
An Improved Approach to Network Regulation

Paper for discussion

18 February 2016





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Executive Summary

This paper considers whether changes could be introduced to the regulatory framework that would provide for a lighter handed, less adversarial approach to setting electricity network revenues. This initiative has been prompted by ElectraNet's discussions with the AER and UnitingCare Australia, as a member of ElectraNet's newly formed Consumer Advisory Panel.

UnitingCare Australia has made a number of valid criticisms of the current regulatory framework. UnitingCare Australia argues that better regulatory outcomes could be achieved if customers and networks are allowed to negotiate and the regulator oversees this process. Case studies from the UK demonstrate that this type of approach – referred to as 'negotiated settlement' – is capable of delivering substantial benefits compared to traditional CPI-X regulation in which the regulator is the decision maker.

UnitingCare Australia's proposal (referred to as Option 2 in this paper) has strong conceptual appeal. In effect, it would put customers in the driver's seat in negotiating regulated outcomes. However, the proposal is a radical departure from the AER's current role, which is mandated by the National Electricity Law and National Electricity Rules. The proposal therefore cannot be implemented without changes to these regulatory instruments.

Furthermore, it is likely to be complex and controversial to establish governance arrangements that ensure the negotiation process is fair and inclusive. As ElectraNet's Revenue Proposal must be submitted in January 2017, it is not possible to resolve and implement these processes in the time available. Given these constraints, it is not feasible to introduce a negotiation process, even in some limited form.

We consider two other options to improve the current framework and address the issues raised by UnitingCare Australia.

One credible approach (Option 1) is to maintain the Status Quo and improve its operation by:

- Reinvigorating the AER's 'first pass assessment' of the company's expenditure forecasts. This approach would enable the AER to adopt 'fast track' regulation if the forecasts were well-justified; and
- Enhancing the consumer engagement process, ensuring that customer perspectives are fully reflected in the company's plans.

This approach has merit, but it partly relies on the AER having sufficient time to conduct a 'first pass assessment' early in the review process.

To address this issue, an alternative approach (Option 3) is to publish a Preliminary Revenue Proposal 2 months prior to the formal submission date as a Fast Track Approach. While this option may present challenges to ElectraNet and the Consumer Advisory Panel in shortening the time available to finalise the expenditure forecasts, it may better facilitate the fast tracking process. On balance, this approach is recommended as the most achievable option to deliver on the objectives identified by UnitingCare Australia.



1 Introduction

ElectraNet is currently preparing for its 2018-2023 revenue reset. The company must submit its Revenue Proposal by 31 January 2017.

ElectraNet has established a Consumer Advisory Panel to assist in developing its consumer engagement plan and to provide input to the Revenue Proposal. Lin Hatfield-Dodds, CEO of UnitingCare Australia¹ has written to ElectraNet making the following observations regarding the current regulatory process²:

“Having been heavily involved in energy network regulatory processes over the past 5 years, including the 2012 rule changes, we are convinced that, compared with current arrangements, better outcomes for consumers and network businesses can be achieved by direct engagement between network businesses and consumer representatives by using deliberative and negotiation processes.

[...]

We believe that ElectraNet is ideally placed to take some steps towards applying a negotiation approach to their next revenue proposal.”

We understand that the Australian Energy Regulator (AER) and ElectraNet would also support a less adversarial and resource intensive regulatory approach. The purpose of this paper is to examine the case for change and feasible options, recognising the constraints of the current Rules and the National Electricity Law.

The remainder of this paper is structured as follows:

- Section 2 sets out high level objectives that define ‘better outcomes’;
- Section 3 recaps on the current regulatory regime and the concerns raised;
- Section 4 considers recent regulatory developments in UK water, airports and electricity sectors;
- Section 5 examines alternative options for improving the current regime, including UnitingCare Australia’s proposal. It concludes with our recommendation.

¹ UnitingCare Australia is the national body for the UnitingCare Network, one of the largest providers of community services in Australia and a member of ElectraNet’s Consumer Advisory Panel.

² Draft letter from Lin Hatfield-Dodds to ElectraNet CEO Steve Masters.



2 High level objectives

UnitingCare Australia has outlined a proposal for an alternative regulatory framework, which it describes as “deliberation, negotiation, and agreement (DNA)”. The high level objective of the proposed approach is to deliver “better outcomes for consumers and network businesses”³.

In considering what might make a ‘better’ outcome, it is important to bear in mind that the outcomes must be consistent with the National Electricity Objective (NEO), which is⁴:

“...to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to—

- (a) price, quality, safety, reliability and security of supply of electricity; and
- (b) the reliability, safety and security of the national electricity system.”

Having regard to the NEO, we suggest that ‘better outcomes’ could be achieved through one or more of the following improvements compared to the current regulatory regime:

- **Reduced resources** engaged in the current regulatory process;
- **Improved shared understanding** of network challenges and customer concerns through enhanced consumer engagement;
- **More efficient** expenditure plans that better reflect customers’ preferences;
- **Greater trust and confidence** in the regulatory outcomes;
- **Increased certainty** in the regulatory outcomes, with ‘no surprises’; and
- **Faster resolution** by delivering an acceptable regulatory outcome sooner.

While these objectives describe what a ‘better outcome’ looks like, any proposal for change should be focused on addressing specific problems with the current regime. Similar to the AEMC’s formal process for assessing a Rule change proposal, it is helpful to address two questions:

1. What issues or problems arise from the current regulatory framework?
2. What is the best approach for resolving the identified issues?

The next section focuses on the first question. We answer the second question by examining options for improvement in section 5, which are informed by a short discussion of recent regulatory developments in the UK in section 4.

³ Ibid.

