Better Regulation

Reform package update

Promoting efficient investment in the interests of all energy consumers

August 2013

AUSTRALIAN ENERGY REGULATOR

Contents

1 Introduction

The Australian Energy Regulator (AER) is Australia's independent national energy market regulator. We are guided in our role by the national electricity and gas objectives. Enshrined in the Electricity and Gas Laws, these objectives focus us on promoting the long term interests of consumers.

A major part of our work is regulating the energy networks (electricity poles and wires, and gas pipelines) that transport energy to consumers. In 2012, the Australian Energy Market Commission (AEMC) changed the rules governing how we determine the total amount of revenue each electricity and gas network business can earn. We initiated the Better Regulation program to update and improve our processes under these new rules. The program also incorporates the consumer focussed reforms agreed by the Council of Australian Governments in late 2012.

National electricity and gas objectives

The objective of the National Electricity and Gas Laws is to promote efficient investment in, and efficient operation and use of, energy services for the long term interests of consumers of energy with respect to—

(a) price, quality, safety, reliability and security of supply of energy; and

(b) the reliability, safety and security of the national energy systems.

The Better Regulation program involves us:

- consulting on seven new guidelines that outline our approach to receiving and assessing network businesses' expenditure proposals and determining electricity network revenues and prices
- establishing a consumer reference group (CRG) for our guideline development work, to help consumers engage across the broad spectrum of issues we are considering
- forming an ongoing Consumer Challenge Panel (CCP) (appointed 1 July 2013) to assist us incorporate consumers' interests in revenue determination processes.

At the commencement of the Better Regulation program we held a public forum on 18 December 2012 to discuss our work program and the consultation process with over 100 stakeholders in attendance. We released issues papers on each guideline between December 2012 and March 2013 to consult on our preliminary views. We've held over 60 meetings with stakeholders since December 2012, ranging from large forums, to targeted workshops, teleconferences, and bilateral meetings. The CRG has met on almost 20 occasions since February.

We have now published six draft guidelines as part of the Better Regulation program—consumer engagement, shared assets, expenditure forecast assessment, expenditure incentives, confidentiality, and rate of return—together with the final Regulatory Investment Test for Distribution (RIT-D). An explanatory statement and two page factsheet accompany all our guidelines.

1.1 How this document can help you

In May 2013 we released a policy note called '*Better Regulation: an integrated package*' which explained the Better Regulation program, provided background to the regulatory process, and outlined the aims of each guideline. This policy note is available on our website.[1]

[1] On our Better Regulation home page at http://www.aer.gov.au/node/18824 under 'Quick information about Better Regulation'.

This document follows from that policy note and provides an overview of the key decisions we have taken in each draft guideline and how stakeholders can have their say prior to publication of the final versions. We also highlight how all the guidelines work together as a package of measures to promote the long term interests of consumers.

1.2 More information on the Better Regulation program

For more information or to get involved in the consultation processes on each of these workstreams, please see our website http://www.aer.gov.au/node/18824. The Better Regulation web page has factsheets on all our draft guidelines, our monthly newsletter updates, links to the pages for each workstream, and an up-to-date calendar of events.

2 An integrated package of reforms

The Better Regulation program aims to enhance the ongoing regulatory process. For those readers not familiar with the regulatory process our first policy note *Better Regulation: an integrated package* provides further background.

We developed our draft guidelines to work as cohesive package—from the new annual reporting on network business efficiency, to new tools for assessing businesses' forecasts of the expenditure needed, and stronger incentives on businesses to spend efficiently. At the same time we are improving the way we determine the return that network businesses can earn on their investments, drawing on a broader range of information. All these new measures are overlayed with a better consumer engagement framework—encouraging greater consumer involvement and communication between network businesses and the communities they serve.

The package of reforms resulting from the Better Regulation program will have an ongoing impact during the regulatory period, as well as at the time of our regulatory determinations, as outlined in Figure 1. There is more detail in the sections that follow on each part of the Better Regulation program.

2.1 Promoting consumer involvement

There are important aspects of the Better Regulation program which provide greater opportunities for consumer involvement and consultation in the regulatory process. We established the CRG to enhance consumer participation in our guideline development work. We have taken into account this consumer input in forming our positions in all our guidelines.

