Stakeholder Feedback on the AER's Process for the 2018 Rate of Return Instrument

PREPARED FOR

The Australian Energy Regulator

PREPARED BY

Toby Brown

Nguyet Nguyen

Ben Qiu

Nick Vernon

27 June 2019

THE Brattle GROUP

Notice

This report was prepared by the authors for the Australian Energy Regulator (AER), and is intended to be read and used as a whole and not in parts. It is provided as is, and the Brattle Group and AER disclaim any and all express or implied representations or warranties of any kind relating to the accuracy, reliability, completeness, or currency of the data, conclusions, forecasts or any other information in this report. Readers of this report should seek independent expert advice regarding any information in this report and any conclusions that could be drawn from this report. The report itself in no way offers to serve as a substitute for such independent expert advice.

The report is the work of the named authors and does not necessarily reflect the opinions of The Brattle Group's clients or consultants. To the fullest extent permitted by law, The Brattle Group and AER, along with their respective directors, officers, and employees, shall not be liable for any errors, omissions, defects, or misrepresentations in the information contained in this report, whether intentional or unintentional, or for any loss or damage suffered by persons who use or rely on such information or any conclusions that could be drawn from the report that turn out to be inaccurate (including by reason of negligence, negligent misstatement, or otherwise).

Table of contents

Executive summary

The Australian Energy Regulator (AER) asked The Brattle Group to conduct telephone interviews with a diverse set of stakeholders who had participated in the process running from July 2017 to December 2018 that culminated in the AER's 2018 Rate of Return Instrument. We asked stakeholders for feedback on the AER's process. This report lists the stakeholders we interviewed and summarises the feedback we collected but does not attribute the feedback.

Stakeholders generally commended the AER for the effort it invested in designing and conducting the 2018 process. Stakeholders acknowledged that the process provided them with opportunities to participate at the various stages of the review, and that the AER published useful reference materials throughout. The innovative elements of the process – the customer, network and investor reference groups, the concurrent expert sessions, and the independent panel review – were perceived as having the potential to add significant value. However, most stakeholders thought that some, but not all, of this potential had been realised. Stakeholders offered feedback on where improvements could be made in relation to these elements of the process.

The questions we asked in interviews were designed to elicit feedback on the process rather than the outcome of that process in terms of the value of the various rate of return parameters. Nonetheless, some stakeholders acknowledged that it was not always easy to provide feedback on the process that did not also have regard to the outcome of the process.

The feedback we collected tended to focus on specific examples of where stakeholders thought that the process could be improved, and our summary in this report therefore reflects that. Most areas of concern were about how the process was implemented, including: that the process did not always successfully identify and prioritise those issues that stakeholders thought were the most important; that at various points submitted evidence was not always assessed on its merits; and that the process ultimately produced an outcome that was surprising to some stakeholders. However, readers should keep in mind that most stakeholders were generally positive about the effort invested by the AER, and the potential for this process to work well.

Our report summarises the key aspects of the process that stakeholders felt could and should be improved on, as well as their recommendations for change.

I. Introduction

1. The AER is currently in the process of considering how to best develop the next iteration of the Rate of Return Instrument. It decided to seek feedback from stakeholders on the process undertaken to develop the 2018 Rate of Return Instrument. The AER retained The Brattle Group (Brattle) to conduct a series of interviews with stakeholders and to summarise stakeholders' feedback.[1]

2. The AER provided us with a list of stakeholders to contact,[2] and divided the stakeholders into six groups (consumers, investors, regulated businesses, retailers, experts, and others). The AER also suggested several individuals as the initial points of contact from each group and asked us to conduct interviews across all six groups.

3. In preparation for the interviews, the AER developed a two-page background description of the 2018 Rate of Return Review process and the current review. In addition, together with the AER we developed a one-page list of questions, a timeline of the 2018 Rate of Return Review process, and a flowchart describing its main features. We sent these materials to the stakeholders we interviewed, and have also included them in this report.[3]

4. The AER notified stakeholders that Brattle was assisting with this review, and provided stakeholders with our contact details. The AER staff was not subsequently involved in the process of collecting feedback and did not attend the interviews.

5. We ultimately conducted 22 telephone interviews with a total 39 individuals (listed in Table 1). Each interview lasted approximately one hour, and was attended by at least two of the Brattle team. We first reached out to the stakeholders the AER suggested as initial points of contact and the stakeholders who contacted us to express their interest in this review. In addition, we contacted other stakeholders on the AER's list to ensure that we would receive feedback from across all the groups.

---

1 The terms of reference for this engagement, extracted from the AER's request for quotation, are attached at Appendix C.

2 We understand that this list included all stakeholders who made submissions during the 2018 process.

3 The flowchart is Figure 1, the timeline is Figure 2, the list of questions is Appendix A, and the AER background document is Appendix B.

