



# Annual Pricing Process Review

## Position Paper

August 2021

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# 1 Introduction

The Australian Energy Regulator (AER) is initiating a review into improving its annual pricing approval process for electricity distribution network service providers (distributors). The aim of the review is to develop a process to facilitate more timely and accurate annual pricing approvals as well as improve the presentation of pricing outcomes for stakeholders.

The initial phase of the review will be undertaken in two stages:

- First, engagement between the AER and distributors to develop a better process for the AER's assessment of annual pricing approvals for years 2 to 5 of the regulatory control period (second half of 2021);
- Second, standardisation of pricing proposal documents and engagement with other stakeholders to ensure the pricing model can provide the required data for their own processes, such as setting retail prices or developing default offers (second half of 2022).

This paper initiates the first stage of this initial phase. We expect this stage to lead to the development of a pre-lodgement engagement process and a standardised annual pricing model template to be implemented for the 2022/23 annual pricing process and beyond.

The development of these aspects for the annual pricing approval process follows our commitment in the [AER Strategic Plan 2020–2025](#) to design our systems to work in ways that deliver efficient regulation of monopoly infrastructure.<sup>1</sup>

A formalised pre-lodgement process will allow for the AER and distributor's resources to be better utilised outside of the constrained timelines of the formal approval process. It will also increase the likelihood of receiving pricing proposals that are compliant and capable of being approved in the first instance.

A standardised pricing model template minimises risk of input and modelling errors. It would also streamline the resources required by the AER and distributors to review and engage on pricing proposals. This is particularly important in the limited timeframe of the annual pricing proposal process. A standardised pricing model will also more easily allow us to develop outputs and reports that would benefit distributors and stakeholders such as retailers, consumer groups and government agencies. We plan on consulting on these outputs and reports in a separate process in 2022.

This paper sets out the AER's initial position on these issues. We are seeking feedback on the positions set out in this paper. The key timelines are set out in section 5.

We will progress other phases of the review over the next 18 months. These phases will likely include a review into the timing of pricing proposal approvals in the first year of a regulatory control period and a review into the application of side constraints as set out in the NER.

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<sup>1</sup> AER, *AER strategic plan 2020–2025*, December 2020, p.9

## 2 What's wrong with the annual pricing process

Each year, the electricity distributors submit to the AER for approval their electricity network and alternative control service prices for the upcoming regulatory year.<sup>2</sup> The AER approves a pricing proposal if:

- it is compliant with the requirements of the NER, the applicable distribution determination and tariff structure statement,<sup>3</sup> and
- all forecasts associated with the proposal are reasonable.<sup>4</sup>

However, each year we encounter a number of recurrent issues which impact our ability to approve pricing proposals within the legislative timelines. For example, in our compliance assessments, we regularly encounter issues that require distributors to resubmit their pricing proposals, or part thereof.

We note that in 2020 and 2021, only 2 of the 28 pricing proposals initially submitted were considered compliant and capable of being approved. For the remaining 26 pricing proposals, we required the distributors to resubmit them before they could be approved. Some key points from the pricing proposals received in 2020 and 2021:<sup>5</sup>

- 64% of proposals included input errors
- 64% of proposals included model errors
- 61% of proposals included compliance issues
- 54% of proposals included typographical and/or transcription errors that required correcting to be capable of approval.

The resubmission of pricing proposals increases the administrative burden for distributors and the AER. In most instances, the issue is minor and requires the distributor to resubmit a document and/or a model to address the issue. However, at times the issue is substantive which requires engaging with distributors, and at times other stakeholders, for resolution.

For each resubmission, the AER must perform a compliance check. If further issues are uncovered in the resubmitted proposals then another round of resubmissions and compliance checks can be required. The back-and-forth and/or further engagement processes are time consuming and puts at risk the AER's ability to approve pricing proposals within the regulatory requirement.

The timely approval of pricing proposals is important for a number of key stakeholders who need approved network tariffs as an input into their own processes.