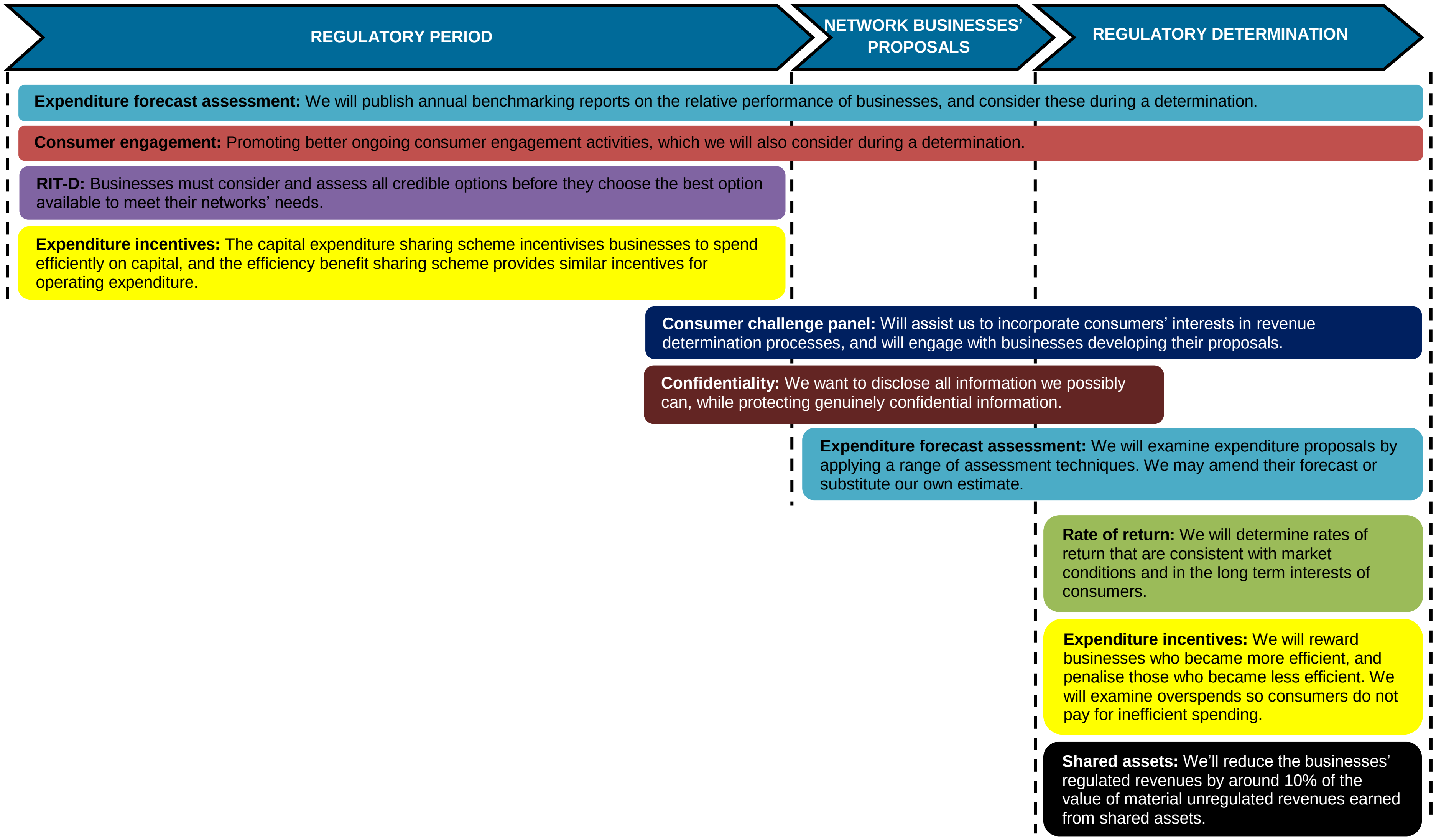
We expect all network businesses to use our consumer engagement guideline to enhance their ongoing consumer engagement activities. Then, when we assess an expenditure proposal from a network business during a determination we will take into account how the business engaged with its consumers. The CCP will also assist by advising us on the effectiveness of the business' engagement activities with their consumers and how this engagement has informed, and been reflected in, the development of their proposals. The CCP will also advise us on whether the business' proposal is justified in terms of the services to be delivered to consumers. This includes whether those services are acceptable to, valued by, and in the long-term interests of, consumers.

2.1.1 Consumer Reference Group

To assist consumer participation in our guideline development project, we established a CRG of 21 members representing the spectrum of consumer interests. The CRG has met regularly throughout our Better Regulation project, including two face-to-face meetings funded by the AER. In addition, the CRG has created sub-groups on each workstream. This has allowed consumer representatives to specialise in particular workstreams and to report their views to the full CRG for further consideration and comment. We have taken into account consumer input received through these meetings in forming our positions in the draft guidelines.

