

Pathway to the 2022 Rate of Return Instrument

Response to Consultation Paper on 2022 Instrument Process

9 July 2021

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Key messages

- » **Significant concerns around balanced treatment of evidence were raised in consultations on the previous 2018 Rate of Return Instrument process** - The independent Brattle review of stakeholders in the 2018 RORI process highlighted significant concerns across a range of stakeholders around the treatment of, and engagement with, evidence in the review.
- » **Opportunities exist to enhance stakeholder confidence by addressing some concerns that have not been resolved in AER process decisions to date or this Consultation Paper** - The AER Position Paper of May 2020 made a series of decisions around the structure of the process, but explicitly considered issues outside of the design of the process out of scope, and to be addressed during the active phase of the review and the Working Paper process. Critically, this Consultation Paper does not progress this important opportunity to strengthen stakeholder confidence on treatment of evidence.
- » **Ensuring clear symmetrical consideration of estimation issues will assist in promoting ongoing stakeholder confidence** – Both AER Working Papers and process design choices can best maximise stakeholder confidence by clearly focusing on the seeking of an unbiased rate of return. Included in this is ensuring an equal exploring, seeking out, and examining of evidence, regulatory developments and evolutions in methodology which would potentially lead to both upward or downward revisions in rate of return estimates.

1 Overview

Energy Networks Australia (ENA) welcomes the opportunity to respond to the AER Consultation Paper *Pathway to the 2022 Rate of Return Instrument Process*.

As a key participant in the 2018 Rate of Return review process, ENA recognises that significant AER and stakeholder efforts were directed to the goal of reaching a rate of return instrument that promoted the long-term interests of consumers consistent with the National Electricity and Gas Objectives.

ENA and its members approached the 2018 review with a positive commitment to trialling new review approaches and techniques to reach the best possible outcome, including a decision that would enhance stakeholder confidence in relation to this important economy-wide regulatory setting. This commitment is continuing.

One consistently reported theme of feedback provided to the AER through the Brattle Report *Stakeholder Feedback on the AER's Process for the 2018 Rate of Return Instrument* was that a range of network, consumer and investor stakeholders had concerns around the AER's engagement with, and the balanced treatment of, evidence in relation to rate of return approaches, data and methodologies.¹ The 2022 review process, including future Working Papers, provides an opportunity to address these views.

¹ Brattle Group *Stakeholder Feedback on the AER's Process for the 2018 Rate of Return Instrument*, 27 June 2019, p.10-12 [para 31-34]

The AER's May 2020 Position Paper reached a number of process design decisions which represented effectively 'incremental' changes to the 2018 review process, whilst noting that other issues raised by stakeholders beyond the process were not within scope and would be addressed during the later active phase of the Instrument review process. This has not yet occurred.

The current Consultation Paper is solely focused on relatively technical process design details. It addresses a narrow set of technical design questions around two aspects of the process – the independent panel membership and the timing of expert sessions.

ENA is not aware of a specific process or mechanism by which the substantial stakeholder concerns around the balanced treatment of evidence is being addressed. These unaddressed concerns held by network businesses are reinforced by some initial directions apparent in early Working Papers through late 2020 and early 2021. As an example, AER Working Papers released to date have proposed:

- Potential movement to reliance on actual debt data despite no compelling evidence that the current debt benchmark approach is flawed; and
- Potential movement to a 5-year government bond proxy contrary to market and regulatory practice, in circumstances where active intervention by the Reserve Bank of Australia has widened the observed margin between the risk-free proxy adopted previously to levels only observed 4 times over the past fifty years.

Both of these potential new approaches would have the impact of lowering future regulatory cost of capital estimates in current and forecast conditions, in circumstances where the AER's expert advisors have already highlighted that Australian network return allowances are amongst the lowest internationally.

Conversely, ENA cannot clearly identify any proposed AER approach or methodology change in the Working Paper series to date that would lead to an *increase* in the rate of return estimate. This highlights the continuing opportunity that exists in the AER process to demonstrate a symmetrical consideration of estimation issues.