⁴ NEL, section16(1)(a).



3 Issues arising from the current regulatory framework

This section starts with a brief description of the current regulatory framework. This is followed by an analysis of the criticisms made by UnitingCare Australia.

3.1 Key features of the current regulatory framework

The National Electricity Law and Rules impose specific obligations on the AER to ensure that it regulates transmission and distribution electricity networks in a manner that gives effect to the NEO⁵. It is worth recalling that the prescriptive nature of the current regime was a response to the perceived shortcomings of transmission regulation prior to the establishment of the AER. In other words, it reflects conscious design decisions, which were informed by experience and extensive stakeholder consultation.

In 2012, the AEMC introduced further Rule changes that sought to improve the regulatory framework. These changes - implemented through the 'Better Regulation' programme - clarified the AER's role in assessing expenditure forecasts, and strengthened the role of benchmarking and consumer engagement in the regulatory process.

The Rules now require the AER to consider the following factors⁶ in assessing whether the company's expenditure forecasts satisfy the expenditure criteria and objectives that are also specified in the Rules:

- (1) the most recent annual benchmarking report and the benchmark expenditure that would be incurred by an efficient network company over the relevant regulatory control period;
- (2) the actual and expected expenditure of the network company during any preceding *regulatory control periods*;
- (3) the extent to which the expenditure forecast includes expenditure to address the concerns of electricity consumers as identified by the TNSP in the course of its engagement with electricity consumers;
- (4) the relative prices of operating and capital inputs; and
- (5) the substitution possibilities between operating and capital expenditure;
- (6) whether the expenditure forecast is consistent with any incentive scheme;

⁵ In addition to the NEO, the AER is required to take the revenue and pricing principles (section 7A of the NEL) into account whenever the AER exercises discretion in making those parts of a regulatory determination relating to prescribed transmission services. For brevity, the revenue and pricing principles are not reproduced in this paper.

⁶ Clauses 6A.6.6(e) and 6A.6.7(e).



- (7) the extent the expenditure forecast is referable to arrangements with a person other than the TNSP that, in the opinion of the AER, do not reflect arm's length terms;
- (8) whether the expenditure forecast includes an amount relating to a project that should more appropriately be included as a *contingent project*;
- (9) the most recent national transmission network development plan and any submissions made by AEMO on the forecast of the TNSP's required expenditure;
- (10) the extent to which the TNSP has considered and made provision for efficient and prudent non-network alternatives;
- (11) any relevant project assessment conclusions report; and
- (12) any other factor the AER considers relevant.

These expenditure factors ensure that the AER's assessment of the company's forecasts is comprehensive. The AER explains that consumer engagement is directly relevant to its assessment of the company's expenditure proposals⁷:

"The [AER's consumer engagement] guideline cannot compel any particular form of consumer engagement by service providers. However, it has links to how we assess service providers' expenditure proposals. For electricity, this link is explicit: the NER requires us to consider the extent to which the proposed expenditure addresses consumers' relevant concerns identified during the service provider's engagement with consumers."

The AER's expenditure forecast assessment guidelines explain that a network company's forecast will be subject to a 'first pass assessment'⁸:

"When we assess expenditure, we will typically follow a filtering process. That is, we will apply high level techniques in the first instance and apply more detailed techniques as required. For example, we must publish an issues paper early in the process. This will likely involve a 'first pass' assessment, which will indicate our preliminary view on the TNSP's expenditure forecasts.

For this first pass assessment, we will likely use high level techniques such as economic benchmarking and category analysis to determine relative efficiency and target areas for further review. We will, however, also use these techniques beyond the first pass assessment.

The first pass assessment will indicate the extent to which we need to investigate a TNSP's proposal further."

⁷ AER, Consumer Engagement Guideline for Network Service Providers, November 2013, page 12.

⁸ AER, Expenditure Forecast Assessment Guideline for Electricity Transmission, November 2013, page 11.



In addition to the assessment of expenditure forecasts, the Rules also set out objectives and principles to guide practically all other aspects of revenue and price regulation. The AER's website shows 18 current schemes⁹, guidelines and models that define how these aspects of the regime will be applied to ElectraNet. In each case, the regulatory arrangements are designed to promote the NEO.

In addition to setting objectives and principles that guide the AER's draft and final decisions, the Rules also define the timeframe and process for the conduct of a review. Details of the key milestones and timeframes for each review are provided on the AER's website¹⁰.

The AER's regulatory determinations are also informed by advice provided by the Consumer Challenge Panel (CCP). The CCP is a panel of experts, each appointed in their individual capacity, to engage with the network businesses' proposals and act as a 'critical friend' providing challenge to AER staff's emerging thinking¹¹.

To summarise:

- The Rules prescribe a comprehensive set of arrangements focused on delivering efficient outcomes for customers in accordance with the NEO.
- Effective consumer engagement is an important feature of the current regime, both in assisting companies in developing their proposals and advising the AER in formulating its decisions.
- While consumers have significant input to the regulatory process, they are not responsible for negotiating regulatory outcomes.

3.2 Concerns raised by UnitingCare Australia

UnitingCare Australia has raised a number of concerns in relation to the current regulatory framework, which are summarised in the following paragraphs:

"Network tariffs appear high, and it is not clear that the regulatory system has protected consumers from unnecessary rises."¹²

[...]

"Network businesses may spend hundreds of thousands of dollars, and thousands of staff hours, to prepare proposals for the regulator's consideration. When the three NSW

⁹ We have excluded 5 guidelines which are shown as current on the AER's website, but appear to be historic.

¹⁰ <http://www.aer.gov.au/networks-pipelines/determinations-access-arrangements>

¹¹ AER's Consumer Challenge Panel: description, Charter and evaluation criteria.