- Retailers – to establish their retail offerings and meet their obligations under the Prohibiting Energy Market Misconduct (PEMM) Act

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<sup>2</sup> NER, s. 6.18.2

<sup>3</sup> NER, cl. 6.18.8(a)(1)

<sup>4</sup> NER, cl. 6.18.8(a)(3)

<sup>5</sup> Average times are measured from submission by businesses. On some occasions submissions have been received later than the regulated date (particularly in the height of COVID-19).

- AER – as part of the development of Default Market Offers
- State regulators– as part of jurisdictional regulation or other process, or, in the case of the Essential Service Commission, for the development of Victorian Default Offers.

The regulated timelines for the annual pricing process were established prior to the introduction of the Default Market Offer and PEMM Act. The current timing for approving pricing proposals, (generally around mid–May), does not reflect the needs of these key stakeholders. For example, the Default Market Offers are required to be published before 1 May, and therefore are unable to reflect approved network prices. Any delays in the process (as were experienced at the height of the COVID-19 pandemic) can create constraints on retailers in developing and communicating retail offerings prior to 1 July and maintain compliance with the PEMM Act.

In this paper, we discuss two issues with the pricing approval process where we consider improvements can be made to assist the distributors in submitting more compliant pricing proposals and the AER achieving more timely pricing approvals:

1. Timing – the constraints experienced under the current process, the increasing workload as Victoria transitions to financial years as regulatory years, and the conflicts with feeding into key stakeholders processes.
2. Presentation – the high frequency of input, modelling, and transcriptional errors, the administrative burden for both key stakeholders and the AER of considering varying models from distributors, and the impact of compliance issues within the constrained timelines.

## **Issues with timing**

The AER has to approve pricing proposals within constrained timelines. This timing can restrict the AER’s ability to engage on key areas of the proposals in detail, particularly when considering the other tasks to be undertaken within that time.

As a result, there are instances where the AER has needed more time than specified in the NER to be satisfied that a pricing proposal is compliant. In other instances, time pressures have resulted in errors not being identified, which has required corrections after publishing approved proposals. These outcomes are not desirable given the importance of timely (and accurate) approvals for stakeholders who rely on the outcomes of this process.

There are two distinct timelines which are set out in the NER.

For the first year of a regulatory control period, the NER states:

- a distributor must submit an initial pricing proposal within 15 business days (usually mid-May) after the AER publishes a distribution determination (usually in April)
- the AER must publish an approved initial pricing proposal as soon as practicable (usually early June).

For all other years of the regulatory control period, the NER states:

- a distributor must submit an annual pricing proposal at least 3 months before the start of the new regulatory year (by 31 March)

- the AER must publish an approved annual pricing proposal within 30 business days from the date of receipt of an annual pricing proposal (usually mid-May).

The annual pricing process is a resource intensive process for the AER. Within these timelines, we:

- review proposals for confidentiality and publish them on our website
- review proposals for compliance and reasonableness
- engage on areas of concern
- receive resubmitted proposals in response to issues raised
- review and publish resubmitted proposals approve proposals
- engage with stakeholders and publish approved proposals.

While the review of pricing proposals generally entail a compliance check, there are some more substantial analysis required to be able to approve a pricing proposal. The more substantial components include reviewing forecasts for reasonableness, reviewing compliance with the tariff structure statements, and considering sub-threshold tariffs.

This analysis can be time consuming, particularly where we have to engage with distributors on contentious or non-compliant aspects of their proposals. In these instances, we spend a significant amount of time issuing and assessing information requests as well as meeting with the distributors on these issues for resolution.

As a result, the distributors are also impacted as their responses to our requests and engagement increases their administrative burden. Because of the time constraints, we only allow distributors a short time to respond to our requests (sometimes within the day) making this an intensive process for them as well.

However, in our recent processes we have found that engagement with the distributors before they formally submit their pricing proposals has resulted in efficiencies in the pricing approval process. Through this engagement distributors have provided us with preliminary information relating to demand forecasts and more substantive aspects of their pricing proposals. This pre-engagement has resulted in less engagement being required on these elements during the constrained timelines of the formal approval process.