We would like to thank the members of our CRG for their continued involvement in the project. We have found that despite the sizeable scope of our activities over the last nine months, we have had the benefit of unprecedented levels of consumer involvement. This has greatly assisted the regulatory decision making process.

Figure 1: The Better Regulation package and the regulatory process



2.1.2 Consumer engagement guideline

We released a draft of this guideline on 1 July. The draft guideline provides best practice principles and a framework for electricity and gas network service providers to better engage with their consumers. This will guide service providers in developing consumer engagement strategies and approaches to apply across their business and also assist them in preparing spending proposals that reflect the long term interests of their consumers.

Our framework has four main components:

- priorities: the need to identify issues and set priorities for engagement with consumers
- delivery: the activities we would expect service providers to undertake to engage effectively with consumers
- results: the outputs and measures of success, focusing on explaining how consumer input affected the service providers' decision making and evaluation
- review: a robust process to identify and make renewed commitment to addressing areas needing improvement.

The five key principles that underpin this framework are accessibility, transparency, communication, inclusivity and measurability. The guideline places the onus on service providers to develop consumer engagement strategies. Service providers are in the best position to understand their consumer base and its issues. For this reason, the guideline is not prescriptive and does not mandate any particular engagement strategy.

2.1.3 Consumer Challenge Panel

On 1 July the AER established its CCP. The thirteen members of the CCP are experts who will provide advice to us to help ensure our decisions on energy network costs properly incorporate consumer interests and views. The CCP members have been appointed for three years and have significant local and international expertise in economic regulation, energy networks and consumer representation.

The CCP will be first used in the revenue determinations commencing in 2014—NSW electricity and gas distribution, ACT electricity distribution, NSW and Tasmania electricity transmission. Before then, we will work with the CCP to settle how they will work in a revenue determination and to ensure that all stakeholders understand the process the CCP will be adopting, including how the CCP will engage with network businesses and consumer representatives.

2.2 Network businesses' spending

We have a strong preference for incentive-based regulation, which rewards businesses for efficient performance. Our improved incentive framework gives businesses ongoing incentives to spend more efficiently during the regulatory period. At the time of a determination our stronger incentive measures will reward businesses that became more efficient during the period, and penalise those whose efficiency worsened. If a business has spent more on capital than the allowance, we will review the efficiency of the overspend. We can exclude inefficiencies from the business' asset base, meaning consumers will only fund efficient capital spending.

Our preference will be to use a business' past spending as a starting point to set its future expenditure allowance, provided we are satisfied that past spending is efficient. Where we are not satisfied we will now be able to draw on our own benchmarking and other assessment techniques to form a view on efficient costs.

Our annual benchmarking reports allow ongoing comparison of network businesses against each other. This public information will encourage businesses to improve or maintain their efficiency, and flag areas that will require attention during the next regulatory determination. At the time of the next determination, businesses will need to provide economic analysis to justify the efficiency and prudency of their expenditure proposals. In the absence of economic justification we are unlikely to accept their forecast expenditure. We will examine a business' expenditure proposal by applying a range of techniques that typically involve comparing the business' forecasts with estimates we develop from other information sources. If a business' total capex or opex forecast is greater than estimates we develop using our assessment techniques and there is no satisfactory explanation for the difference, we will amend the forecast or substitute our own estimate. We will also take into account our most recent benchmarking report in this process.

We have improved the way we determine the return that network businesses can earn on their investments. By drawing on a broad range of information we will be able to set rates of return that are more in line with efficient investment practices. This will mean that consumers will pay no more than necessary to attract the investment needed to keep the networks operating. Consumers can also expect to see less volatile prices over time.

2.2.1 Expenditure incentives

On 9 August we published our approach to incentivising efficient expenditure. These were two documents—our draft capital expenditure incentive guideline, and proposed operating expenditure efficiency benefit sharing scheme. Together, these provide better incentives for network businesses to spend efficiently and to share the benefits of efficiencies with consumers.

Our capex incentives centre on a new capital expenditure sharing scheme (CESS) and our approach to efficiency reviews of past expenditure. Our proposed CESS will apply equally to all network businesses. It provides a 30 per cent reward to businesses for becoming more efficient with capex (underspending) and a 30 per cent penalty for becoming less efficient (overspending). Consumers and businesses will share the benefits of efficiency savings on capital and will share the cost of efficient capital overspends. New ex-post measures also ensure consumers do not pay for inefficient spending on capital. Under our package of capex incentives a business will lose between 30 and 100 per cent of any capital overspend.