¹² UnitingCare Australia, Changing the DNA of network tariff setting in Australia, June 2015, page 4.



network businesses lodged documentation as part of their latest regulatory proposals, it ran to over 44,000 pages.”¹³

[...]

“Under the current model, networks put a price and revenue proposal to the regulator, and then defend that proposal during the Australian Energy Regulator’s deliberations. This ‘propose and defend’ approach entrenches the network’s position from the start, and automatically relegates consumers to a reactive and usually marginal role.”

[...]

“Utilities can build trust through high quality consumer engagement, or they can erode that trust by doing it badly. The opportunity is there for more intensive engagement, both within and outside the context of regulated decisions/determinations.”

UnitingCare Australia advocates an approach based on deliberation, negotiation, and agreement (DNA), which means:

“That regulators oversee agreement between consumers and network businesses on price and conditions for network services.”¹⁴

The DNA approach is intended to deliver the following improvements compared to the current arrangements:

“Benefits include cost savings from reduced ElectraNet costs in developing the regulatory proposal, more focused use of consumer and ElectraNet staff time, reduced time required during the prescribed regulatory process and greater certainty for all parties, leading to greater trust in an industry where consumer trust is currently at a very low level.”¹⁵

The table below shows how the concerns raised by UnitingCare Australia relate to the high-level objectives described in section 2. We comment briefly on each of the issues that they raise.

Table 1: Key concerns raised by Uniting Care Australia

High Level Objectives	Key Issues Raised	Our comments/observations
Reduce resources engaged in the regulatory process	Network businesses spend hundreds of thousands of dollars, and thousands of staff hours, to prepare proposals for the regulator’s consideration.	Agree. The volume of regulatory submissions has increased markedly in recent years. However, this partly reflects the AER’s information requirements.

¹³ Ibid, page 9.

¹⁴ Ibid, page 3.

¹⁵ Draft letter from Lyn Hatfield-Dodds to ElectraNet CEO Steve Masters.



High Level Objectives	Key Issues Raised	Our comments/observations
Improve understanding of network challenges and customer concerns	The opportunity is there for more intensive engagement, both within and outside the context of regulated decisions / determinations.	Agree. Section 3.1 explains that the Rules mandated effective consumer engagement. We understand that ElectraNet is developing its program with the assistance of the CAP.
More efficient expenditure plans that better reflect customers' preferences	Network tariffs appear high, and it is not clear that the regulatory system has protected consumers from unnecessary rises.	Partly agree. Historically, this appears to be correct in some jurisdictions. However, the 2012 Rule changes described in section 3.1 should address this issue. We also note that improved customer engagement has the potential to deliver more efficient plans.
Greater trust and confidence in regulatory outcomes	Consumer trust is currently at a very low level.	Agree. Consumer trust is at a low level and should be improved. ElectraNet's enhanced consumer engagement program may assist.
Increase certainty in regulatory outcomes, with 'no surprises'	UnitingCare Australia's proposal is intended to increase certainty by allowing the parties to negotiate an outcome.	Partly agree. Currently, neither the network company nor customers have direct control over the outcome of the AER's determination. However, it is a design feature of the regulatory regime that the AER is responsible for making draft and final decisions.
Faster resolution by delivering an acceptable regulatory outcome sooner.	UnitingCare Australia's proposal is intended to reduce the time required to make a determination.	Agree The timetables in the Rules are being met. However, we agree that it would be desirable to settle the key elements of a regulatory proposal more quickly.

In each case, we agree or partly agree with the views expressed by UnitingCare Australia. The concerns raised therefore highlight potential areas for improvement. It is less clear, however, whether these improvements should be achieved through:

- Better implementation of the current regulatory framework; or
- Changes to the current framework, such as the DNA approach advocated by UnitingCare Australia.

To assist in addressing this question, it is useful to consider recent regulatory developments in the UK. The UK Government has placed considerable weight on the opinions of customers in regulatory processes for over a decade now. Contrasting Australian practice with that in the UK provides insights into how our arrangements could evolve.



4 International examples of extensive consumer consultation

UnitingCare Australia proposes that the regulator should oversee negotiations between consumer representatives and the network company. This process is referred to as a 'Negotiated Settlement', which has been widely applied in North America¹⁶:

"In the United States 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 regulatory commissions. This has been documented in detail in the federal regulation of interstate gas pipelines and electricity transmission in the United States, in the regulation of major oil and gas pipelines in Canada, and in the regulation of electricity utilities in Florida.

The arguments in favour of negotiated settlements are that they are quicker, less expensive, and more innovative than traditional regulation."

The regulatory arrangements in North America differ from the CPI-X regulation applied in Australia. Therefore, the recent experience of UK regulators in implementing 'Negotiated Settlements' is more relevant to our circumstances.

The Scottish water regulator and airport regulator have both successfully introduced forms of 'negotiated settlement'.

- The UK airport regulator implemented 'constructive engagement', in which the airports and airlines were given the task of agreeing building block inputs such as traffic forecasts, investment plans and the quality of service parameters. The regulator retained responsibility for determining other parameters such as the WACC, asset base and operating expenditure efficiencies.
- Scottish Water successfully negotiated its business plan with a specially created 8 member Consumer Forum. The regulator subsequently based its determination on the business plan negotiated by the parties.

The UK electricity regulator, Ofgem, introduced 'fast track' regulation as part of its RIIO (**R**evenue = **I**ncentives + **I**nnovation + **O**utput) form of regulation. Fast track regulation allows the regulated company to avoid submitting a revised business plan and further regulatory scrutiny¹⁷. This lighter form of regulation only applies if the company has submitted a 'well-justified' business plan, which reflects consumer engagement.