As discussed below, we propose to develop a more formalised pre-engagement process with the distributors to allow better engagement on these more substantial elements of the pricing proposal prior to formal submission. A more formalised pre-engagement process is expected to increase the likelihood that a pricing proposal submitted is compliant and capable of approval.

## **Issues with presentation of pricing proposals**

In addition to the timing constraints, our assessment of pricing proposals is further complicated by the wide range of documents and models distributors submit to support their proposals and to demonstrate compliance. The range of documents and models vary across distributors, each presents similar information in different ways and can include a variety of supporting information.

As a result, AER staff can spend a significant amount of time in the initial phases of an approval process familiarising themselves with the distributors' models and documents. This reduces the time available to undertake the compliance assessment. This time consuming 'discovery' phase is sub-optimal given the time constraints of the approval process.

The distributors are also impacted by the presentation of differing pricing proposals. Often we issue information requests to the distributors because we are unable to locate information or have misunderstood how a pricing model works. Responding to the information requests increases the administration burden for distributors.

We consider there is scope to improve the presentation of pricing proposals for approval which will reduce the administrative burden for distributors and the AER.



### 3 Pre-lodgement engagement

We propose to introduce a formal pre-lodgement engagement process between the AER and electricity distributors to develop a better process for the assessment of annual pricing approvals for years 2 to 5 of the regulatory control period.

We consider the introduction of a formal pre-lodgement engagement will assist in streamlining the formal pricing approval process. A formal pre-lodgement engagement process will allow engagement with distributors on key elements of pricing proposals that are known with some certainty in advance of their formal submission. Based on our experience to date, these elements would include forecast demand, proposed alternative control services prices, and other compliance elements of the pricing proposal such as impacts of jurisdictional scheme amounts.

Early engagement on these elements will reduce the strain on resources within the formal timelines, by reducing the time the AER requires to review proposals and the amount of engagement with distributors on these issues once formally submitted. In our experience, we observe benefits for the distributors in receiving less information requests from the AER and fewer resubmissions of proposals.

Additionally, we will also consider the opportunity for distributors to submit preliminary pricing proposals, as well as for the AER to pre-fill inputs in the standardised model template. As discussed below, we see this as an opportunity to test the standardised model template for the 2022-23 pricing approval process.

We also consider that earlier engagement will increase the likelihood of compliant proposals being submitted in the first instance that are capable of being approved. This may provide for the opportunity for earlier publication of approved pricing proposals which will benefit the distributors, stakeholders and the AER. In particular, earlier publication of approved pricing proposals will be of particular benefit to stakeholders that rely on approved network prices, such as the DMO and Victorian Default Offer, as well as retailers.

In future phases of this review, we will consider how a pre-lodgement process might be incorporated into the pricing approval process in the first year of a regulatory control period, or what other opportunities may be available.

#### **Opportunities**

The following sets out the pre-lodgement engagement opportunities for distributors, stakeholders and the AER:

- earlier engagement on forecasts – ability for the AER to undertake better and more rigorous analysis on forecasts, such as forecast demand
- earlier engagement on more substantial components of pricing proposals – ability for the AER to engage with distributors in less constrained timelines, allowing distributors to provide more detailed and structured information in response to the AER's queries

- earlier engagement on tariff structure statements – ability for the AER to engage with distributors on more substantial compliance issues and work to a more constructive outcome where relevant
- submission of a preliminary pricing proposal – ability for the AER and distributors to work through potential issues, including confidentiality concerns, in a less constrained timeline
- AER pre-filling models with known inputs – reduces the burden on distributors, and allows the AER to identify any potential issues with inputs or other components earlier in the process.