In ENA's view, the AER Working Paper and process designs can be optimised by a strong focus on strengthening and maintaining stakeholder confidence in the seeking out of an unbiased rate of return consistent with the AER's recent guidance on its interpretation of the long-term interests of consumers in estimating required market returns.

It is important that this occurs by the process led by the AER ensuring an equal exploring, seeking out, and examining of evidence, regulatory developments and evolutions in methodology which would potentially lead to both upward or downward revisions in estimates.

2 Background to the 2022 Instrument Process

2.1 Context and legislative framework

In reviewing the proposed process to be adopted in the 2022 Instrument review process, it is important to consider the overarching policy purpose and context of the legislative requirements placed on the AER by the 2018 amendments to the National Electricity and Gas Laws.

At several points in the Consultation Paper preferred technical design choices are selected on the basis of what would best assist the AER in reaching its final instrument determination.

This criterion does not encompass the full policy purpose in introductions of the mandatory review steps. In setting out the legislative changes the Council of Australian Governments Energy Council highlighted that a key rationale for the changes were to:

Making the regulators' process more robust to enable early resolution of contested issues, so as to increase confidence in the regulator's decisions.²

This goal of increased stakeholder confidence was acknowledged in an AER earlier Consultation Paper which indicated 'its aim' for an 'accessible, transparent and collaborative' guideline, to promote confidence in decisions.³

As noted, the AER received strong feedback from a range of stakeholders following the 2018 guideline that that process did not lead to this outcome of confidence. Given this, it would be appropriate for the AER to consider every positive opportunity for strengthening confidence in the 2022 process, including in design of the Independent Panel and Expert Sessions. An outcome of strengthened stakeholder confidence is not likely to be achieved by minor or incremental design modifications to individual process steps of the review, without accompanying steps focused on the manner of considering and reaching views on substantive instrument issues.

2.2 Industry views and feedback on 2018 Instrument process

Network stakeholders raised a number of significant concerns with AER staff, senior leadership and the AER Board through the 2018 review around the treatment of evidence, the outcomes of the review, and the AER's explanations of its reasoning. Specifically, network stakeholders raised significant concerns that the AER process risked being perceived as featuring predetermined outcome such that:

- empirical evidence that was inconsistent with a reduction in rate of return outcome was dismissed with insufficient reasoning; and
- weak evidence that was consistent with an outcome of reducing the rate of return was given inappropriate weight.

Many of these concerns were repeated and comprehensively detailed by stakeholders in the subsequent Brattle review commissioned by the AER. For example, the Brattle review noted the following observations from stakeholders:

There was a perception among some stakeholders that the AER applied higher standards of evidence to submissions from groups seen to be aligned with networks than to those seen to be aligned with consumers.⁴

² COAG Energy Council SCO Bulletin, Binding Rate of Return Guideline, June 2018, p.1

³ AER Consultation Paper Pathway to the 2022 Rate of Return Instrument, November 2019, p.6

⁴ Brattle Group (2019), p.10

[S]takeholders from both network and consumer groups thought that the AER did not substantively engage with the evidence that the stakeholders presented during the process. Stakeholders thought that the AER did not provide adequate reasoning for its positions in its decisions. Relatedly, stakeholders perceived that the AER's decisions did not necessarily treat issues in a way that corresponded to the importance that stakeholders assigned to the issues.⁵

Stakeholders claimed that evidence that pointed towards a lower rate of return seemed to be accepted or given greater weight, whereas evidence pointing towards a higher rate of return seemed to face a much more critical review, or that the AER appeared unwilling to ignore countervailing evidence even if it had major flaws.⁶

In another example, the networks presented evidence that inputs into estimations for beta and the MRP considered by the AER had increased since 2013, yet in the AER's 2018 decision, values for beta and the MRP decreased. These stakeholders claimed to have lost confidence in the process as a result of the AER's inconsistent assessment of evidence. Stakeholders highlighted that while the AER allegedly said throughout the process that the networks submitted good evidence, none of this evidence seemed to have weight in the final outcome.⁷

Stakeholders cited several instances where the AER did not provide satisfactory reasons for taking or not taking information into account. These stakeholders felt that there was a sense of inevitability in the outcome of the review (i.e., the outcome was somewhat pre-determined) and that the evidence they provided against this outcome was ignored.⁸

Stakeholders said the AER had created crosschecks to test whether its proposal for the return on equity was reasonable. However, the return on equity that the AER determined did not pass the crosschecks that the AER had set up. When the AER proceeded with this return on equity, it provided no reasoning for discounting the result of the crosschecks.⁹

More generally, stakeholders thought that there were insufficient opportunities at times to provide further evidence when the AER dismissed a submission's evidence.¹⁰

In previous submissions to the AER on the Rate of Return Instrument process ENA has made 13 specific recommendations to enhance stakeholder confidence and the efficient operation of the review.

