NER
	RIT-D application guidelines	2018	Required by NER
	Capital Expenditure Sharing Scheme (CESS)	2013	Required by NER
	Efficiency Benefit Sharing Schemed (EBSS)	2013	Required by NER
	Annual benchmarking reports	2020	Required by NER
	Cost allocation guidelines	2013	Required by NER
	Roll forward model	2020	Required by NER
	Post Tax Revenue Model (PTRM)	2021	Required by NER
	Shared asset guidelines	2013	Required by NER
	Final decision on values of customer reliability	2020	Required by NER
	Capex assessment outline for electricity distribution determinations	2020	Guidance only
	Repex model outline for electricity distribution determinations	2020	Guidance only
	Guidance note on non-network ICT capex assessment	2019	Guidance only

Topic	Instrument	Last amended	Legal status
	Consultation paper on assessing DER integration expenditure	2019	Guidance only
	Industry practice note – asset replacement planning	2019	Guidance only
	Final decision – forecasting productivity growth for electricity distributors	2019	Guidance only
	Guidance in individual distribution determinations (e.g. recent Victorian determinations)	N/A	Applies to those decisions only
Other	Demand management incentive scheme (DMIS) and demand management innovation allowance (DMIA)	2017	Required by NER
	Service Target Performance Incentive Scheme (STPIS)	2020	Required by NER
	Customer service incentive scheme	2020	Optional under NER
	Distribution ring fencing guidelines	2017 (currently under review)	Required by NER
	Distribution service classification guidelines	2018	Required by NER
	Asset exemption guidelines	2018	Required by NER
	Distribution confidentiality guidelines	2017	Required by NER
	Position paper on treatment of inflation	2021	Guidance only
	Draft guidance note on insurance pass through events	2021 (currently under development)	Guidance only
	Position paper on profitability measures for regulated gas and electricity businesses	2019	Guidance only

Appendix G Constituent decisions under the NER

Under clause 6.12.1 of the NER, a draft and final distribution determination must include decisions by the AER on the following matters (constituent decisions):

1. the classification of services
2. the annual revenue requirement for the DNSP for each regulatory year
3. the commencement and length of the regulatory control period
4. any asset exemption requests
5. forecast capex
6. the amount of expenditure for a restricted asset that must be excluded forecast capex
7. forecast opex
8. contingent projects, including what projects are contingent projects, the capex for each project, the trigger events for each project and any asset exemptions for each project
9. the allowed rate of return for each regulatory year
10. the allowed imputation credits for each regulatory year
11. the opening regulatory asset base (RAB)
12. the estimated cost of corporate income tax for each regulatory year
13. depreciation schedules
14. how any applicable incentive schemes are to apply to the DNSP
15. decisions on 'other appropriate amount, values or inputs'
16. the form of control for standard control services and the relevant formulae
17. the form of control for alternative control services and the relevant formulae
18. how compliance with the control mechanism is demonstrated
19. additional pass through events
20. the DNSP's Tariff Structure Statement
21. the DNSP's negotiating framework
22. the DNSP's negotiated distribution service criteria
23. the DNSP's policies and procedures for tariff class assignment and reassignment
24. the DNSP's pricing methodology for transmission standard control services (if applicable)
25. whether depreciation of the RAB is based on actual or forecast capex

26. how the DNSP is to report to the AER on its recovery of designated pricing proposal charges and adjustments to account for over or under recovery of those charges
27. how the DNSP is to report to the AER on its recovery of jurisdictional scheme amounts and adjustments to account for over or under recovery of those amounts
28. the DNSP's connection policy.