



NEW REG: TOWARDS CONSUMER-CENTRIC ENERGY NETWORK REGULATION

A joint initiative of the Australian Energy Regulator,
Energy Consumers Australia, and Energy Networks
Australia

Approach Paper
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1. INTRODUCTION

In June 2017 the Australian Energy Regulator (AER), Energy Networks Australia and Energy Consumers Australia agreed to establish a project aimed at improving engagement on network revenue proposals, and to identify opportunities for regulatory innovation.

The overall vision for the project is that energy consumers' priorities and stated preferences should drive, and be seen to drive, energy network businesses proposals and regulatory outcomes. We believe there are significant opportunities to better incorporate consumer preferences in revenue determination processes, and to improve consumer trust and confidence in network regulation. Further, there is scope to improve the efficiency and effectiveness of the regulatory process.

The project is proposing a new dialogue and a better process to align interests so that revenue proposals and AER determinations reflect the interests of consumers. This will also provide consumers with confidence that the network revenue is no more than necessary. Other regulatory processes associated with revenue determinations, such as tariff structures, can also benefit from an innovative approach to consultation.

Consumers need to be partners in regulatory processes – respected, recognised and “rewarded” with outcomes about which they can be absolutely confident provide the services they want at an efficient cost (lowest cost that delivers the services consumers want).

A process that puts consumers at the centre of the regulatory process will benefit network businesses and the regulator.

Upfront agreement that the network business revenue proposal reflects consumer interests provides greater certainty than lengthy and detailed regulatory processes about what the long term interests of consumers are.

A new regulatory process also needs to support the transformations occurring in the energy sector. Consumers now have additional choices they can exercise to express their preferences through investments in generation and storage technologies.

Networks have not been participants in competitive markets; they have not been subject to the direct and immediate market consequences faced in competitive markets from failure to understand end user preferences. Part of the function of economic regulation is to seek to deliver outcomes consistent with those in normal markets.

In the transforming energy sector, network businesses will benefit from enhanced opportunities to understand the preferences of, and meeting the needs of, their end-consumers.

Success in this project will be reflected in a qualitatively different culture by all parties – consumers, networks and the regulator.

The aspirations above are captured in the project name *NewReg: towards consumer-centric energy network regulation*.

2. PROJECT OUTLINE

Starting from the principles of putting consumers at the centre of regulatory outcomes, the benefits that all parties can obtain and our desire to be innovative, we announced in August¹ our joint initiative to explore options for residential and business consumers to have more influence in the development and approval of regulatory proposals. We said then that this may lead to developing an alternative path for network businesses to take in forming their regulatory proposals, and for the AER in approving those proposals.

We have looked at ways for the AER to closely engage with the network businesses and consumers to identify key issues earlier, and work collaboratively to resolve them even before a regulatory proposal is lodged. As part of the regulatory decision making process under the National Electricity Rules, the AER may have regard to the degree of agreement reached between the business and customer representatives and the reasoning for that agreement. Also, where the AER considers it appropriate it may streamline or expedite the decision making process.

In our August announcement we said that we would be pursuing an experimental approach to promote regulatory innovation. We said:

We intend to learn by 'doing'. The goal is to undertake a trial in the development of one or more network businesses' revenue proposals in the near future, and consider further reform opportunities. This process of exploration will be an important outcome of the joint initiative.

This is the path we are pursuing. This Approach Paper provides an overview of the project, project governance and an explanation of how we are proceeding.

To guide the project the three organisations have formed a Program Board comprising the CEO of each organisation, Anne Pearson (the CEO of the AEMC) and Sandra Gamble. A Project Team led by Anthony Bell (AER), Garth Crawford (Energy Networks Australia) and David Havyatt (ECA) together with other resources from our organisations has developed the proposed approach to deliver on our visions and objectives. Mark McLeish is now taking over Anthony Bell's role for the AER. A wider Reference Group has also been formed to allow the Project Team to closely consult with key stakeholders throughout the development of the project (see Appendix A – List of Reference Group Members).

We also said that we would consult with our stakeholders, including through a discussion paper, workshop and public submissions process. Our Reference Group asked us to reconsider the approach of a discussion paper and public submissions and to consider alternative means of effectively engaging with stakeholders.

Consequently, and in keeping with the principle of 'learning by doing,' we are releasing along with this Approach Paper a Directions Paper rather than a discussion paper. The Directions Paper sets out an alternative process that we are aiming to trial.

The Project Team will continue to engage with stakeholders on this project and on the trialling of the NewReg process.