We are also proposing amendments to the existing opex incentives in our efficiency benefit sharing scheme (EBSS). The current EBSS will continue largely in its current form. We have, however proposed to make some changes to ensure it operates in conjunction with the new CESS and with our new approach to expenditure forecasting.

We designed these incentive measures alongside our expenditure forecast assessment guideline. Together the package reflects our strong preference for incentive-based regulation which rewards businesses for efficient performance. Where we consider incentives are not effective, our improved approach to expenditure forecasting and assessment will promote efficient outcomes for consumers, as discussed in the next section.

2.2.2 Expenditure forecast assessment guideline

We published this draft guideline on 9 August. It sets out our enhanced expenditure assessment approach. It provides for a nationally consistent reporting framework allowing us to compare the relative efficiencies of network businesses, and determine efficient opex and capex allowances. Our guideline and explanatory statement set out our new assessment techniques, refined techniques, assessment principles and more detailed information requirements. With these enhancements comes more rigorous assessment of businesses' spending proposals, with better outcomes for consumers.

We will complement our existing assessment techniques with two new benchmarking techniques—economic benchmarking and category analysis—to assist us to form a view about efficient expenditure levels. Economic benchmarking techniques will enable us to measure a business' efficiency overall, while category analysis will enable us to analyse expenditure drivers and the costs of conducting similar activities across businesses. We have also developed a new tool to better forecast the expenditure needed to build, upgrade or replace network assets to address changes in demand (the augmentation capex model, or augex model). This complements our existing tool that examines the expenditure needed to replace aging assets (the replacement capex model, or repex model).

We will integrate our new and refined techniques into our assessment approach, but they will not displace our existing techniques. Rather, we will use them in combination with existing techniques to form a view about forecast expenditure. However, we anticipate placing increasing reliance on benchmarking techniques as more data becomes available.

The techniques used and data collected under the guideline will also form the basis of our annual benchmarking reports we will begin publishing from September 2014. These will provide regular information on the relative efficiency of network businesses.

2.2.3 Rate of return guideline

On 30 August we published our draft rate of return guideline. The allowed rate of return is an estimate of the appropriate cost of capital expenditure for the business. A good estimate of the rate of return is necessary to promote efficient prices in the long term interests of consumers. The rate of return is calculated as a weighted average of the return on equity and the return on debt. In the draft guideline we set out our substantially revised approach to setting the rate of return for electricity and gas networks.

On the return on equity, we propose a model allowing us to take account of a broad range of information, rather than being limited to the output of one particular financing model. We previously used the Sharpe-Lintner Capital Asset Pricing Model (CAPM) to determine the return on equity. Our proposal would use the Sharpe-Lintner CAPM (referred to as our 'foundation model') to set a range and point estimate on the final return on equity. Other financial models and other information would be used to either set the range of inputs into the foundation model, or assist in determining the point estimate within the final range. We would also consider additional information to estimate the final return on equity. This includes estimates from valuation reports, brokers, other regulators and alternative financial models. This flexible approach allows us to determine an equity estimate consistent with the new rate of return objective—for the overall rate of return to correspond to the efficient financing costs of a benchmark efficient business.

For the return on debt, we propose to move to a trailing average model that would align the allowed cost of debt with the cost of a hypothetical portfolio of seven year bonds, with one-seventh of the portfolio refinanced each year. This would be a better reflection of efficient debt financing practices of regulated businesses and would also provide a less volatile price profile over time. The old rules prescribed a once-every-five-year estimation of the cost of debt by measuring the return on 10 year bonds issued by Australian companies. After the global financial crisis, there was a very small or no pool of bonds to observe in this class. This led to an estimation method that did not reflect actual debt financing practices and overcompensated network businesses. Our draft guideline proposes adopting a seven year benchmark term to estimate the allowed cost of debt at the start of the next round of regulatory determinations. We propose a gradual transition from using prevailing rates to the trailing average approach. The transition will occur over a period of seven years and will apply to all businesses.

2.3 Better regulatory processes and outcomes

Other aspects of the Better Regulation program designed to improve the regulatory process include the RIT-D, which is part of a new distribution planning framework aiming to promote non-network alternatives where these are more efficient. The RIT-D provides an open and transparent planning and consultation process for network businesses to publicly assess all credible options, including embedded generation demand management, before committing to network upgrades.

Secondly, prior to businesses submitting their regulatory proposal we will hold pre-lodgement discussions with them and aim to agree on what information is confidential and why. To achieve a transparent regulatory process we will ultimately disclose all the information we possibly can for stakeholders, while protecting genuinely confidential information.

Finally, If a business expects to earn a material amount of revenue from providing other services using the assets consumers pay for in the next regulatory period (shared assets), we will reduce their regulated revenues to reflect this.