¹⁶ Bruce Mountain, A summary of evidence and thinking on negotiated settlements in the regulation of energy network service providers, April 2013.

¹⁷ Ofgem, Handbook for implementing the RIIO model, October 2010, page 10.



Ofgem’s approach to consumer engagement stops short of requiring the parties to negotiate. Instead, the approach is closely aligned with the Australian arrangements¹⁸:

“The onus is on the network companies to determine their strategy for engagement, and to demonstrate how this engagement influences their thinking on what needs to be delivered and how it should be delivered.”

Nevertheless, each of the UK examples shares a common objective of reducing the role of the regulator by:

- Facilitating negotiation to enable the parties to agree matters previously determined by the regulator; and/or
- Reducing the extent of regulatory scrutiny.

Further information on the UK case studies is provided in the Appendix.

In considering whether some form of negotiated settlement should be introduced in Australia, the following comments from Dr Biggar highlight the significance of the change compared to the current arrangements:

“If (as argued here) the primary objective of public utility regulation is the re-creation of the long term contract the parties would have negotiated if they could have negotiated costlessly ex ante, then who better to negotiate and agree key regulatory outcomes than the parties themselves?

Customers of service providers should be directly involved in negotiating regulatory outcomes. Instead, as we noted earlier, the involvement of customers in most regulatory processes in Australia is relatively weak and under-developed. Customers do not take direct responsibility for regulatory outcomes. Customers are not directly involved in approving investments or investment-tariff trade-offs, or trade-offs between tariffs and service quality. Customers are not directly involved in the design of incentives, risk-sharing arrangements, or in the design of the regulatory framework itself. There is relatively little scope for customers to enter into new, innovative, or out-of-the-ordinary arrangements with regulated firms — such as special arrangements for the approval of investment, information provision arrangements, complaint handling procedures, longer-term price paths, and so on.”¹⁹

We agree with Dr Biggar’s comments. However, he also acknowledges the risks and challenges associated with a negotiated settlement approach. Bruce Mountain identified the following issues in a series of interviews in Australia²⁰:

¹⁸ Ibid, page 16.

¹⁹ Darryl Biggar, Public utility regulation in Australia: Where have we got to? Where should we be going? ACCC/AER Working paper no. 4, July 2011, page 42.

²⁰ Bruce Mountain, A summary of evidence and thinking on negotiated settlements in the regulation of energy network service providers, April 2013, page 4.



- Negotiated settlements transfers decision-making from regulatory commissions to utilities or effective pressure groups such as large consumers;
- Consumers are unable to master the complexity needed to successfully negotiate. Therefore negotiated settlements will be unbalanced at consumers' expense;
- Consumers have different priorities and so they will not be able to agree to settlements with NSPs;
- Consumers will choose short-term gains at the expense of long term efficient outcomes;
- Negotiated settlements lack transparency, with no public explanation or justification of the terms involved; and
- Network service providers will not agree to a more generous settlement with consumers than they would get from the regulator.

While Bruce Mountain addresses each of these concerns, it remains the case that a negotiated settlement approach would need to be designed carefully. In the next section, we build on the discussion thus far to consider the options for improving the current regulatory arrangements.



5 Options analysis

5.1 Identification of Options

In light of the concerns raised by UnitingCare Australia and the recent regulatory developments in the UK, this section considers the options for improving the current arrangements in Australia.

In broad terms, there are three options:

1. Maintain the status quo; or
2. Implement UnitingCare Australia's DNA approach; or
3. Develop a 'fast track' approach.

We consider each of the three options in turn and evaluate them against our objectives.

5.2 Option 1 - Status Quo

In considering any proposal for change, it is essential to consider the 'do nothing' option or the status quo. In this instance, however, the status quo does not exclude the possibility of change. Specifically, the current regulatory framework could be operated more effectively in future.

There are two important examples where improvements could be made without any change to the regulatory design or process:

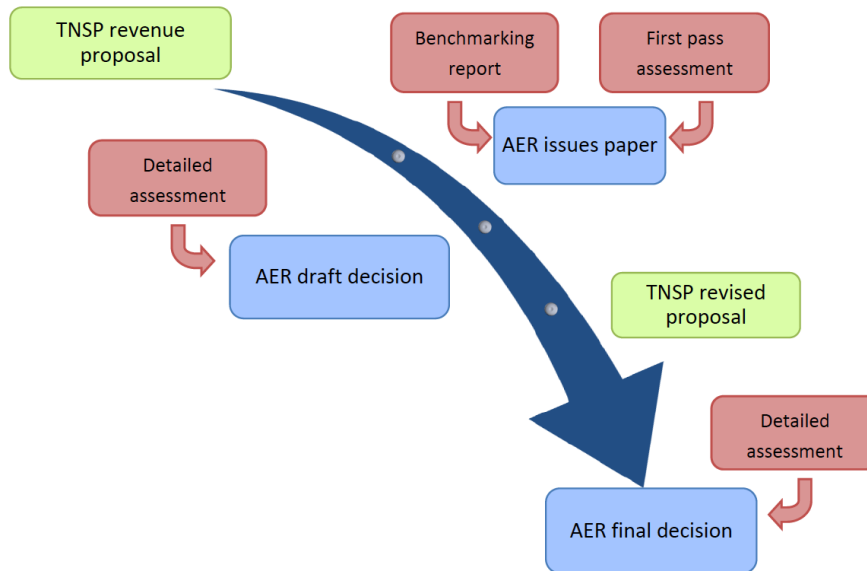
1. Fast track regulation through the AER's 'first pass assessment'; and
2. Enhanced consumer engagement.

Each is discussed in turn below.