¹ Put in all three links <http://energyconsumersaustralia.com.au/news/working-together-improve-engagement-network-revenue-proposals/>

Also in keeping with the experimental approach, the Project Team has invited businesses that are about to commence revenue proposal development to trial the approach. AusNet Services has agreed in principle to undertake a trial.

The nature of this trial is that it will not be limited by the process outlined in the Directions Paper if the experience in implementation provides sound reasons for trying a different approach.

All this is being conducted within the framework of the existing Rules and Guidelines. Nothing in the trial will reduce the ability of any consumer or advocacy body, or the AER's Customer Challenge Panel to have their view on the network regulatory proposal heard. It is the Project Team's hope and expectation that the model in the revised process will provide an opportunity for those perspectives to be heard, considered and responded to by the network business as part of the proposal that is submitted to the AER.

A goal of the project is to identify ways the Rules can facilitate greater engagement and innovation. The experience of the trial will inform any Rule change proposal. Any such proposal would go through the normal processes for Rule changes.

3. WHAT PROBLEM ARE WE SOLVING?

This section discusses the need for change drawing on the general observations of the parties. It observes poor outcomes of the current regulatory process (section 3.1) and considers the role of negotiation in the regulation of utilities. Opportunities for improvement are identified based on these observations (section 3.2).

3.1 Observations on the current regulatory process

The forms and processes of engagement for network revenue determinations continue to evolve, including in the way the network businesses develop their proposals and the AER makes decisions. Since the Better Regulation package in 2013 network businesses have been developing their consumer engagement approaches². The AER's Consumer Challenge Panel has also contributed an additional consumer perspective in the process.

Nevertheless, stakeholders make some of (or all of) these observations about the current regulatory process:

- The regulatory process has an adversarial nature.
- The regulatory framework is complex, network businesses need to communicate a highly complex set of issues and trade-offs with consumers and consumers find it challenging to ensure their perspective is heard.
- It is unclear that network revenue proposals adequately reflect consumer interests.
- The process does not result in a narrowing of issues as proposals work through the approval process.

Further incremental development will continue to improve the process and outcomes. However, the pace of development may not be sufficient to meet the changing needs of the sector.

² As reflected in the quality of submissions for the Energy Consumers Australia, Consumer Engagement Award recently presented in Canberra.

The project has considered relevant regulatory processes and reforms internationally including long standing practices in the United States energy sector; and recent reforms in the United Kingdom energy and water sectors including the specific case of Scottish Water,

The project also examined lessons from energy network engagement to date and recent reforms in the Victorian water sector.

These reforms suggest a more central role for networks gaining the agreement of consumers to the revenue proposal before it is considered by the regulator is worth trialling in energy regulation in Australia. In the literature this is often referred to by its North American name of ‘negotiated settlement.’

The term ‘negotiation’ means ‘a discussion aimed at reaching an agreement’. However, we want to distinguish what we are doing in the NewReg project from the use of the word ‘negotiate’ in other contexts:

1. In the Australian energy regulation context existing negotiate and arbitrate regulatory frameworks already apply to:
 - a. non-scheme gas pipelines under the newly established part 23 of the *National Gas Law*, and existing scheme pipelines under part 12, and
 - b. certain electricity network services, like public lighting and some network connection activities, that have historically been regulated as negotiated services, although this regulatory treatment has changed in more recent AER decisions.
2. In the more general Australian infrastructure access context the negotiate-arbitrate model refers to a specific process under Part IIIA of the *Competition and Consumer Act 2010* which is also used in other settings.

‘Negotiation’ can have a negative connotation of bargaining, of each party conceding, rather than a process of discovery of outcomes that maximise the benefit for all parties (i.e. collaborative optimisation). Our interest in negotiation is in seeking alignment and agreement, which may involve or go beyond give and take bargaining. Negotiation in our context should allow parties to think across different elements of a building block proposal and allow more space for creative trade-offs and ‘win-win’ outcomes.

Negotiation in international cases

Negotiation is not at all an unusual or foreign element of monopoly price regulation processes, either in Australia or overseas.

Overseas, particularly in the United States, public utility regulatory frameworks have long involved some form of facilitated negotiation either before or during the public utility hearing process. For example, the Regulatory Assistance Project, in its report summarising public utility regulation processes in the US mentions that it is common for the parties to be encouraged to enter into negotiations with the aim of reaching agreement, to expedite the overall regulatory process.