Figure 1: 2018 AER Rate of Return Review Process Summary Flowchart

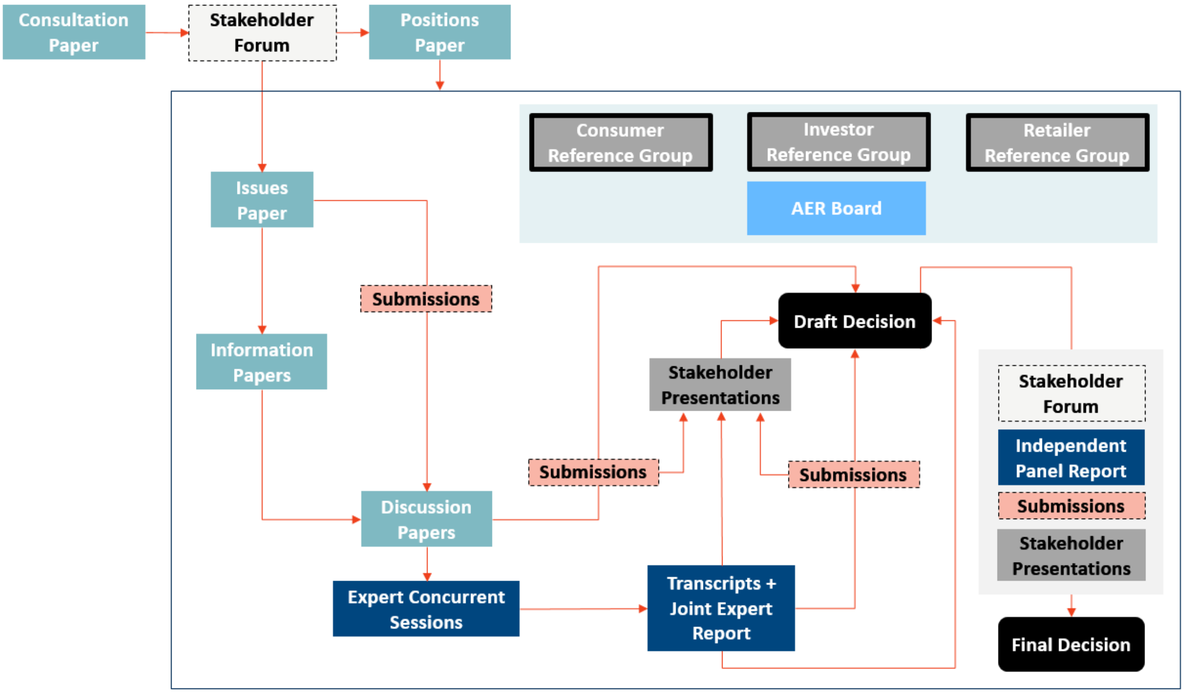

Figure 2: 2018 AER Rate of Return Review Process Timeline

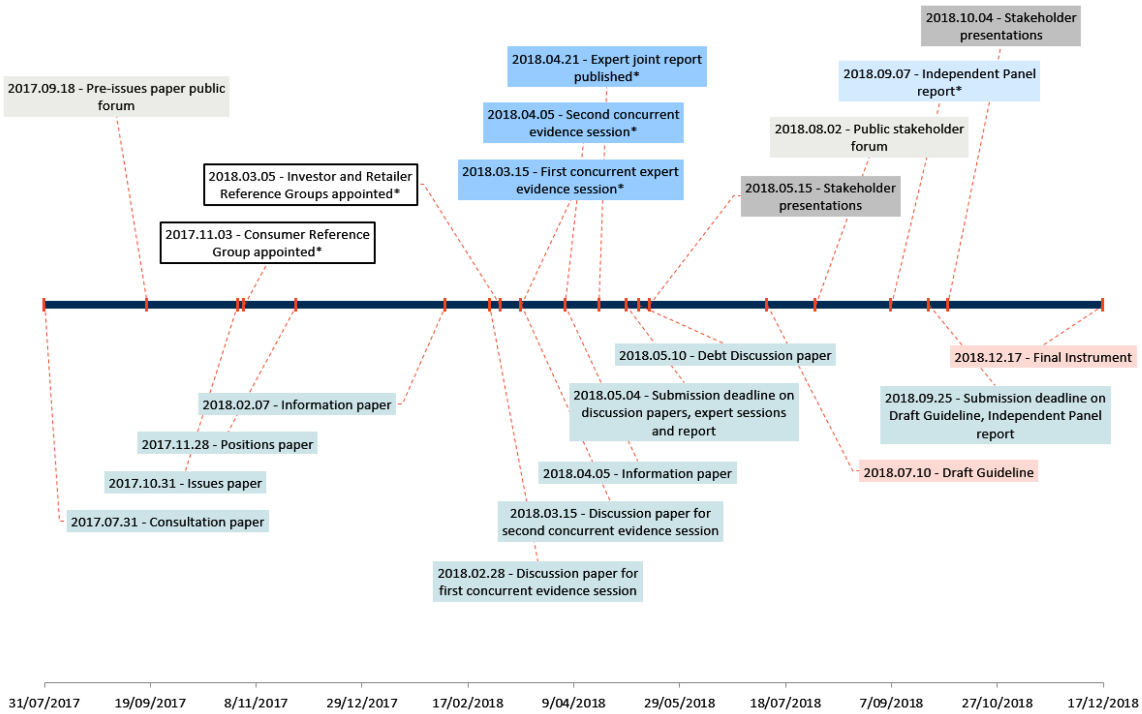

Table 1: Interviewed Stakeholders

Derek Chu	Australian Super
Cristina Cifuentes	AER Board
Benedicte Colin	Caisse de dépôt et placement du Québec (CDPQ)
Jim Cox	AER Board
Josh Crane	IFM Investors
Garth Crawford	Energy Networks Australia
Craig de Laine	Australian Gas Infrastructure Group
John Devereaux	Tasmanian Small Business Council, Goanna Energy
Pat Duignan	Previously New Zealand Commerce Commission, member of the Independent Panel
Michael Faulkner	Morrison & Co
Geoff Frankish	Previously Goldman Sachs, member of the Independent Panel
Stephen Gray	University of Queensland, Frontier Economics
Sean Greenup	Origin Energy
Mark Grenning	Energy Users Association of Australia
Jim Hancock	South Australian Centre for Economic Studies
David Havyatt	Energy Consumers Australia
David Headberry	Major Energy Users
Bev Hughson	Darach Energy Consulting Services
Chris Joseph	Member of the CRG
Sandeep Kumar	Jemena
Martin Lally	Capital Financial Consultants
Patrick Makinson	SA Power Networks
David Markham	Australian Energy Council
Ian McAuley	CARE ACT
Sally McMahon	Spark Infrastructure
Kym Mercer	Anti-Poverty Networks SA
Jonathan Mirrlees-Black	Cambridge Economic Policy Associates
Stewart Myers	MIT Sloan School of Management, member of the Independent Panel
Graham Partington	University of Sydney
David Prins	Etrog Consulting
Stasha Prnjatovic	AMP Capital
Andrew Robertson	APA Group, Australian Pipelines and Gas Association
Natalia Southern	Previously FTI Consulting, member of the Independent Panel
Caroline Taylor	TransGrid
Michelle Trinh	TransGrid
Steve Whan	National Irrigators Council
John Williams	APA Group, Australian Pipelines and Gas Association
Nick Wills Johnson	Australian Gas Infrastructure Group, Dampier-Bunbury Pipeline
Kieran Zubrinich	Macquarie Infrastructure

II. Feedback

6. The rest of this report is our summary of the feedback we collected from stakeholders in the interviews. We have organised the feedback under six topics that we consider to be those of most importance to stakeholders. We have also included a catch-all topic at the end to capture all other points stakeholders made unrelated to the six topics we identified. Included in our summary are recommendations from stakeholders for improving the process. This report does not contain any recommendations from the authors.

7. We have not attributed feedback to the stakeholders we interviewed.

8. Overall, most stakeholders recognised that the AER had put significant thought and effort into the 2018 Rate of Return Instrument process and noted aspects of the process that they thought to be positive. There was a general understanding that there had been sufficient opportunities for each stakeholder to participate at the numerous stages, and that the AER provided useful reference materials throughout the process. At least at the outset of the process, most stakeholders thought highly of the new elements of the process, including the reference groups, the concurrent expert sessions, and the Independent Panel. Some stakeholders were also pleased that the AER is currently re-examining the design of the rate of return process, and commended the AER for undertaking this work.

9. Most stakeholders showed appreciation for the effort that the AER put into the 2018 Rate of Return Instrument process. However, many raised specific concerns with the execution of the process and its outcome. Some stakeholders suggested that the financial markets were surprised by the outcome of the process, linking this to a lack of explanation from the AER throughout the process.