## Proposed pre-lodgement process

The following sets out our proposed timing for the pre-lodgement engagement process:<sup>6</sup>

- Before 4 February (at least 8 weeks prior to submission) – AER to provide model template with available inputs pre-filled for preliminary pricing proposals.
- Before 18 February (at least 6 weeks prior to submission) – distributors submit preliminary pricing proposal including:
  - actual year t-2 data
  - best estimate year t-1 data (we propose these estimates reflect actuals for the first 6 months of the year)
  - forecast year t data
  - placeholder inputs where inputs not known (e.g. WACC, x-factor, STPIS, etc.).
- Between 18 February and 18 March – AER to review and engage with distributors on preliminary pricing proposals, with particular attention to:
  - forecast year t data (forecast demand, forecast designated pricing proposal costs, forecast jurisdictional scheme amounts)
  - estimated year t-1 data (estimated demand and resulting estimated revenues)
  - tariff structure statement compliance
  - sub-threshold tariffs
  - proposed new alternative control services
  - under/over-recoveries and impacts.
- Before 18 March (at least 2 weeks prior to submission) – AER to provide model template with finalised inputs and any appropriate adjustments resulting from pre-lodgement engagement.
- Before 1 April (at least 3 months prior to the commencement of the new regulatory year) – distributors submit pricing proposal with any updated data and any

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<sup>6</sup> In 2022, the pre-lodgement process will allow us to test the standardised model template prior to final submissions before 1 April. In subsequent years we will also have the opportunity to test any updates to the model through the pre-lodgement process.

appropriate adjustments resulting from pre-lodgement engagement. We expect that estimated and forecast demand are unchanged from the preliminary pricing proposal except in response to the AER's queries.

We do not consider that the preliminary pricing proposals or pre-filled model templates provided by the AER need to be published as a part of the pre-lodgement engagement process. We intend to continue the current process of publishing the formal submissions, resubmissions, and approved pricing proposals, as per the NER requirements.<sup>7</sup>

## **Opportunity for feedback**

We are seeking feedback on our suggested process for pre-lodgement engagement. We are interested in views on the following:

- proposed timelines for pre-lodgement engagement
- the availability of data at the proposed preliminary pricing proposal submission date
- how much (and what) data could be expected to change between preliminary and final pricing proposal submissions
- whether a guideline should be in place for estimating year t-1 demand and revenues (e.g. we propose actual data is to be used for the first 6 months, and estimated data used for the final 6 months)
- whether the pre-filling of inputs would be beneficial to distributors or cause additional burden
- other suggestions that could improve the pre-lodgement process
- preliminary thoughts on options for pre-lodgement processes in the first year of the regulatory control period
- preliminary thoughts on other options mentioned in relation to managing the relationship of initial pricing timelines and other processes.

## **Preliminary views on improving first year pricing approvals**

Where a distributor is entering the first year of a new regulatory control period, they are generally required to submit 'initial' pricing proposals in late May, 15 business days after the relevant determination is published. Because of this timing, it is not possible to undertake the same pre-lodgement engagement process as set out above. Largely because a number of elements (such as tariff structure statements, allowed revenues, alternative control services price caps) are not available until the final determination is made in late April.

In future development work, we will consider alternate timelines for the initial pricing process, such as the possibility of receiving preliminary pricing proposals once relevant parts of the determination is settled. We intend to progress this work in time for the 2024/25 pricing process when we will receive the next first year pricing proposals from distributors.

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<sup>7</sup> NER cl. 6.18.2(c); NER cl. 6.18.8(c3).

However, our preliminary views on options to improve the timing of first year pricing approvals are:

- submission of indicative pricing schedules by distributors for publication in the final determination reflecting final decision revenues
- shifting regulatory determination timelines forward by 1-2 months (including shifting averaging periods forward by the same amount of time)
- a later publication of the DMO in those instances, and setting the expectation for annual price changes from retailers to occur on 1 August rather than 1 July.

We welcome any views on these options.

## 4 Standardised Model Template

In addition to the pre-lodgement engagement process, we intend to introduce a standardised model template to assist distributors with their submissions, create efficiencies in the AER's approval process and improve stakeholder understanding of our pricing approval outcomes.