5.2.1 First pass assessment

In section 3.1 we noted that the AER's expenditure assessment guidelines explain that the AER will conduct a 'first pass assessment' in assessing a company's forecasts. The stated purpose of a first pass assessment is to indicate the extent to which the AER needs to investigate the expenditure forecasts further²¹. Potentially, therefore, the first pass assessment could deliver 'fast track' regulation. The process is depicted in the figure below.

²¹ AER, Expenditure Forecast Assessment Guideline for Electricity Transmission, November 2013, page 11.

**Figure 1: Overview of AER's assessment process²²**

The figure shows that the results of the AER's first pass assessment is to be reported by the AER in its Issues Paper, which is published not more than 40 business days after the Revenue Proposal is submitted.²³

In practice, however, in recent reviews the AER has not applied a first pass assessment in its Issues Paper. We think this aspect of the current framework could be reinvigorated in the future. A fast track approach would be analogous to Ofgem's approach and consistent with the following objectives described in section 2:

- Reduce resources engaged in the regulatory process;
- Increase certainty in regulatory outcomes, with 'no surprises'; and
- Faster resolution by delivering an acceptable regulatory outcome sooner.

5.2.2 Enhanced consumer engagement

Section 3.1 explained that the Rules were amended in 2012 to place a greater emphasis on consumer engagement. ElectraNet is presently finalising its consumer engagement plan with the assistance of its newly formed Consumer Advisory Panel (CAP).

It is expected that the consumer engagement plan will deliver significant improvements compared to previous approaches, consistent with the following high level objectives described in section 2:

²² Ibid, page 12.

²³ Clause 6.9.3(b) of the Rules.



- Improve understanding of network challenges and customer concerns;
- More efficient expenditure plans that better reflect customers' preferences;
- Greater trust and confidence in regulatory outcomes;
- Increase certainty in regulatory outcomes, with 'no surprises'; and
- Faster resolution by delivering an acceptable regulatory outcome sooner.

In summary, improvements against each of the 6 objectives described in section 2 can be achieved through more effective operation of the status quo by:

- Reinvigorating the 'first pass' assessment; and
- Enhancing the consumer engagement process.

5.3 Option 2 – Deliberation, Negotiation, and Agreement

UnitingCare Australia's proposed solution is to implement a regulatory approach, which it refers to as Deliberation, Negotiation, and Agreement (DNA). As explained in section 4, this approach is a form of negotiated settlement, which is supported by recent case studies in the UK.

However, UnitingCare Australia also recognises that the current Rules present a potential constraint on its adoption in Australia²⁴:

"It is not the purpose of this paper to provide opinions on interpretation of the rules, nor to consider all aspects of the rules that may need adjustment to facilitate the transition to application of the proposed DNA process. The rules are, however, critical to application of a different approach to distribution regulation and must be considered as a part of next steps.

Clarification is needed on how the AER would regard an agreement as described, being presented as part of a regulatory process. Alternatively, a rule change may be needed."

In effect, the proposal would significantly change the role of the AER. Under the proposal, the AER would facilitate negotiations between consumer representatives and the network company. The AER would essentially devolve its decision making role to the consumer group and verify that the agreed outcome satisfied a reasonableness test (which is currently undefined).

As already noted, UnitingCare Australia's proposal is a form of 'negotiated settlement', which has delivered substantial improvements in outcomes in the UK airport and water sectors. However, the proposal is a radical departure from the current electricity network

²⁴ UnitingCare Australia, Changing the DNA of network tariff setting in Australia, June 2015, page 22.



regulation in Australia where the AER is the decision maker. Therefore, it would not be possible to implement the DNA proposal in the absence of Rule changes and, possibly, legislative change.

We have also considered whether a modified version of UnitingCare Australia's proposal could be introduced to operate in parallel with the current regime. Under this modified approach, the negotiated outcomes could be taken into account by the AER, without changing any of the current regulatory arrangements or processes.

In our view, this approach has merit, not least because it commences the longer-term development of a more formal negotiated settlement approach. Based on the UK case studies, the effectiveness of this more limited form of negotiated settlement would depend on the following process and governance being addressed:

- What is the constitution of the consumer group?
- Should negotiations be conducted in accordance with a formal agreement between the consumer group and ElectraNet?
- How are the rights of other consumers protected?
- What is the scope of the negotiation?
- What is the output from the negotiation?
- What role should the AER adopt in establishing the negotiation process?
- Should the AER be party to the negotiations?
- How are disputes to be resolved?
- What tests / principles should the regulator apply in assessing the output from the negotiation?
- What happens if negotiations are not successfully concluded?

In our view, these questions could be resolved, but not within the timeframes required for ElectraNet's forthcoming determination process. Specifically, we note that ElectraNet must submit its Revenue Proposal in less than 12 months from now. This provides insufficient time to resolve the above issues and implement the negotiation with customers. In our view, 2 years would be an appropriate lead-time, rather than 12 months. Furthermore, it would be a high risk approach for all parties to proceed with the negotiations without first resolving these issues.

For these reasons, we do not regard the DNA approach or a variant of it as feasible within the timeframes available.



5.4 Option 3 – A fast track approach

This option builds on the approach adopted by the UK electricity regulator, Ofgem. It provides for a ‘fast track’ regulatory process if the network company submits a well-justified Revenue Proposal. The well-justified Revenue Proposal would need to be supported by extensive consumer engagement, but it would not involve negotiation as described in Option 2.

As already noted, a ‘fast track’ approach could be implemented through the status quo option. The rationale for this Option 3 is that it provides additional time for the AER to conduct its ‘first pass assessment’ of the company’s expenditure forecasts which would be set out in a Preliminary Revenue Proposal, say, 2 months prior to the formal submission of the Revenue Proposal.