10. In the rest of this report we summarise stakeholders' feedback that we collected during our phone interviews.

A. Timing and pacing of the process

11. While there was acknowledgement of the hard work that the AER put in to keep the process on schedule, some stakeholders expressed concerns with the pacing of the process. These stakeholders stated that they believed that more could have been achieved in the first half of the process, and that the second half of the process was too rushed. Stakeholders mentioned the organisation and execution of the concurrent expert sessions and the subsequent joint expert report, the submissions on the draft report, and the May 2018 discussion paper on estimating the allowed return on debt (debt discussion paper) as examples of components of the process that were time-constrained. These stakeholders thought that better time management would have improved the process.

12. Some stakeholders also commented on the timing of the establishment of the Consumer Reference Group (CRG), stating that the CRG was established too late in the process without a clear and well-defined objective. This made it difficult for the CRG to put together timely and well thought-out submissions. According to these stakeholders, the CRG did not have an opportunity to comment on the consultation and issues papers from July and October 2017, nor to participate in the initial stakeholders' forum in September 2017; the CRG's members were not able to collectively comment on the broad approach of issues, and the CRG spent a lot of time playing catch-up in the midst of figuring out its role. The process whereby the CRG and Energy Networks Australia (ENA) came together to narrow the issues between them was said to have worked poorly because of the short and delayed timetable, as the CRG was still working on where they stood on issues internally.

13. One stakeholder commented on the issue of timing in the context of not having advanced knowledge of what needed to be done. For example, it was not clear that the experts from the concurrent expert sessions were expected to subsequently produce a joint report. This impeded the ability of stakeholders to engage experts over an adequate timeframe.

14. Some stakeholders also commented on the timing of the 2018 Rate of Return Review process relative to other processes. One stakeholder mentioned the legislative process to replace the rate of return guidelines with a binding instrument. This stakeholder thought that it would have been advantageous for the review process to have commenced after the legislative changes had been finalised. Another stakeholder mentioned that the Rate of Return Review occurred at the same time as the New South Wales (NSW) revenue determinations. This stakeholder thought that while the outcome of each process was independent, it did increase the burden on stakeholders responding to both sets of regulatory processes that the two coincided.

B. Scope and objective of the process

The concept of "incremental review"

15. The term "incremental review process" was brought up by most stakeholders in the interviews. Below is a short excerpt from the AER's October 2017 issues paper describing an "incremental approach" that industry and consumer advocates supported.

> "We [the AER] have taken the approach of identifying key issues for the review, rather than a 'blank slate' approach of reviewing every aspect of the rate of return. We consider that a targeted approach to the review will allow for a more efficient review process, including more effective consultation and stakeholder engagement on significant matters. A targeted approach to the review can acknowledge the significant analysis that was the basis of our current approach to the rate of return, while more effectively addressing matters that require further consideration. Industry and consumer advocates broadly supported this incremental approach at the public forum we held on 18 September 2017 [f/n omitted].

… [W]e consider this review should seek to build on the current Guideline rather than start afresh. There are a number of aspects of the current approach that are reliant on market data and empirical analysis, and this material would clearly need to be updated. However, there are a number of aspects of the current approach that are driven by finance theory and available academic literature. We not aware of any significant new developments in this area that might warrant us taking a new approach."[4]

16. The concept of an "incremental approach" seems to have resulted in disagreement amongst stakeholders about what issues were or should have been in scope, what items were subject to examination or change, and the evidentiary threshold for making changes. Some stakeholders were not sufficiently satisfied with the scope and identification of issues from the start of the process.

17. Some stakeholders viewed that this was not an "incremental review" since several allegedly significant changes were ultimately made. These stakeholders said they did not have a problem with a review that considered broader issues; however, they would have liked the AER to announce that up front, without the use of the term "incremental review". Stakeholders who shared this view were surprised by the change in approach to the foundation model, specifically the zero weighting on the Black Capital Asset Pricing Model (Black CAPM) and the Dividend Growth Model (DGM), in contrast to the non-zero weighting these models had in the prior guideline. They believed that the decision to change the foundation model to this extent was inconsistent with the idea of an incremental review.

18. In contrast, some other stakeholders claimed that the issues were not broad enough, and more conceptual issues should have been considered up front before tackling the narrowing of issues. These stakeholders disagreed with the AER's approach of starting with an "incremental review". One stakeholder thought that the initial set of issues was too restricted and wanted more conceptual issues on the table from the beginning of the process. For example, this stakeholder thought that it would have been appropriate to test the logic of using a theoretical model such as the Sharpe-Lintner Capital Asset Pricing Model (SL-CAPM) before diving into discussions over the values of the various components of this model.

Process for narrowing and prioritising issues

19. Some stakeholders said the AER was effective in narrowing and prioritising issues, with one saying the AER put in great effort in consulting on what the most important issues were, which was useful for setting the direction of the review. In contrast, other stakeholders thought that the process was not particularly effective in narrowing issues nor making decisions to take issues off the table.

20. Some stakeholders thought that influence from other stakeholder groups and wider political concerns pressured the AER to broaden the scope of the review process, after

[4] Australian Energy Regulator, Issues Paper – Review of the rate of return guidelines, 31 October 2017, pp. 7-8.

the review had commenced, beyond what these stakeholders believed to have been implied by an "incremental review". Stakeholders who did not have a strong view about the term "incremental review" thought the issues started quite broad from the outset, and there was not sufficient narrowing as the process went along. Other stakeholders believed that the key issues were known from the outset of the process, and that instead of real progress on these issues as the process went along, agreement was reached only on uncontroversial topics, so that effectively the same issues remained to be determined at the end of the process.

21. Some stakeholders felt surprised because there seemed to be a parallel set of issues being examined throughout the process, with different stakeholders that had different ideas addressing separate issues. These stakeholders further claimed that while certain issues were put through a process that appeared robust, as they had the opportunity to be tested by the experts and were part of submissions to the AER, certain issues that appeared later in the process such as the debt discussion paper and information from experts that came after the expert concurrent sessions (see below) did not go through similar levels of rigour because they came late in the process.

22. A more thorough and selective identification of key issues was suggested, as one stakeholder felt that issues would be included in the analysis if they were raised by a stakeholder, even if there was not broad agreement that the issue was important. Some stakeholders suggested the AER could consider certain issues ahead of the Rate of Return Review to reduce the burden during the review period. These stakeholders suggested that these issues marked for early consideration could include specific technical issues like the use of arithmetic or geometric averaging, or whether the estimation of gearing should rely on book or market value. These stakeholders thought that the introduction of such a process would mean there could be agreements on the approach to be used in calculating a figure, not the actual computation of the figure itself. One stakeholder claimed that this would create less of a win or lose paradigm and would facilitate joint exploration towards common understanding.