⁵ Brattle Group (2019), p.10

⁶ Brattle Group (2019), p.10

⁷ Brattle Group (2019), p.11

⁸ Brattle Group (2019), p.11

⁹ Brattle Group (2019), p.11

¹⁰ Brattle Group (2019), p.12

Appendix A sets out these recommendations, together with an assessment from currently available AER materials as to whether these process-focused recommendations have been adopted.

From the thirteen recommendations made, it appears only a single measure has been adopted, 5 have been rejected, and it remains uncertain whether the remaining 7 will be progressed through and after the review.

2.3 Continuing opportunity need to respond to stakeholder concerns

2.3.1 **Balanced treatment of evidence feedback not yet addressed in process review**

The significant concerns around balanced treatment of evidence which have been raised in AER consultations on the RORI process have not been addressed to date. The AER Position Paper in May 2020 set out a series of decisions around the structure of the process, but explicitly considered issues outside of the process out of scope, and to be addressed during the active phase of the review and the Working Paper process.

As a result, these concerns have not yet been addressed clearly to date. The current Consultation Paper addresses a narrow set of technical design issues around two aspects of the process (independent panel and expert sessions). There has not yet been an indication given how the substantial stakeholder concerns around the balanced treatment of evidence will be addressed.

2.3.2 **Initial Working Papers – Pathways to 2022**

Some of the unaddressed industry concerns discussed above have been reinforced by elements of the approach of early Working Papers.

The AER Working Papers released to date have proposed:

- Potential movement to reliance on actual debt data despite no compelling evidence that the current debt benchmark approach is flawed; and
- Potential movement to a 5-year government bond proxy contrary to market and regulatory practice, in circumstances where active intervention by the Reserve Bank of Australia has widened the observed margin between the 5-year government bond yields and the 10 year government bond yield currently used to levels only observed 4 times over the past fifty years

Each of these approaches would have the impact of lowering future regulatory cost of capital estimates in current and forecast conditions, in circumstances where AER's expert advisors Brattle have already advised that Australian network return allowances are amongst the lowest internationally. Conversely, ENA cannot clearly identify any AER proposed approach in the Working Paper series to date that would lead to an increased estimate.

Symmetrical consideration of estimation issues is a practical opportunity to strengthen stakeholder confidence in the 2022 process. AER Working Paper and process designs have an important role to play in building and maintaining stakeholder confidence in the seeking of an unbiased rate of return – by equally seeking out, and examining evidence, regulatory developments and evolutions in methodology which would lead to both upward or downward revisions in estimates.

Areas industry and investor stakeholders have highlighted to AER as warranting further evaluation and potential action from the AER in the 2022 RoRI review include:

- » **Examination of risk-free proxy issues** - Carefully assessing the continuing capacity of Commonwealth Government Securities to serve as the sole input to the determination of the risk-free proxy rate, particularly in the light of extraordinary monetary policy actions, and international regulatory developments.
- » **Financeability** – Consideration of movement to conduct a high-level financeability assessment on a hypothetical benchmark firm using the proposed Instrument settings and current data, to ensure the benchmark firm has a reasonable opportunity to meet and maintain the benchmark credit rating which the AER has assumed in the cost of debt estimate.
- » **Engaging with the key findings of Brattle review on cost of capital approaches** – This should include consideration of taking forward key recommendations to enhance the weight provided to forward-looking evidence in return on equity estimates, seeking opportunities to address the finding that Australian allowed returns on equity are substantially beneath any relevant international comparators, and development of robust ‘cross-checks’ on return on equity estimates.