Option 3 could proceed provided that:

- The availability of an additional 2 months to the AER to review the company’s expenditure forecasts is required to enable it to complete a robust ‘first pass assessment’;
- The CAP would be supportive of this initiative, noting the consequential shortened timeframe to provide input to the company’s expenditure plans;
- ElectraNet is able to publish its expenditure forecasts two months in advance of the mandated timeframe.

Subject to the views of the relevant parties, this option would proceed as follows:

- A draft Preliminary Revenue Proposal would be developed during the consumer engagement process.
- The Preliminary Revenue Proposal would focus primarily on expenditure forecasts, and would demonstrate compliance with the Rules. It would be informed by extensive consultation, including advice from the CAP.
- The Preliminary Revenue Proposal would be published in, say, early November 2016, at least 2 months in advance of ElectraNet formally submitting its Revenue Proposal.
- It is expected that the expenditure forecasts in the Revenue Proposal would be consistent with those provided in the Preliminary Revenue Proposal (unless unforeseen circumstances arise).
- The AER’s Issues Paper (scheduled for March 2017) would apply its ‘first pass assessment’ and determine whether the expenditure forecasts should be ‘fast tracked’ – which means that they would be subject to limited additional scrutiny.



- Stakeholders would be invited to lodge submissions in response to the Issues Paper.
- The AER may consider early publication of its Draft Decision and Final Decision.

The table below shows the likely scope of the Preliminary Revenue Proposal.

Table 2: Suggested outline of a Preliminary Revenue Proposal

Revenue Proposal Chapter	Scope of the Preliminary Revenue Proposal	Comments
1. Executive Summary	<ul style="list-style-type: none"> • A short summary of key points 	This section would also include estimated revenue requirement.
2. Introduction	<ul style="list-style-type: none"> • Explanation of purpose of the Preliminary Revenue Proposal 	Drafting would be substantially different from the Revenue Proposal.
3. Business Environment and Key Challenges	<ul style="list-style-type: none"> • Description of issues/challenges identified through consumer engagement consultation 	This section would be shorter than the Revenue Proposal.
4. Historic Cost and Service Performance	<ul style="list-style-type: none"> • Brief overview of recent cost and service performance 	This section would be relatively brief.
5. Forecast Capital Expenditure	<ul style="list-style-type: none"> • Key assumptions and inputs, including demand forecasts • Expenditure forecasts for each category • Contingent projects • The network capability incentive parameter action plan • Demonstration that forecasts meet Rules requirements 	<p>Together, these two sections are the focal point of the Preliminary Revenue Proposal.</p> <p>The section should explain why the forecasts meet the Rules requirements, including the expenditure factors in clauses 6A.6.6(e) and 6A.6.7(e).</p> <p>Pass through arrangements could be included, depending on whether ElectraNet is proposing any changes.</p>
6. Forecast Operating Expenditure	<ul style="list-style-type: none"> • Key assumptions and inputs, including demand forecasts • Application of base, step, trend forecasting approach • Pass through arrangements • Demonstration that forecasts meet Rules requirements 	<p>These sections should explain how the plans reflect input from consumers.</p>
7. Regulatory Asset Base	<ul style="list-style-type: none"> • Opening RAB at 1 July 2018 • Forecast RAB for next period 	Section will be shorter than Revenue Proposal. It is included in the Preliminary Revenue Proposal for completeness.
8. Depreciation	<ul style="list-style-type: none"> • Depreciation forecast 	This section will set out the information for completeness only.
9. Cost of Capital and Taxation	<ul style="list-style-type: none"> • WACC and tax allowance assumptions based on the AER guideline. 	This section would provide a table showing the WACC and tax values. It would not include any discussion of the issues.
10. Service Target Performance Incentive Scheme	May be excluded from the Preliminary Revenue Proposal	The exclusion of this material will reduce the size of the document and improve its accessibility.



Revenue Proposal Chapter	Scope of the Preliminary Revenue Proposal	Comments
11. Expenditure incentive schemes a. EBSS b. CESS	As above	As above.
12. Revenue and average prices	<ul style="list-style-type: none"> Maximum allowed revenue Average price path 	This information is provided for completeness.
13. Other matters a. Negotiating framework b. Transmission Pricing Methodology	May be excluded from the Preliminary Revenue Proposal	The exclusion of this material will reduce the size of the document and improve its accessibility.

5.5 Overall assessment of the competing options

The table below summarises the pros and cons for each option and provides an overall assessment.

Table 3: Summary of option assessment

Option	Pros	Cons
Option 1 – Status Quo	<ul style="list-style-type: none"> No additional resource requirements Consistent with current Rules Capable of delivering improvement 	<ul style="list-style-type: none"> AER may have insufficient time to apply its ‘first pass’ assessment. Does not capture the potential benefit of a negotiated settlement approach
Option 2 – UnitingCare’s DNA approach	<ul style="list-style-type: none"> Has the potential to capture the benefits of negotiating with customers directly Consistent with UnitingCare’s proposal Potential to improve certainty and early acceptance of key elements of the Revenue Proposal 	<ul style="list-style-type: none"> It is not consistent with the Rules Even a more limited negotiation process could not be implemented in the necessary timeframes
Option 3 – Fast Track approach	<ul style="list-style-type: none"> Provides the AER with additional time to conduct ‘first pass assessment’. It enables ‘fast track’ regulation, reducing resourcing and benefiting companies that deliver well-justified expenditure plans. 	<ul style="list-style-type: none"> Creates pressure to produce a submission on key elements early in the review process (and by no later than November 2016). It will compress the timeframe for consumer engagement in relation to the forecast expenditure.