The general objective of the process

23. One stakeholder mentioned that (i) they thought that the process was so focused on procedural matters that it neglected to give adequate consideration to market expectations and that (ii) this led the process away from achieving a rate of return that might have been expected by financial market participants, particularly equity investors. The stakeholder pointed to 2013, at which point the National Gas Rules (NGR) required that the rate of return be commensurate with the efficient financing costs of a benchmark business. This requirement, which was said to have been around since 1997, was not explicitly included in the NGR as of 2018. The stakeholder asked that the AER interpret the current statutory requirements up front in the process. The current National Gas Law (NGL) states that "[t]he AER may make an instrument only if satisfied the instrument will, or is most likely to, contribute to the achievement of the national gas objective to the greatest degree".[5] The stakeholder viewed the current

5 National Gas Law, section 30(D) 3.

statutory requirements as incomplete and vague, and said that there needs to be a debate on what the statutory requirements mean before beginning the process of working out how the parameters should be estimated. The stakeholder emphasised the importance of having a rate of return that represents efficient financing costs, commensurate with conditions in financial markets. For example, the stakeholder noted that during the debate around the use of SL-CAPM the AER did not consider whether the SL-CAPM produced a rate of return that is reflective of market conditions. The key concern to this stakeholder was a lack of a governing question to the process. The stakeholder was concerned that the prior guidance (efficient financing costs, commensurate with conditions in financial markets) had largely been displaced by requirements for processes to convene reference groups, experts, and an Independent Panel. Another example was the market risk premium (MRP), where stakeholders were already focused on what practitioners currently do, but there was little discussion on whether this is the right way to measure equity market returns. Stakeholders said that a lack of proper guidance meant reference groups, experts, and the Independent Panel were not as useful as they might have been.

24. Stakeholders identified a perception that the AER had set the rate of return too high in the 2013 Rate of Return Review process and that consequently the 2018 Rate of Return Review needed to reduce the rate of return to correct for this prior decision. The perception that the process could only ratchet downwards was said to have undermined confidence in the process. It was suggested that the AER should be explicit in stating that the Rate of Return Review is a forward-looking process and that it will not consider the outcome of the last round in setting a new rate of return. Other stakeholders said that they felt frustrated with the process, which they thought to be generally sound but executed so as to produce an outcome that the AER had already reached. There was a view that the AER wanted to drive returns down, and it was only open to submissions that moved the outcome in that direction. One stakeholder identified a similar concern with the inflation review that was occurring at the same time.

25. Stakeholders also shared their views on what the AER needs to consider in future reviews.

26. Stakeholders wanted a discussion on whether the AER should continue to refine its approach, or have a complete revisit of the whole rate of return methodology. The same stakeholders said that they would not want to see the latter, because having a stable framework that works well is good for investors and consumers in an industry where long-term investments have to be made. One stakeholder thought it would be hard to start from a blank sheet of paper since a lot of evidence and arguments were already distilled in the past, and to start with a blank sheet would mean the loss of some of the lessons that were learnt earlier.

27. Another stakeholder recommended that the AER reconsider the current use of the Rate of Return Review framework. They argued that instead of estimating parameters that make up the rate of return, the AER should set a rate of return going forward that is based on a fixed premium above the risk free rate, adjusting it upwards and downwards depending on the level of investment required.

28. Some stakeholders emphasised that the ideal Rate of Return Review process should be a predictable and transparent one, where stakeholders can (i) replicate the outcomes determined by the AER and (ii) assess movements of certain parameters and corresponding outcomes over several review periods based on their own assessment of market conditions.

C. The AER's consideration of submissions and evidence

29. Stakeholders were clearly split on whether submissions were adequately addressed by the AER. One group of stakeholders said that they thought the AER did a good job in addressing issues comprehensively, while another group said that the AER did not do enough to address certain issues and evidence. Some stakeholders from both network and consumer groups thought that the AER did not engage sufficiently with the material that they had submitted. Some stakeholders acknowledged in the interviews that they found it difficult to assess the quality of the AER's process separately from assessing the outcome of the process.

30. Some stakeholders thought that the AER had given adequate and due consideration to the submissions that they made through the review process. These stakeholders also believed that the AER had adequately considered other stakeholders' submissions. While these stakeholders recognised that not everyone agreed with the AER's decisions, they had not heard complaints of the AER not addressing some issues. Stakeholders pointed to the final decision and the Independent Panel's report as evidence that the AER had given adequate consideration to all submissions.

31. In contrast, other stakeholders raised concerns with the AER's consideration of submissions for two key reasons. First, 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. Second, stakeholders 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. Below, we elaborate further on these reasons.

The AER's consideration of evidence

32. A theme that arose from the interviews was some stakeholders' perception that the AER applied different standards in considering evidence presented by different stakeholder groups. 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.

33. These stakeholders gave examples of the AER giving what they perceived to be undue weight to poor quality evidence from consumer groups, including evidence on

consumer reliability preferences and the MRP. With respect to the former, some stakeholders thought the AER placed weight on the CRG's suggestion that consumers would be willing to accept less reliability in exchange for lower prices, while these stakeholders thought that the CRG did not present adequate evidence to support its suggestion, particularly given survey information presented by the networks that contradicted the CRG's suggestion. With respect to the latter, some stakeholders said that the AER referred to a website brought to its attention by other stakeholders for the calculation of the MRP, despite this website containing evidence that was of a questionable standard (and despite other stakeholders pointing out flaws in the evidence).

34. The same stakeholders also pointed to situations in which they felt that the AER unreasonably dismissed evidence presented by the networks. In one example, the networks submitted evidence, supported by academic research in leading journals, on the topic of low beta bias, but these stakeholders claimed that the AER disregarded this evidence. 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.

35. In contrast with the above view, other stakeholders thought that the AER was biased towards outcomes that favoured networks. These stakeholders thought that the AER was overly conservative with regard to the range of potential outcomes from the beginning of the review process for fear of reducing future investment.

The AER's reasoning for its decision

36. Some stakeholders were generally pleased with the way the AER approached submissions, saying that the AER seemed to have comprehensively acknowledged everything it had received in submissions from all stakeholders. But some stakeholders from both customer and network groups also provided examples of separate instances where they felt that the AER had not provided adequate reasoning. 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. They said that while the AER cited most submissions, the AER did not provide adequate reasoning for why some positions were or were not adopted. Another stakeholder felt that reasons were written simply so that the AER could say that the evidence was considered, and that the AER was not concerned with engaging more substantively with the evidence. 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. One stakeholder suggested that there were a few instances in

the explanatory statement where the AER had either incorrectly cited a particular view or misunderstood a view put forth by stakeholders.