Engagement and positive proposals from the AER on these issues, resulting in real world adjustment to its 2018 Instrument approaches, would provide a clear signal of the AER’s response to stakeholder concerns with the balanced treatment and assessment of evidence in the previous review.

2.4 Expert conclave and concurrent sessions

A proposed change to the 2018 expert sessions is the convening of a closed ‘conclave’ expert session, prior to the series of expert concurrent sessions. This Conclave will play a role in identifying areas for discussion at the following expert sessions, including narrowing the topics for consideration.

For appropriate process transparency, it will be important for all stakeholders to fully understand the role and outputs of this expert conclave. While the Consultation Paper indicates that the December 2020 Information Paper and stakeholder submitted questions will be considered by the Conclave, the outputs of this process are less clear.

ENA considers that, to assist stakeholders seeking to follow the consideration of material issues raised through the review, the Conclave should provide a short summary of its outcomes. This could usefully include a summary of which issues the Conclave considered contentious, and which were agreed to be reasonably settled.

In this regard, ENA notes the AER’s view that the expert sessions should not play a determinative role, just as they did not in 2018. The recommendation for the Conclave to develop a clear summary statement is simply designed to allow stakeholders to clearly understand the basis upon which the subsequent expert sessions will proceed.

2.5 Ensuring the Independent Panel can efficiently assess the Draft Instrument

Energy network businesses remain concerned at the potential risk – which was realised in 2018 – for the Independent Panel to not have sufficient information to clearly assess areas of specific and strong concerns with the Draft Instrument.

2.5.1 Experience in the 2018 instrument review

Through the 2018 review stakeholders (including networks) sought an opportunity to ensure that each member of the Independent Panel reviewed major submissions to ensure familiarity with the major issues in discussion in the review. This was reiterated in the network sector response to the December 2019 AER consultation on the review process.

It remains unclear the extent to which the 2018 Independent Panel had any reference – as opposed to access – to any stakeholder submissions or associated expert materials. The detailed analysis and focus on matters that no stakeholder considered material, and the lack of any detailed commentary on several central contentious issues in the review, appears to indicate that Energy Networks Australia’s submission and materials may not have been reviewed by the Panel.

If this were the case, it would represent a deficient outcome for any form of independent process of review, which would not be consistent with the intended goal of enhancing stakeholder confidence. It is clear that without an improved capacity to understand and focus on issues in material dispute, versus abstruse methodological issues raised by no stakeholder, the Independent Panel process risks not achieving its goal of enhancing stakeholder confidence.

As an example, the 2018 Independent Panel report gave around one paragraph of consideration to dividend growth estimates of the market risk premium, which was one of the key elements of industry submissions and one of the most contentious and material issues discussed throughout the whole process. Strikingly, the 2018 Panel report simultaneously engaging for a number of pages in a lengthy discussion about the number of decimal points to which the gamma parameter should be rounded (a matter no stakeholder had considered relevant enough to raise). This outcome demonstrates that the 2022 Independent Panel could strongly benefit from enhanced guidance over that the 2018 Panel received in order to make the most meaningful and relevant contributions to the process of ensuring a robust and high-quality final Instrument.

To this end, energy network businesses continue to consider that major stakeholder groups such as ENA, the Consumer Reference Group, and investor representative stakeholders, should be able to make a short submission (for example, limited to 2-5 pages) highlighting specific areas of concern with the draft Instrument – if necessary, strictly constrained to referring the Panel to previously submitted material on the highlighted priority issues. This would ensure that the Panel was only considering information relevant to the issue that was before the AER at the time of the draft instrument.

2.5.2 Proposed AER approach to Independent Panel submissions

The AER has indicated that stakeholders may include a submission to the Independent Panel in response to the AER’s December 2021 Information Paper.

The AER indicates that these submissions will be due by February 2022, following the Concurrent Expert Evidence Sessions.

This proposed approach has several significant weaknesses. In particular, consistent with occurrences in the 2013 and 2018 reviews, the AER could potentially:

- » materially change its approach on an estimation approach or methodology in a way not previously signalled, meaning that the Independent Panel has **no** alternative materials, data or views on the record to inform its independent assessment on this changes approach; or

- » rely on evidence (for example, new expert reports) not known or available to stakeholders in February 2022, leaving the Independent Panel with no means of testing the strength or quality of this new evidence with reference to materials on the record.