5.6 Recommendation

Subject to the views of the AER, ElectraNet and the CAP, we recommend adopting Option 3 – Fast Track Approach. This option would require ElectraNet to publish a



Preliminary Revenue Proposal in November 2016, detailing its expenditure forecasts and indicative revenue and price paths.

We note that Option 1 (Status Quo) may be preferred, if the AER were able to conduct its 'first pass assessment' within the more limited timeframe afforded by that approach. This key issue will need to be tested with the AER.



Appendix: International examples of consumer engagement

A. Civil Aviation Authority

As explained by Professor Littlechild and Bruce Mountain, the UK airports regulator the Civil Aviation Authority (CAA) introduced the concept of constructive engagement following an extensive appraisal of the 2005 airport price control.²⁵

The CAA had several concerns about the confrontational nature of the previous process and the fact that the CAA was forced to make many of the key investment and operational decisions, which it felt it was not well placed to do. Looking forward, airlines wanted more focus on (airline) customers, mainstream consultation and a real input into decisions. Airports wanted greater consensus on plans, more structured information on airline requirements and more recognition of realities. The CAA wanted improved information and inputs, less intrusion on commercial issues, a more focussed role and better decisions.

In May 2005 the CAA proposed that some of the work usually carried out by the regulator will instead be taken forward by the airports and their airline customers through a process of 'constructive engagement'. The matters to be dealt with under this process were (primarily) the traffic forecasts to be used in setting the controls, the investment programmes at each airport and the desired quality of service parameters.

The key responsibilities that the CAA would retain included analysis of market power and opex efficiencies, addition of past investment costs to the RAB, proportion of future capex to be recovered in the next price control period, assessing the cost of capital, determining any price profile adjustment, establishing a revenue requirement (including allowance for non-regulated revenue), assessing options for the structure of the control, and developing proposals for financial incentives.

The CCA explained its approach in the following terms²⁶:

"Whilst the requirement to produce the plans naturally rests on the airports, the engagement process from which the plans should result is the responsibility of both the airports and their airline users. Airline contributions need to address preferred outputs, preferred service levels linked to these outputs and a realistic appraisal of what the industry is likely to be required to pay to obtain them. Any airline issues around airport performance need to be dealt with on the basis of evidence. This could most usefully be developed in the context of joint airport/airline working to improve both airport efficiency and mutual understanding of operational and other challenges."

[...]

²⁵ Ibid, pages 12 and 13.

²⁶ Civil Aviation Authority, Airport Regulation looking to the future – learning from the past, May 2004, paragraphs 31 and 33.



The CAA will continue, as required by law, to set price caps at the four designated airports. The key change is the scope for agreement between airports and airlines to determine key inputs into that decision. The CAA accepts that securing agreements between airlines and airports will be no easy task, particularly against the background of expectations established by a regulatory system. Airlines will need to recognise the need to resource this in the way they would other key business negotiations. And they will need to ensure that differing - and entirely natural – commercial motivations can be accommodated to ensure benefits for all. The challenge for airports will be to see the regulatory process as an integral part of the continuing dialogue with customers.”

Appraising the situation in May 2007, the CAA considered that the outcome so far had generally been satisfactory, indeed better than expected, at least at Heathrow and Gatwick. A subsequent review of airport regulation by the UK Department of Transport concluded that the CAA should build on the process of constructive engagement²⁷.

B. UK electricity regulation

The UK’s regulatory model developed by Ofgem is referred to as “RIIO” (Revenue = Incentives + Innovation + Outputs). It includes a fast track process.

Each network business is required to develop a business plan that is informed by extensive consultation with a wide range of stakeholders. Ofgem can “fast-track” approval of “well justified” business plans, while subjecting less satisfactory plans to greater scrutiny over a 30-month process. To date, Western Power Distribution and the two Scottish transmission companies have obtained fast track status.

The “fast track” approach is described as “proportionate regulation”, which enables Ofgem and the network companies to reduce the costs of regulation. Ofgem made the following comments in relation to its fast-track decision for the transmission companies²⁸:

“Under the RIIO process, network companies are required to take into account the needs and views of stakeholders in order to submit to us well-justified business plans. We are taking a proportionate approach to our scrutiny of companies’ plans, i.e. the level of our regulatory scrutiny varies according to the quality of plans. Companies that submit very high quality plans will be able to agree price controls early, i.e. achieving fast-tracking.”

Ofgem applied five broad criteria to assess the plans:

1. Process: has the company followed a robust process?
2. Outputs: does the plan deliver the required outputs?

²⁷ Department of Transport, Reforming the Framework for the Economic Regulation of Airports Decision Document, December 2009, page 10.

²⁸ RIIO-T1: Decision on fast-tracking for SP Transmission Ltd and Scottish Hydro Electric Transmission Ltd, 23 January 2012, page 2.



3. Resources (efficient expenditure): are the costs of delivering the outputs efficient?
4. Resources (efficient financial costs): are the proposed financing arrangements efficient?
5. Uncertainty/risk: how well does the plan deal with uncertainty and risk?

It is noted that Western Power Distribution's business plan was approximately 780 pages. Although the preparation of this document and consultation with customers was an extensive process, it was a substantial improvement compared to 'slow track' companies, which were required to submit revised plans and were subject to further scrutiny.

C. Scottish Water

While the previous regulatory determinations in the water sector had delivered significant benefits in terms of price reductions and quality improvements, by around 2010 the Water Industry Commission for Scotland (WICS) felt the need for a new way of challenging Scottish Water. The Commission also considered there was a need for more customer input into the decision-making process. It was therefore looking for a new approach that met these two needs.