37. Stakeholders thought that the AER was at times too quick to dismiss evidence and did so without adequate reasoning. In one example, one stakeholder said that the AER dismissed evidence that they had presented on the basis that the evidence was too complex. This stakeholder thought that the AER should have engaged with them to try to reach a common understanding before dismissing their submission. In another example, the AER dismissed an approach that a group of stakeholders had proposed to narrow a parameter range for the DGM which the AER had deemed to be problematic. The stakeholders said that the AER based its decision to dismiss their approach on potential issues identified by a consultant, but did not suggest how the stakeholders might mitigate these potential issues. The stakeholders thought that the AER did not then engage with them sufficiently when they proposed a method of crosschecking the results of the dismissed approach. More generally, stakeholders thought that there were insufficient opportunities at times to provide further evidence when the AER dismissed a submission's evidence.

38. Stakeholders raised circumstances in which they felt that the AER was inconsistent in its approach towards submissions, sometimes showing a bias in favour of the status quo and sometimes not. For example, stakeholders asked the AER for the reason it changed the foundation model in the current round, noting that the AER had said in 2013 it would only make changes if there were changes in theory or evidence. The alleged AER response was that if one waited for theory to change one would never change anything. Stakeholders suggested that this was in contrast to AER decisions on other parameters. For example, the stakeholders said that despite evidence that a previously-rejected model for the MRP was now in wider use than before, the AER appeared to modify its criteria for selecting a methodology by adding the requirement that a change in the methodology must result in a material change in outcome to be accepted.

39. Some stakeholders perceived the AER's handling of issues to be unbalanced. They thought that the detail given to an issue in the draft guideline at times did not correspond to the degree of importance that stakeholders gave that issue. One stakeholder commented that the AER gave limited reasoning to support its decisions on a number of key issues and extensive reasoning to support its decision on issues that were less important. One way in which stakeholders suggested that the unbalanced treatment of submissions and topics impacted the process was through the Independent Panel. Stakeholders suggested that because the AER's draft guideline did not always identify which issues were of most importance to stakeholders, the Independent Panel would have needed to look beyond the draft guideline into the submissions themselves to get an understanding of stakeholders' priorities. This would have been a very significant task for the Independent Panel due to the volume of submissions. Some stakeholders suggested that a potential improvement might be for stakeholders to rank the issues raised in their submissions and for the AER to address more fully issues stakeholders ranked as important.

40. Some stakeholders suggested that the AER should have arbitrated more actively during the review process. These stakeholders thought that a number of questions of fact

remained as disputed issues throughout the process and that this prevented more constructive work later on. According to these stakeholders, the AER did not spend enough time to reconcile stakeholders' positions on technical parameters, historical movements in prices, and spending and investment. This was because there was a lack of arbitration on the part of the AER on the reliability of the different sources of data that stakeholders used to support their positions. Stakeholders suggested that the AER should have verified the position it would take on some arguments, such as whether networks had spent excessively on capital investment, without unnecessarily prolonging discussion. It was suggested that if the AER were to adjudicate more actively on issues of fact, stakeholders could discuss the remaining issues based on a common pool of shared facts. It was also suggested that the AER could play a more active role in identifying what issues were disputed between stakeholders and prioritising the resolution of these disputed points. Similarly, some stakeholders suggested that that AER could have done more to address early on in the process what were seen as extreme positions, whether held by networks or consumer groups, as they viewed these positions to be unhelpful to the process.

D. Contributions of the Reference Groups

41. Some stakeholders raised several concerns about the lack of clarity regarding the roles, objectives, and selection and nomination criteria for the different reference groups. Stakeholders suggested that there should be a set of criteria for nominations for individual groups, criteria that should be linked with what the AER wants to achieve out of the groups. Stakeholders also suggested that individuals should have their reasons to join and motivation assessed. Stakeholders also expressed confusion and/or dissatisfaction with how the different groups interacted with each other and/or with the AER. But most stakeholders commended the AER's effort in corralling different stakeholder groups as a means of increasing participation and engagement.

The Consumer Reference Group

42. The value of the Consumer Reference Group (CRG) was questioned by some stakeholders. Some said that the role of the CRG was not clearly defined in the beginning, and that the group initially appeared not to understand the process nor know how to be effective. Others commented that the CRG was not well resourced, with one stakeholder suggesting that groups other than the AER (such as Energy Consumers Australia) should provide the CRG with more support. Stakeholders mentioned that it was important to have people on the CRG that have a good understanding of the issues, the process, and the language used in the process.

43. Most stakeholders brought up concerns about the lack of clarity of the CRG's role. Stakeholders mentioned that the AER was enthusiastic about involving consumers in the review process, but they did not have a plan upfront on how best to incorporate the CRG. Many said it would be helpful if the CRG had from the beginning a more defined role in the process, an example being clarity on what outputs the CRG was to produce. Several stakeholders said the CRG was left to its own devices on deciding on what to do. The CRG's under-defined role in the beginning also led to commitment issues that occurred during the nomination process. Stakeholders said the CRG members were not

properly informed about the time commitment required, and many members could not fully participate in the meetings and submissions during the process (partly also due to the lack of funding and resources, as explained below). Stakeholders did comment that after the AER had settled on the CRG's role, the AER provided very good support to the group, and had utilised them more effectively, creating better value add.

44. The CRG's lack of resources, especially in comparison to other well-funded stakeholder groups, were raised as a concern by several stakeholders. A stakeholder noted that while the AER was accommodating with funding, the CRG should have had a budget and resources plan from the beginning (and along with a proper roadmap with the role, objectives, and deliverables of the CRG). According to some stakeholders, several issues related to the CRG were directly caused by resourcing limitations, including the nomination of the expert representatives, and the authoring of CRG's submissions. A stakeholder pointed to how the CRG's experts were paid for by Energy Consumers Australia. Stakeholders claim that better resourcing would alleviate the power asymmetry that exists between the stakeholder groups, and that better contributions could have be accomplished by the CRG. A stakeholder encouraged the AER to fund the CRG's experts for the next round. A different stakeholder observed that experts nominated by the CRG were not there from the beginning for all sessions, in contrast with the experts for the network groups. Stakeholders were appreciative of the support that the AER gave CRG members.

45. Some stakeholders were concerned about the lack of technical expertise from the CRG representatives, while also noting that the diverse member backgrounds gave the CRG greater perspective on issues, and forced other participants to reconsider the ways in which they explained issues throughout the process. While the process drew from people from a variety of places, some people were either very new to economic regulation or had formed strong opinions on how economic regulation should work already. A stakeholder added that the CRG was well briefed by the AER on technical matters. On a related point, a stakeholder emphasised that it was not a stringent requirement to have technical expertise, but the nominees should be an effective advocate of issues that matter to consumers. Some stakeholders said the perspectives from the CRG were not entirely representative of the broad consumer experience, but other stakeholders were pleased that new groups were represented in the process that previously were not. One stakeholder mentioned that because of the complexity of the issues at hand, in the end, even after efforts by the AER to educate the group, only a small group of people (either with expertise, or with funding) could actually contribute. The stakeholder wanted nominations to the group be based on merit, and that there should better funding overall for the CRG, and better expertise building of the CRG members.