2.3.1 Power of choice implementation

This workstream promotes greater consumer choice and innovation in electricity services, including non-network solutions. The AEMC completed its Power of Choice review in November 2012 and its review of energy market arrangements for electric and natural gas vehicles in December 2012. The AEMC has also recently commenced consideration of an annual distribution network pricing rule change request.

Once the rule changes that follow the AEMC's reviews have been finalised, we will be implementing any required changes to how we regulate. The exact scope and timing of these rule changes is uncertain, but our power of choice implementation workstream will capture our role which is likely to involve:

- reviewing incentives for distributors to improve demand-side participation
- reviewing arrangements pertaining to distribution tariff reviews
- considering possible amendments to the AER's retail guidelines.

The AEMC also introduced a new national framework for electricity distribution network planning and expansion in October 2012. The RIT-D is one component of this new framework and was included under the power of choice implementation workstream given its linkages with many of the recommendations coming out of the power of choice review. We published the final RIT-D on 23 August. The RIT-D relates to the process of distribution network businesses conducting 'regulatory investment tests' before making significant investment decisions for their networks.

The new framework applies to distribution businesses across the national electricity market, and is designed to promote efficient planning processes for network investment. It aims to provide transparency and information on distribution businesses' planning activities and decision making processes. In particular, this will enable non-network providers to put forward non-network options as credible alternatives to network investment.

The RIT-D contributes to this objective by establishing the processes and criteria the distribution networks should apply before making investment decisions. The RIT-D requires network businesses to consider and assess all credible options before they choose the best option available to meet their networks' needs. The preferred option is the most economical investment project among all credible options. The RIT-D application guidelines provide guidance on how to assess these options and the circumstances in which businesses are required to consider and quantify market benefits when undertaking a RIT-D.

2.3.2 Confidentiality guideline

We published this draft guideline on 9 August. It sets out our process for managing confidentiality claims over material submitted by network businesses. This includes the types of information considered confidential and the process for disclosure.

We aim to balance protecting genuinely confidential information with disclosing information for an open and transparent regulatory decision making process. We consider this balance involves all stakeholders having access to sufficient information to understand and assess the substance of issues affecting their interests.

Our draft guideline proposes a two stage process for managing businesses' confidentiality claims. The first stage involves pre-lodgement discussions where the AER, the business and stakeholders aim to agree on what information is confidential and why. In the second stage the business submits its proposal with a completed confidentiality template identifying what (if any) information it claims is confidential and why, categorising the information. If we reached an understanding in the first stage and agree with the claims, we can proceed to disclose all information possible. If we don't agree with the claim we may decide to use our formal disclosure powers. In both cases we will disclose all the information we possibly can for stakeholders, while protecting genuinely confidential information.

2.3.3 Shared assets guideline

We released a draft of this guideline on 30 July. In it we propose how electricity consumers will benefit from the other services network businesses may provide using the electricity assets that consumers pay for.

Consumers will now share in the benefits when businesses use regulated assets for unregulated purposes. Our shared assets process applies when the unregulated revenues from shared assets are material—more than 1 per cent of a service provider's total annual revenue. When this occurs we will reduce a business' regulated revenues by around 10% of the value of unregulated revenues earned from shared assets.

3 Next steps

We have now published all our draft guidelines. Submissions on our shared assets guideline are due on 13 September. The following week on 20 September submissions close for the guidelines covering expenditure forecast assessments, expenditure incentives and confidentiality. Submissions on our draft rate of return guideline close on 11 October.

While the formal consultation periods may be closing, we are still available to meet with stakeholders to discuss issues in the lead up to our final guidelines. In addition, many of the workstreams will be holding additional forums and workshops with stakeholders. For more information contact the relevant workstream or check their webpage. Contact details are included in the table below.

Guideline/ workstream	Project Director/s	Contact e-mail
Expenditure forecast assessment	Lawrence Irlam Mark McLeish	expenditure@aer.gov.au
Rate of return	Blair Burkitt Scott Sandles	rateofreturn@aer.gov.au
Expenditure incentives	Arek Gulbenkoglu	incentives@aer.gov.au
Shared assets	Moston Neck	costallocations@aer.gov.au
Power of choice implementation (RIT-D)	John Skinner	demandmanagement@aer.gov.au
Confidentiality	Adam Petersen	confidentiality@aer.gov.au
Consumer engagement	Moston Neck	consumerengagement@aer.gov.au
Consumer reference panel and Consumer Challenge Panel	Tanja Warre	consumerreferencepanel@aer.gov.au