Once the testimony of all parties is filed (or even before), it is common for the parties to enter into settlement negotiations, with the goal of presenting an agreed position on all

issues (or a partial settlement on some issues) to the commission. This gives interveners an opportunity to have an important influence on the final result. All parties normally participate in settlement negotiations, and 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 all of the parties the time and expense of the expert-witness hearings. It also typically gets the utility a rate decision sooner than going all the way through the six-to-12-month hearing process.

The majority of states in the United States have established some form of funded body for the explicit task of representing consumer interests in negotiations with public utilities in regulatory proceedings. In some cases in the US, the sheer volume of cases has overwhelmed the regulatory agencies, making negotiated settlements a matter of necessity rather than desirability. Mountain (2013), drawing on the work of Prof Littlechild summarises the experience of FERC as follows:

FERC introduced settlements of gas pipelines in the 1960s in response to legislation that resulted in an unmanageably large workload. Settlement became increasingly popular so that now it is the predominant method for setting rates in gas pipelines and interstate electricity transmission. More than 90% of rate cases for gas pipelines are currently established through settlement. The relevant laws require FERC to give priority to settlement.

There is also some recent experience with negotiated settlement approaches in the UK. In the mid-2000s, so-called 'constructive engagement' was trialled by the UK Civil Aviation Authority (the UK Airport regulator) to promote agreement on key elements of the regulatory proposal for airports. More recently a form of negotiation was trialled in the water industry in Scotland. That experiment involved the creation of a Customer Forum to represent customers in negotiation with the monopoly business, Scottish Water. As Havyatt (2016) notes the Customer Forum successfully agreed a business plan which formed the basis of the regulatory decision:

In October 2012 the Customer Forum was asked to agree a Business Plan with Scottish Water, consistent with Ministerial Objectives and with guidance notes from WICS. In January 2014 this agreement on the Business Plan was reached, and in March 2014 WICS made a Draft Determination consistent with that plan.

That the agreed Business Plan was the basis for the Draft Determination is a strong recommendation for the processes adopted in this case. Two specific outcomes are important to note. The first is that the Forum successfully dealt with a proposition from Scottish Water to increase reliability by interconnecting more water systems. The conclusion was that customers were not prepared to pay as much for this as Scottish Water originally planned to spend. The second was the inclusion in the Business Plan of two new measures on Scottish Water; a Customer Experience Measure and the High Esteem Test. In addition Scottish Water set higher targets for its Overall Performance Assessment.

Despite the fact that direct negotiation between customers and regulated network businesses for their main energy transportation services has not been a major feature of the regulatory framework for energy networks in Australia in the past, there is considerable evidence of negotiation being a key element of regulatory frameworks overseas and offers promise to

improve confidence in and the quality of regulatory outcomes for the long-term interests of consumers.

The parties believe there is scope to learn from this international experience to develop a process in which a network business and its consumers aim to reach agreement on the revenue proposal. We envisage that through discussion, the network businesses and their customers will better understand each other's interests and therefore will be better placed to reach an agreement which is mutually beneficial.

It is important to recognise that these discussions do not take the place of regulation, or eliminate the need for regulation and regulator. Rather this negotiation occurs against the backdrop of the regulatory process; it supplements rather than replaces the existing regulatory process.

The overall objective of each of the energy market laws is economic efficiency to promote the long term interests of consumers. In the ordinary regulatory process, the regulator has to infer what those consumer interests are; the process of negotiation allows those interests to be revealed to both the regulator and the network business.

While any reform to energy regulatory processes will need to take account of the Australian context, the international examples above provide confidence that the proposed direction for change is right. In particular the UK cases have usefully provided precedents for developing the details of any new arrangements.

3.2 Opportunities for improvement

Reflecting on these outcomes and international regulatory developments, the parties consider that there are significant opportunities for improvement in Australia's energy network regulatory processes.

From a consumer perspective (noting that experience varies across different regulatory determinations), there are opportunities to improve confidence that:

- all the issues that are important to consumers in each regulatory proposal have been identified and understood;
- the consumer voice is being adequately heard in the regulatory process, considered, and reflected in the final regulatory decisions, including that consumers understand the regulatory process itself, and thereby know how best to make a productive contribution to a particular network's determination process; and
- consumers are paying no more than they need to for network services.

From a network perspective there are opportunities to:

- reach agreement between the network and consumers on certain matters early in the regulatory process and find ways for the AER to indicate that it will support such agreements in its subsequent review – this would positively affect the incentives for networks to maximise engagement with consumers, and aid consumers' confidence that their views will be carried in determinations;
- improve planning for future network transformation issues to ensure networks develop services that consumers will seek or value; and

- improve the efficiency of regulatory effort by network business in preparing regulatory proposals.