In summary, the proposed timeline places each major stakeholder in the position of seeking to speculate, on the basis of an Information Paper in December 2021, the significant areas of concerns which they *may* have with a draft Instrument made approximately 6 months later.

Such an approach would appear to leave participants with an incentive to seek to identify a wider range of possible matters where they have concerns the AER's decision may contain weaknesses or errors, compared to an opportunity to efficiently highlight in a short document actual areas of concern with an actual draft Instrument.

An Independent Panel which engages in an efficient and focused assessment of key priority areas of the draft Instrument, clearly informed by stakeholders' perspectives on the relevant issues, has the greatest opportunity of promoting stakeholder and regulatory confidence, enhancing the quality of the final Instrument, and giving the AER the capacity to best contribute to the NEO and NGO.

As discussed in Section 2.5.1, energy network businesses continue to consider that major stakeholder groups such as ENA, the Consumer Reference Group, and investor representative stakeholders, should have the capacity to make a short submission (of 2-5 pages) highlighting specific areas of concern with the draft Instrument. If consider necessary by the AER this could be strictly constrained to referring the Panel to previously submitted material on the highlighted priority issues. This would ensure that the Panel was only considering information relevant to the issue that was before the AER at the time of the draft instrument.

3 Matters raised for consultation

3.1 Expert funding arrangements

ENA supports the proposals for experts who appear in the Concurrent Evidence Sessions to be remunerated by the AER.

This approach enables greater assurance to all stakeholders that the best possible support is provided on a uniform basis in the relevant sessions and reinforces the primacy of the duty of the experts to providing best unbiased evidence to inform the AER's decision.

ENA notes that experts are also likely to have strong pre-existing reputational incentives to provide clear, fair and well-balanced views and evidence. Due to these reputational incentives, ENA considers the alternative of retaining of stakeholder-based funding would also be workable, alongside clear agreed obligations to provide views independently.

3.2 Scheduling of sessions

ENA supports to proposal for the scheduling of four two-and-a-half hour sessions, thematically based to enable a good opportunity for high priority issues to be discussed.

To maximise transparency and utility of the session, ENA suggests that it will be important for the topics and questions to be discussed by the Concurrent Sessions to be identified and published in advance of each session.

This is to avoid an outcome where it is unclear to stakeholders ahead of the sessions which issues and questions are being discussed and why. This may impact stakeholders resourcing decisions around potential further empirical or theoretical work in some areas.

3.3 Membership of the Independent Panel

ENA supports the appointment of a 5-person panel drawing on a diversity of skills and experience.

ENA broadly concurs with the observations of the Consultation Paper with respect to the Independent Panel but would make three points.

- » **Steering the Independent Panel towards substantive review and testing, rather than editorial suggestions** -The Independent Panel plays a critical role in the absence of any other form of review of the substance of the AER's decision in promoting stakeholder confidence that the best decision possible having regard to the evidence has been made. This should be both the basis for selection of the Panel, but also outlined to the Panel in its preliminary briefings and tasking.

The role and expertise of the Independent Panel is not best exercised by merely suggesting to the AER areas in which its reasoning can or should be 'more clearly explained'. Requests for clarity and more explanation constituted around 20 of 30 formal recommendations made to the AER in 2018.¹¹

Guidance included advice to consider the location of discussions within sections of the document. Such suggestions may have value as editorial input toward a clear and well-written Explanatory Statement. There are alternative lower cost ways of obtaining this feedback, and it is clear that undertaking this quasi-editorial function is not the best use of the skills of a highly specialised expert Panel. It also does not deliver on the primary objective of ensuring that the reasoning or chain of logic in the decision itself is strong.

Rather, the prevalence of editorial guidance suggests that in a range of areas, the Panel was not able to sufficiently follow the chain of logic, in order to test it. Incorporating feedback to more clearly explain issues does not itself provide any particular guarantee as to the underlying strength of logic or chain of reasoning. Clear guidance should be given to the Panel to primarily focus on the soundness of reasoning and chain of logic in the draft Instrument, and to offer editorial suggestions in a separate Appendix if required.