In our experience with the Victorian distributors, a standardised model template will allow:

- the AER to pre-fill known information into the model to reduce the amount of data entry required by the distributors
- development of built-in automated calculations and compliance checks in the model to highlight and reduce data input errors as well as streamlining our assessment process
- greater familiarity with the models to increase our understanding of submitted proposals. This will result in less engagement with (and therefore less burden on) distributors during the constrained timing of the approval process.

We intend to develop the model template in consultation with the distributors to develop agreed set expectations on the information the AER requires and how the model can demonstrate compliance. This will reduce the disparity that exists at times between what is submitted by distributors and what is required for the AER to determine compliance.

The standardised model template will reduce the risk of input, model, and compliance issues that are currently a large component of our engagement with distributors after submission. In turn, the use of the standardised model template will increase the likelihood of compliant proposals being submitted by 1 April that are capable of approval.

A substantial benefit will be the ability to develop a universal guideline for the review of pricing proposals, creating time efficiencies in the review.

We intend to develop the standardised model template for use by distributors for their 2022/23 pricing proposals. We propose that distributors submit the standardised model with preliminary information as part of the pre-lodgement engagement process to allow the AER and distributors to test the functionality of the model.

Additionally, we propose to develop a model that produces outputs that are of greater use to distributors and the AER, as well as key stakeholders. We will initiate progressing our views on this with the distributors as part of the standardised model template development. We will further this part of the model by engaging stakeholders following the 2022/23 pricing process.

This process is expected to produce a first version of the model in December, for use in the 2022/23 pricing proposals. A second version, focusing on improving the outputs of the model, will be produced after the 2022/23 pricing process, and will allow for any revisions to be made for functionality issues that arose in the 2022/23 pricing process.

We expect that the model is then updated and published in line with the regulatory determination process for each business every 5 years. This will allow for any changes to be made in line with the regulatory determination. For example, the upcoming 2024–29 regulatory determinations for NSW, ACT, NT and Tasmanian business are expected to

incorporate any changes that result from our upcoming review of the application of side constraints, and revisions to the model would be made alongside the determination for use in the year 1 pricing process.

## **Opportunities**

While we consider that the introduction of a standardised model template will assist the AER with streamlining the review process, we consider that there are also benefits to the distributors, as well as key stakeholders. The opportunities for the distributors, stakeholders and the AER include:

- prescribed inputs and required information – removing unnecessary inputs and reducing the need to request further information from distributors
- model including only necessary components – removing unnecessary burden for distributors
- AER potentially pre-filling models with known inputs – reduces the burden on distributors, and reduces necessity to engage with distributors on disputed inputs
- set calculations and application of mechanisms – removes the need for the AER to review the model itself during the pricing process
- consistent inputs, presentation, and outputs – creates efficiencies within the AER for introducing staff to the process and reviewing; increased ability for stakeholders to interpret the model
- prescribed calculations and outputs – automatic analysis can be built into the model for transparency as well as creating efficiencies, easier interpretation for stakeholders
- defined bill impact analysis – consistency in messaging between distributors and the AER
- built-in analysis for other processes (DMO, PEMM) – reduce data requests to distributors, create efficiencies within the AER and reduce risk of error
- built-in compliance checks – ease of review and interpretation, reduces risk of ongoing engagement during process as distributor can identify initial compliance through these checks
- prescribed outputs – distributors can use outputs for pricing proposal documents, reduced incidence of excess information, consistency in presentation of tariffs, etc.

We consider there are further opportunities in providing standardised templates for pricing proposal documents as well, and will engage further on this at a later stage.

## **Experience with the Victorian standardised model**

The Victorian distributors have been using a standardised model template with pre-filled inputs for some time, and benefits have been realised.

We note that in the 2020 and 2021 years, only 40% of Victorian proposals had model errors in contrast to 78% of non-Victorian proposals.<sup>8</sup> Because the model is familiar, AER staff have been able to engage the Victorian distributors with initial queries on average 7 business days after initial submission, in contrast to 11 days for non-Victorian distributors.

These efficiencies have improved our timing for approving the Victorian pricing proposals.