Professor Littlechild (former UK electricity regulator) advised WICS on the establishment of the Customer Forum, and describes the background as follows²⁹:

"The Customer Forum was set up in September 2011 with three aims: to work with Scottish Water on a programme of customer research; in the light of this to understand and represent customer priorities to Scottish Water and to the Water Industry Commission for Scotland (WICS); and to seek to secure the most appropriate outcome for customers in the Strategic Review of Charges. In October 2012 the Forum was additionally asked to seek to agree a Business Plan with Scottish Water, consistent with Ministerial Objectives and with guidance notes that WICS would provide. At the end of the engagement process, Scottish Water and the Forum would prepare a document (or documents) setting out the extent to which they agreed or disagreed. WICS would take these documents into account in its Draft Determination, which would propose Scottish Water's charges for the period 2015-2021."

Interestingly, Scottish Water was a member of the Consumer Forum³⁰:

"The Customer Forum is to consist of "8 ordinary members and a chairman each of whom will be appointed jointly by the parties". One of the three parties was of course Scottish Water. It might seem odd that a regulated company should play such a major

²⁹ Stephen Littlechild, *The Customer Forum: customer engagement in the Scottish water sector*, Regulatory Policy Institute, N.S.4.2 2014, page 1.

³⁰ *Ibid*, page 7.



part in the design of a customer body that is to negotiate with it, and indeed in the appointment of members of that body. The explanation is that WICS wanted buy-in from all parties, which was more likely with a framework that all parties had agreed.”

The Customer Forum was established by means of a formal 7-page Cooperation Agreement, plus a 12-page Schedule specifying membership, timelines and other matters. Forum members were cognisant of the need for a professional approach³¹:

“Members were also aware that, if this approach was to work in Scotland, with its complex regulatory structure, it was very important for the Customer Forum to be knowledgeable, insightful, professional and to justify its legitimacy so that it could not be ignored even if Scottish Water wanted to do so. They also felt that Scottish Water could not simply ignore it, because if agreement was not reached, Step 9 of the Timeline called on the Forum and Scottish Water to explain why, which was a powerful lever.”

Professor Littlechild regards the Consumer Forum as highly successful, as noted below:

“In my view, the Customer Forum process has been one of the most innovative, successful and encouraging developments in UK utility regulation.”³²

[...]

“Scottish Water’s understanding of what customers want appears to have radically improved. Its presentation of its thinking – in its 25 year vision and its business plan - is considerably more customer-friendly than before. These documents are more readable than the previous engineering business plans. But there are changes of substance too. It has been forced to think more carefully about the rationale for its investment. In that process it has modified its proposals, to an extent that is difficult to document because the evolution of its thinking over time means that it is not clear what it would otherwise have proposed. It also came to appreciate that, because of the customer situation in the recession, it was not appropriate at this stage to have real increases in prices over time.”³³

Professor Littlechild highlighted the following aspects of the Forum as being critical to its success³⁴:

“Regulatory body WICS took a proactive role. This included proposing and developing the concept of the Forum in the first place, canvassing support for it and developing and adapting it to the views of the main parties, leading the design of the Cooperation Agreement and Timeline and the associated activities of the Forum, and monitoring the implementation of the Cooperation Agreement. The WICS Guidance Notes gave the parties assurance that they were negotiating in the right space, and the nature of these

³¹ Ibid, page 8.

³² Ibid, page 1.

³³ Ibid, page 19.

³⁴ Ibid, pages 20 and 21.



Notes was responsive to the negotiations as they progressed. The innovative financial tramlines³⁵ set out by WICS were helpful to the process.

This was consistent with the Commissioning Letter for the Strategic Review, which said that Ministers' policy is for charge caps that are affordable and broadly stable.

In general WICS staff also played a proactive role in the engagement process, much like FERC trial staff do. That is, they not only indicated what the regulator's formal position was, the CEO in particular also sought to bring the parties together, helped to resolve differences, and provided a sounding board for possible ways forward, all without interfering in the negotiations or compromising the independence of the parties."

In relation to whether the agreement reached by the Consumer Forum should be binding on the regulator, Professor Littlechild commented as follows³⁶:

"[...] I would be inclined not to require the Commission to accept any agreement reached between the Forum and the company. The Commission necessarily has broader responsibilities than the Forum, including having reference to constituencies not necessarily reflected in the composition of the Forum's membership, and could not properly be bound by an Agreement reached by others. As far as I know, in other jurisdictions in the world where negotiated settlements are used, the ultimate responsibility for setting a price control rests with the regulatory body, which has to satisfy itself that any particular settlement is an appropriate basis for such a control.

Having said that, a regulatory body would be advised to think very carefully before rejecting a settlement reached between company and customer representatives after an appropriate engagement process encouraged by the regulator itself. When negotiated settlements were first developing in Canada, the National Energy Board accepted the substance of the first two settlements put to it except for a reduction in the agreed rate of return, where it imposed a lower value. This discouraged companies from entering further settlements for nearly seven years, and it required an explicit change of stance by the regulator to get negotiations and settlements going again

In the present case, WICS Guidance Notes proved to be a very effective means by which the regulator indicated its preferences and concerns. The parties welcomed and respected these Notes. In due course, the Commission prudently made its Draft Determination consistent with the Minute of Agreement. This not only gave satisfaction to the parties, it surely encouraged subsequent engagement."

While Professor Littlechild's comments are undoubtedly correct, it is questionable whether the regulator should be influenced by the incentive properties of the regime in the way he describes. A better approach would be to define more clearly the role of the regulator at the outset, including the circumstances in which the negotiated settlement would be accepted.

³⁵ The concept of 'financial tramlines' ensured that the negotiation would deliver a financially acceptable outcome to the company.

³⁶ Ibid, page 25.