46. Suggestions were made by stakeholders on how to better utilise the CRG for the next review: having a core group of consumer representatives that would carry on meeting between review periods, and allow continuity between ideas and approaches from period to period which would eliminate the need to begin from scratch.

Interactions between the groups and interactions with the AER

47. Some stakeholders were confused about the interaction between the CRG and the Consumer Challenge Panel (CCP) and what their respective roles were. The two groups had different expectations going into a January 2018 meeting, which ended up making the meeting quite difficult due to criticism laid against the individuals attending. Stakeholders recommended that more active support from the AER to get the group members up to speed at the outset would allow for the groups to be more productive moving forward. Appointments and nominations to the groups were also said to be confusing, on whether people were being compensated, and what their roles were.

48. A stakeholder questioned the whole exercise of having the CRG and ENA meet, pointing to a CRG submission that occurred after the meetings which proposed a return on equity that was allegedly lower than term deposits at the time.

49. Some stakeholders made an observation that the CCP had a close relationship with the AER, claiming the CCP had even drafted parts of the guidelines. Further, the CCP were said to have had regular meetings with AER staff while the AER were forming their views and writing up the draft and final guidelines/instrument. This seemed to the stakeholder to be inconsistent with the idea that the CCP should be an independent entity that makes submission to that AER, and not part of the AER team. A stakeholder further added that a written terms of reference for the CCP covering interactions with the AER and other participants in the process would be useful for next time.

50. Similarly, some stakeholders saw privileged access by certain reference groups with the AER staff and the AER board, claiming a two way dialogue granted to certain reference groups was not evident in other reference groups.

Other reference groups

51. Some stakeholders were disappointed with the level of engagement the Retailer Reference Group (RRG) had, claiming that they had the resources to be effective but ultimately were not. Other stakeholders said the retailers could have contributed more to the process by providing direct information on the cost of capital. A stakeholder said that there was difficulty for retail groups to justify resources committed to the process because the Rate of Return Review process is largely a theoretical matter and one would need to engage subject matter experts to have an influence on the debate. They added the AER was already providing experts and adding experts by retail groups could not have been justified cost-wise. The stakeholder said opinions offered by parties that did not have experts were not able to provide the level of detail that could be relied on by the AER, or that would be sufficiently rigorous for legal scrutiny. While retailers can offer practical experiences and more applied views on the WACC as important reference points, the stakeholder claimed it to be hard for retailers to match the resources devoted by both the AER and networks.

52. The Investors Reference Group (IRG) was seen to have mixed effectiveness. A stakeholder claimed that the IRG had excellent contributions from some but not all members, and that views were quite varied, which was postulated as being a result of them coming into the process quite new and uncertain whether they should be

speaking with one voice or not. Another stakeholder praised the inclusion of the IRG as part of the process.

E. Contribution of the Concurrent Experts

53. Stakeholders were positive about the introduction of the concurrent expert sessions, as it was seen as another opportunity for the testing of ideas, and it allowed people to get their message across. Some stakeholders thought the process was well done while other stakeholders had a variety of comments on needs for improvement on timing, expert selection, execution of the concurrent expert sessions, and the joint expert report.

Timing of the concurrent expert sessions

54. A stakeholder raised the issue that the expert sessions were not run according to the initial schedule. Their expert was unable to participate fully because of incorrect contract terms and scheduling problems as a result of the reliance on the initial schedule. The stakeholder also commented that the AER did not finalise their expert appointments sufficiently early, which impeded the expert search process for other stakeholders.

55. Some stakeholders commented that the concurrent sessions were rushed, started later than intended, and did not leave sufficient time afterwards. Some stakeholders recommended an optional extra day for the sessions while others said the length was adequate and everyone got a chance to get across their views. One stakeholder raised that the session should have been organised at a time when the AER board was not on holidays. The stakeholder claimed the big lesson from the exercise was the experts needed more time. Another suggestion was made that the expert sessions should also occur after the draft decision.

The selection of experts

56. Some stakeholders were concerned with bias and influence of interest groups. The experts were instructed to set aside who they were appointed by, but stakeholders claimed that the experts were not expressing independent views. Other stakeholders commented that there was no real expectation for experts to be independent. Stakeholders questioned the nature of this exercise given the deeply entrenched views of some experts, based on their long history of working in this area.

57. The debate at the expert concurrent session was said to be unbalanced and one stakeholder claimed that consensus was reached on certain issues because the session was filled with experts on the same side of the issue. Other stakeholders also observed the strong representation of certain stakeholder groups over others. Still, others claimed that the perceived imbalance in numbers was entirely a result of the process, and (i) they have no issue with greater participation from the opposing side, and (ii) this should have been brought up before the session when the process was already known and not after the fact (or during the sessions).

58. Some stakeholders found it odd that the AER was selectively putting forth and withdrawing their experts to the discussion—using the example of Dr Lally, who was asked to talk about his views on gamma, but was not able to speak on other issues (such

as the MRP). A stakeholder thought experts should be allowed to say what they think about any of the issues discussed. Another stakeholder commented that the AER's switching of experts seemed designed so that only experts agreeing with a certain pre-determined view were able to contribute.

59. Some stakeholders raised the issue with experts not being well informed about the process, impeding their ability to provide constructive opinions. It was important that all experts should be committed to the task at hand within the terms of the prevailing paradigm; however, this did not appear to be the case. Stakeholders noted that having an expert questioning the prevailing paradigm was not an appropriate use of time or useful to advance the debate. Stakeholders wanted more careful scrutiny of each expert, whereby a willingness to do background research and engage with literature should be demonstrated. They suggested that an expert who has not been well briefed and adopts a completely left-field approach will not be able to offer relevant evidence or constructive arguments. A stakeholder further suggested that the experts be better informed on how regulation worked in a basic sense.

How the concurrent expert sessions were run

60. First, the role of the sessions was questioned. A stakeholder claimed it was not clear whether the session was for presenting information to the board, or was for giving the opposing sides an opportunity to hear each other and state the evidence. They added that having a clearer objective of what the concurrent session was about and the rules of conduct would solve many of the issues raised by some stakeholders. Examples included being clear on what is open for discussion and what is not, and that new information has to be genuinely new information, not old information repackaged differently. A stakeholder also raised that the first half of one of the sessions dealt with political and legal issues that the experts had no control over and it was not the best use of time.