- » **Institutional investment experience** – ENA supports the panel including participants with strong institutional investment expertise. The AER Consultation Paper describes the value of this perspective as informing the AER as to whether the 'replicability and transparency of the methodology' chosen by the AER is sufficient to promote investor confidence.

ENA considers this is an incomplete description of the potential value and appropriate scope of this perspective. In view of the AER's agreed objective of providing an 'unbiased estimate' of the market rate of return required for efficient investment and use, this expert and the Panel should also be

¹¹ Independent Panel Review of the Australian Energy Regulator's Rate of Return Draft Guidelines, 7 September 2018, p.V-VIII

tasked with assessing whether applying the AER's draft Instrument is likely to result in an unbiased estimate of the required market rate of return over the period of its operation, thereby producing the outcome of efficient investment in, and use of, the regulated services to the greatest degree.

4 Appendix - Recommended review process enhancements

Recommended process step	Comments	Adopted?
Before the review		
AER should set out a purpose for the review process and design the process around that purpose.	This purpose needs to include promoting confidence in the outcome of the decision and balanced treatment of evidence.	Yes
Testing of stakeholder confidence in process both prior to review and after.	The performance indicator should be that stakeholder confidence in the treatment of evidence, predictability and independence of the process should stay the same or increase following the review.	No
Establishing set of common 'agreed data'.	AER should set out the range of materials, data and evidence it proposes to rely on, and publish and provide access to this data. This would assist to enable to the review to proceed on a set of 'agreed facts'.	No
Pre-established return on equity cross-checks and defined responses for failures in cross-checks.	AER should define upfront its proposed cost of equity cross checks and provide clear guidance on what actions will result from the failure of any or all of these cross checks.	Unclear at this stage
During the review		
Gather and test empirical evidence on a full range of grid customers and consumers perspectives on price/reliability and investment risk trade-offs.	This would provide clarity and predictability and inform consumers if they should expect higher investment risks to manifest in lower service outcomes for current or future grid customers and consumers.	Unclear at this stage
Draft and final decision to include discussion of how investment risks, reliability, infrastructure availability risks have been balanced.	It is important for transparency for stakeholders to understand how risks have been balanced, and how the AER has satisfied itself that this risk package best promotes the National Energy Objectives and takes account of the Revenue and Pricing Principles.	Unclear at this stage

Use of financiability checks.	AER draft and final guidelines should be robustly tested for their financiability impacts on the defined benchmark efficient entity	Unclear at this stage
Independent Panel to be informed of priority stakeholder issues.	Stakeholders should be invited to include a 5-page summary of key issues with the AER draft guideline with their submissions to the draft guideline.	No.
Independent Panel to be required to provide a view on the appropriateness of the draft rate of return proposed by the AER.	The existing tasking of the Panel focused on whether the AER's decision is 'capable of promoting' the NEO/NGO does not provide any material guidance, or adequately direct the Panel to test the strength and quality of AER methodologies or estimates.	No.
Independent Panel to be required to separately identify in summary table form substantive recommendations, and requests for clearer explanation of AER positions	The 2018 Independent Panel report featured predominant focus on requests for 'clearer' explanations of AER reasoning. For the assistance of stakeholders, it should be clear where the Panel has substantively queried an AER approach.	Unclear at this stage
Final decision to indicate in summary table form where stakeholder input has altered draft decision.	Indicating where a decision is different based on further information and evidence is critical for transparency. The 2018 Explanatory Statement noted and mentioned evidence throughout, but did not identify where this input had changed the decision. Just as energy network businesses' regulatory proposals routinely identify where stakeholder engagement has led to a different proposals, the AER should identify which specific elements of its draft decisions have been changed by stakeholder input.	Unclear at this stage
After the review		
Independent Panel to be required to publish assessment of AER final instrument.	This report should indicate whether the issues it raised with the draft instrument have addressed.	No.
Re-testing of stakeholder confidence in process after the completion of the review.	The performance indicator should be that stakeholder confidence in the treatment of evidence, predictability and independence of the process should stay the same or increase following the review.	Unclear at this stage