From the AER's perspective:

- revenue proposals will have been subject to greater scrutiny and consideration before they are submitted, and
- the ability to play a greater role as a facilitator of industry transformation rather than simply policing a set of rules.

4. THE PROPOSED APPROACH

The Directions Paper sets out the process for an alternative regulatory approach that we wish to trial. The process has been developed using experiences in international approaches. It seeks to materially augment and complement networks' existing reset and business-as-usual engagement activities, not replace these. The project expects a scale shift in the extent and magnitude of engagement activities.

4.1 The design of the process

The overarching principle in the design of the process is the opportunity for a network to reach agreement with its consumers on its revenue proposal resulting in a regulatory proposal that reflected consumer preferences.

We are conscious that we are seeking an innovative approach and do not want to be so prescriptive that the network business, consumers or the regulator can't try different approaches. Nevertheless, there are certain elements to the model that need to exist to fulfil the objective. In the Directions Paper we outline the elements of the process in more detail.

In this section we simply outline the elements in the process and the reasons for their inclusion.

- **The Counterparty**
The most significant departure from the current practice is that the network is seeking to present the AER with a revenue proposal, which has been developed and agreed with the network's consumers. As such, the network needs an entity with which it can reach agreement with. This entity is called the *Consumer Forum*, although we note that the title is unimportant. What is important is that this entity can be credibly seen to represent the perspective and interests of consumer. In this context we mean 'consumer' in the same way as it is used in the National Electricity Objective; which is all end users, be they residential, small business or commercial and industrial.
- **The Plan**
A network business could change the way it conducts its engagement and seek to end with a formal agreement of some kind. But in doing so there is no 'buy in' from the regulator on that outcome.
The process proposed seeks to create a basis on which the regulator can be involved early and assist the network and consumers to reach an agreement to which the AER can have regard to when considering the network's revenue proposal.
To do so we think the starting point is for the network to set out the process by which it will create the Consumer Forum and how the revenue proposal will be developed to reach agreement with the Consumer Forum.

- **Governance and Support**
The governance arrangements for the Consumer Forum need to promote independence, transparency and accountability. The Consumer Forum also needs support from both the business and the AER to be able to form a view on the revenue proposal.
- **The Consumer Perspective**
The Consumer Forum is not 'representing consumers', it is representing the consumer perspective. It is not composed of people selected from consumer constituencies. Its function is to take information from a wide variety of sources to develop a composite view of consumer preferences. The Consumer Forum needs to satisfy itself that it, and the network business, are properly researching consumer preferences and that this information is properly incorporated in the development of the revenue proposal.
- **Reaching Agreement**
The core outcome is the extent to which the Consumer Forum agrees to the network's revenue proposal. The extent of that agreement (or disagreement) needs to be formally reported to the AER (and all other stakeholders) together with the basis for reaching that agreement.

4.2 The trial

We want to understand how these innovations will work in practice. To that end the process will be trialled with one or more network businesses. So far, AusNet Services has agreed to trial the process for its Victorian electricity distribution business.

The objectives of trials are:

1. To successfully apply the proposed process to produce a revenue proposal that reflects consumer preferences and provides the regulator with a proposal with which it will be able to substantially agree.
2. To improve understanding of the prerequisites for a successful alternative regulatory process - for example, 'respect' and 'trust' are likely to be foundations of constructive negotiation.
3. To understand how much of the alternative regulatory process needs to be determined as a standard approach, and how much flexibility can be provided for individual arrangements, including:
 - a. the scope - matters to be included and excluded
 - b. the steps to be followed
 - c. the roles and relationships of the parties.
4. To gain a stronger understanding of the role that the AER should take to facilitate and develop the alternative regulatory process
5. At the completion of the trial to prepare a report for stakeholders on learnings; areas of future development and improvement.

The Project Team is developing a more detailed plan for how trials will be evaluated.

5. ONGOING REVIEW AND KEY CONTACTS

As discussed above, the Directions Paper has been released together with this Approach Paper.

The intention of the Directions Paper is to provide the framework to be used by a network business proposing to trial the process. It will be subject of ongoing review as the Project Team gathers further stakeholder responses and as businesses trialling the process seek further clarification.

Accordingly, stakeholders are encouraged to contact any of the Project Team members at any time:

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