61. Second, some stakeholders expressed concerns over how the sessions were run. While stakeholders found the session to be a valuable step in the process, some stakeholders thought in some ways the concurrent sessions were not helpful because the discussions got overly academic, and often the discussion would go on tangents. Stakeholders claimed the same discussion points had been brought up from past reviews, and the same arguments had been presented over and over. The session also was said to have slid into pettiness at times. A stakeholder thought that time was wasted on agreeing on undisputed issues and there was no real process to narrow down the key issues where there were disagreements of substance. Another stakeholder mentioned that the issues and approach for the session were constrained by the AER staff. The discussion papers prepared for the sessions were said to have constrained the agenda, so that there were certain issues that the experts should have considered but did not.

62. Stakeholders praised the role of the facilitator, who had a good understanding of the underlying issues, kept the flow of conversation going, and allowed each expert a say. Some stakeholders recommended making it an explicit requirement of the facilitator role to have detailed knowledge of the issues for future rounds. Stakeholders also suggested that the overall expert concurrent session process could have been improved if the board's role and the facilitator's role in the session were further clarified, an example being whether the board was there to actively participate or just there to listen,

and how much the facilitator could interject. Stakeholders thought the AER board was very valuable as they asked appropriate, intelligent questions. A stakeholder also recommended that the facilitator should have had an opportunity to present the findings of the concurrent expert sessions to the AER board to outline the issues which would require the most careful consideration.

The joint expert report

63. Some stakeholders had issues with the AER's decision not to rely only on the joint expert report, but instead to have regard separately to the views of individual experts that were not recorded in the joint report, on the grounds that (according to the AER) the outcome of the report could have been different if the AER experts had had more time to devote to the report. This was not satisfactory to stakeholders from many segments, including networks, consumers, and others.

64. One stakeholder said the AER's draft decision in two places recognised that the joint expert report agreed unanimously on certain issues, but then said that if the AER's expert had had more time he might have come to a different view. Stakeholders were disappointed with how the AER rejected points that were unanimously agreed upon by the experts, saying that if the AER was allowed to consider other avenues for the experts to express their views apart from the joint expert report, this begged the question of the purpose for the joint report. Some stakeholders commented that the AER ignored points in the joint report that it found inconvenient. Stakeholders mentioned that the AER needed to do more to reassure people they were not cherry picking. A stakeholder said that it was enough at times for an expert to merely suggest that a position be considered for the AER to dismiss more rigorous evidence supporting a countervailing position (for example, geometric and arithmetic averages in relation to estimating the MRP).

65. Related to this point, some stakeholders opined that expert material other than the joint report had not gone through the same process of testing (via the concurrent expert sessions and the process of creating a joint expert report). A stakeholder mentioned this also occurred to the debt discussion paper which came out after the expert sessions. Another stakeholder mentioned that while the AER did not have to follow either majority or dissenting views from the joint expert report, if they followed the dissenting view the AER should provide very good reasons why.

66. Some stakeholders praised the joint expert report, saying it provided further value on top of the transcripts of the sessions. However, one stakeholder argued that the joint expert report should be discounted because not all experts had been able to participate. Other stakeholders thought there was not enough time for the experts to sufficiently discuss with one another and agree on the joint expert report.

67. Some stakeholders recommended that a joint report should be written prior to the concurrent expert sessions, identifying the main areas of agreement and disagreement, which would then more efficiently allocate time to the issues of disagreement while everyone was present at the sessions. One stakeholder drew parallels with the litigation process where a similar approach is done with expert witnesses, and the other stakeholder mentioned that the current process (joint expert report after the concurrent

expert sessions) was only done because of time constraints. One stakeholder claimed that the existing process also meant the experts had to defend their positions made during the sessions in the report. Other stakeholders, however, commented that discussions in the concurrent sessions were much more effective than an exchange of written materials in helping the experts to understand one another's positions.

F. Contribution of the Independent Panel

68. Most stakeholders thought that having the Independent Panel was a good idea. Some stakeholders were happy with what was achieved, other stakeholders were not happy with how the Independent Panel was instructed, and thought that its role could be more valuable with different instructions. One stakeholder said that the Independent Panel did not add much value to the 2018 process.

The role of the Independent Panel

69. To some stakeholders, it became apparent that the scope of what the Independent Panel had been asked to do had not been effectively communicated at the start of the process, so that stakeholders were surprised and disappointed when they received the Independent Panel's report. Stakeholders commented that the Independent Panel's scope and the process that it would follow should have been laid out more clearly.

70. Some stakeholders thought that having the Independent Panel there to comment on process was an inappropriate use of the panel's expertise, and that the AER should raise the bar and allow a review of the outcomes from the draft decision. Others thought it was fair that the review was on process and that the commentary from the Independent Panel was robust.

71. One stakeholder thought the Independent Panel did not add much value. Although they thought that the Independent Panel had identified areas for the AER to be clearer on, the Independent Panel did not get much beyond that, perhaps because of the limits of the Independent Panel's role. Another stakeholder commented it would be beneficial if the Independent Panel were able to check AER's work (i.e., to review the outcome), but without becoming an alternative decision maker or appeal panel.

72. Some stakeholders mentioned that the idea of having an Independent Panel made up of eminent individuals with relevant expertise to review the results was a sensible option. While it would be better if the panel came to some conclusion on the number, this might not be feasible.

73. Some stakeholders said that the terms of reference should be changed so that instead of whether the draft decision is capable of promoting the National Electricity Objective, the panel should be asked whether it best promotes the National Electricity Objective.

74. Some stakeholders also suggested that if the AER chooses not to implement a recommendation from the Panel, it should explain why not.

75. Some stakeholders thought it was a failure of the process that the Independent Panel did not form a view on whether the rate of return was appropriate. In the absence of a merits review, they claimed the Independent Panel should have been tasked to reaffirm

the outcome not the process. A stakeholder added the question of whether a reasonable person could have made the decision that the AER made was not particularly useful.

Issues considered by the Independent Panel

76. Some stakeholders thought the Independent Panel was a waste of resources, that the panel had ignored issues that were important to the stakeholders, and that the panel spent too much time focusing on issues that no one found to be controversial. For example, the number of decimal places used in the estimation of gamma was not raised by any stakeholders and added little to the quality of the AER's decision. It was also pointed out that the Independent Panel failed to take into consideration key issues in the draft guidelines such as changes to the foundation model.

77. A stakeholder said the time and resources available to the Independent Panel did not permit it to review all of the materials that were available to the AER. There were suggestions for giving the Independent Panel more time to go through all of the submissions. Some stakeholders said a lack of resources to review the voluminous submissions may have been a reason why the Independent Panel did not address certain key concerns of stakeholders. Another suggestion was for the AER to prepare, and consult on, a list of topics that were most contentious or of most concern to stakeholders. This would guide the Independent Panel as to which topics to have focused on in assessing the draft Instrument.