## **Cost movement analysis**

In terms of outputs from our pricing approvals, the AER is expected to report expected customer bill impacts as a result of approving prices for the upcoming regulatory year. Distributors generally also report these expected impacts.

However, it is common for the expected impacts to vary between the AER and the distributors as a result of differing methodologies, consumption profiles, or even the inclusion of metering charges.

In creating a standardised model template, we propose to explore a common approach to calculate the cost movement analysis that produces these expected impacts and build this functionality into the model template. A common approach will provide more consistent reporting which will create greater transparency for stakeholders.

As part of this development, we will investigate including analysis on a wider range of tariffs (such as time of use tariffs) and/or easy adjustment of contributing factors to the calculations. We intend to further the reporting of cost movement analysis by engaging stakeholders following the 2022/23 pricing process.

## **Side constraints**

Currently the distributors have different interpretations and applications of the side constraint mechanism as set out in the AER distribution determinations. As noted, we are intending to undertake a review of this issue in the future. As part of this review, we intend to develop a consistent interpretation and application across all distributors in their pricing proposals.

As a result, the model will initially be developed with some flexibility regarding the application of side constraints (that is, for the 2022/23 approval process). Following the side constraints review, we will endeavour to implement the resulting approach into the model in line with the relevant changes in the next regulatory determination for each distributor.

## **Opportunity for feedback**

We are seeking feedback on our process for standardising the model, as well as the model itself. We are interested in views on the following:

- the draft standardised model template:
  - functionality and layout
  - proposed inputs

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<sup>8</sup> Some modelling errors were encountered for Victoria in adjusting the model to transition to financial years and in introducing elements of the new 2021–26 regulatory control period.

- application of mechanisms and calculations within the model
  - outputs and reporting
  - built-in compliance and error checks
- the indicative timelines and two-stage process (set out in section 5)
- the intended approach to cost movements analysis
- the application of side constraints in pricing proposals for the current regulatory period
- the intention to develop standardised templates for the main pricing proposal document at a later stage.



## 5 Timelines

The key timelines for this review are set out in the table below.

The process for considering the formalisation of a pre-lodgement engagement process is expected to be completed by December 2021, to be applied in the 2022/23 pricing process from February. There will be some consideration of the pre-lodgement engagement process after the 2022/23 pricing process and feedback will be encouraged from distributors.

The standardised model template will be developed in two main stages.

We expect to complete the first stage of developing a standardised model template for use in the 2022/23 pricing process by the end of 2021. The intention of this process is to develop a model template that is fit-for-purpose, and delivers on the needs for the distributors and the AER to propose and approve pricing proposals, respectively.

We expect the second stage to occur from June–December 2022. The intention for this stage of the review is to engage a broader group of stakeholders and further develop the model, or develop additional models, to deliver on the needs of those stakeholders through reports and outputs, as well as general transparency. This stage will also allow for the model template to be revised for any issues that arose in the 2022/23 pricing process.

Key steps	Indicative dates
Publish draft position paper and model (v0.1)	27 August 2021
Workshop 1 (for this position paper and standardised model)	13 September 2021
Feedback on position paper and model	24 September 2021
Workshop 2 (for submissions on this paper)	13 October 2021
Distribute updated model (v0.2)	15 October 2021
Workshop 3 (for standardised model only)	4 November 2021
Feedback on updated model (v0.2)	12 November 2021
Distribute updated model for quality assurance (v0.3)	26 November 2021
Distribute decision paper and final model (v1.0)	17 December 2021
AER provides 2022/23 model template with pre-filled inputs	Before 4 February 2022
Distributors submit preliminary 2022/23 pricing proposals	Before 18 February 2022
AER provides 2022/23 model template updated for final inputs	Before 18 March 2022
Distributors submit 2022/23 pricing proposals	Before 1 April 2022
AER publishes approved 2022/23 pricing proposals	Before 18 May 2022
Initiate second stage (internal and external stakeholder consultation)	June 2022
AER reviews pre-lodgement engagement process	July 2022
Finalise second stage and publish updated model (v2.0)	December 2022