78. Some stakeholders suggested that it would be useful if the peak bodies from the customer groups and networks were able to submit a one or two page document highlighting the key issues for that stakeholder group for the Independent Panel's consideration. Similarly a suggestion was made that the customer groups and networks should have an opportunity to meet with the Independent Panel over the course of an hour with a presentation and Q&A session to allow for issues to be brought up.

79. Some stakeholders expressed great interest in making contact with the Independent Panel to help the panel focus on issues that each group wanted, while other stakeholders were in agreement with the decision of the AER not to allow direct communication between stakeholders and the Independent Panel.

80. To allow the Independent Panel to fully take into account the information developed by the process, including submissions that stakeholders generated in response to the draft decision, and for the Independent Panel to obtain a good understanding of which issues were most contentious or of most concern to stakeholders, a stakeholder suggested that the Independent Panel could be involved at a later part of the process. For example, the panel could be asked to review a "draft final instrument", which already reflects stakeholder feedback on a draft decision. The Independent Panel could report back to the AER on the draft final instrument, then the AER would prepare the final instrument, and would publish the final instrument, the draft final instrument, and the Independent Panel's report all at the same time.

G. Other suggestions and feedback

Data reporting and sharing provisions, and the use of metrics

81. Some stakeholders suggested better incorporation of real data into the review process. This was mainly suggested in two forms, (i) the networks could provide more data, either through more stringent reporting requirements or through better data sharing, and (ii) retailers can contribute their data, for example on their cost of capital, into the mix to better inform real world experience. A stakeholder mentioned that the goal of the review should be to look at results of past decisions and whether these fit within the national energy objectives. The stakeholder said that this can only be done if the returns actually achieved by the networks can be observed, and that they cannot currently do so using public data. The stakeholder added that because this data is not reported by the networks, the review process was necessarily more theoretical rather than practical.

82. A stakeholder said that because of certain comparable aspects between retail businesses and network businesses, in the sense that both own long life assets in the energy industry, a risk adjusted return on retail businesses could serve as a guide on what private investors look for in terms of a rate of return. The stakeholder suggested using better confidentially provisions to give retailers an opportunity to share their return information. Another stakeholder added that the AER should explore ways to obtain evidence from parties like gas businesses and retailers to draw informed inferences around the differences in risks facing those businesses. There was a claim that internal hurdle rates of retailers do not differ that much from what the networks receive despite the retail business being far more risky.

83. Another stakeholder said the AER should come up with common metrics to measure whether the rate of return was too high or too low, or what constitutes a success or failure in guideline outcomes. This might include statistics on sums invested in the networks.

Suggestions for documenting the process

84. A stakeholder suggested that the AER develop a consolidated version of the rate of return report that would be entirely self-contained, and only include information on what decision was made and the final methodology/reasoning behind it. The AER could explain in this report what an incremental review means and how future iterations of the review process would focus on different issues. For example, how should one work with so few listed entities for the issue of estimating gearing and asset betas. The stakeholder mentioned that if the report identified what the important issues are moving forward, some of these issues could be worked on between reviews avoiding the compressed time scale of the rate of return review process.

85. Some stakeholders mentioned that the AER could improve its report writing, as the final report was not as transparent as it could have been given its considerable length. They said it seemed that the AER wrote with the mindset that everything from stakeholder submission had to be mentioned in the draft decision, to demonstrate that the AER had considered everything.

86. One stakeholder stated that it was not possible to replicate the AER's analysis because insufficient detail was given to be able to derive the conclusion the AER reached from the evidence it considered.

87. However, some stakeholders thought the many other materials put out by the AER were helpful in distilling the issues involved, and that it was a good way to quickly get abreast of the issues. Some added that the explanatory statement was a high quality document in comparison to other documents on the cost of capital from other regulators.

Other suggestions and feedback

88. Some stakeholders mentioned that the next review process will need to take into account the fact that there will be new AER board members who are likely to have less experience with rate of return issues than the current board. Other stakeholder suggestions include enhancing the AER's project management capabilities. For example, the AER should be clearer about what processes the review will follow, and there should be a broader post-implementation review (saying that the present exercise of stakeholder interviews was but one step in the post-implementation review process that needs to take place).

89. It was suggested that the AER should be consistent across different decisions. For example, in the inflation review, more weight was put on more recent updates to one parameter rather than older figures; in the rate of return review the opposite occurred—more weight was given to older data rather than more recent data. Another stakeholder said the teams within the AER should be more coordinated, as the tax review was occurring at the same time as the rate of return review, the AER teams did not appear to be co-ordinating on the issues, and stakeholders had to respond to requests from both reviews at the same time.

90. A stakeholder raised an issue regarding the stakeholder presentations sessions that occurred after the draft guideline. The stakeholders had many questions for the AER yet the AER did not answer a single question. The AER said that they would take it on notice or take it into future consideration. The stakeholder commented that, the board should have been standing behind their draft decision and offering to explain what they had decided and why.

91. On the public forum, some stakeholders said that people only spoke to their views without discussion or engagement on issues. It was suggested that the AER could facilitate engagement on specific issues that all stakeholder groups would have the opportunity to discuss, identify what is agreed upon and what is not, and that this would better inform the expert concurrent session and the Independent Panel.

92. A stakeholder suggested that the AER should not endorse the idea of different stakeholder groups attempting to reach agreement between themselves, because it is the AER's responsibility to make decisions and reach conclusions.

93. A stakeholder suggested having the Productivity Commission conduct a review of the AER's approach to rate of return. This would avoid a bias in favour of entrenched models that can only produce incremental changes to the rate of return.

III. Appendix A – Interview questions

Interview Framework

Each interview will take place for up to 60 minutes, with a consistent interview framework for all interviews, provided to interviewees in advance.

Part 1 includes topics to be discussed with all interviewees, and part 2 identifies secondary issues to be discussed if time permits.

A. Part 1 – Topics to be discussed with all interviewees

- Identification of key issues. Which step/s were effective in narrowing and prioritising the issues for consideration during the 2018 Instrument process?
- AER consideration of submissions. Were stakeholder submissions effectively considered and incorporated by the AER? Were the issues that were most important to your stakeholder group addressed?
- Nomination and selection. Was there an appropriate process for nominating and selecting members of the:
  - reference groups,
  - concurrent expert evidence sessions, and
  - independent panel?
- Use of external advisors. What were the strengths and weaknesses of the AER's use of the:
  - reference groups,
  - concurrent expert evidence sessions, and
  - independent panel?
- Suggestions for improvement. What process changes would you suggest in order to improve the next Rate of Return Instrument review?
- Overall conclusion. How would you rate the overall process for establishing the Rate of Return instrument?

B. Part 2 – If there is available time

- AER engagement. Did the AER pro-actively address issues relevant to stakeholder groups during the 2018 Instrument process?
- AER documents. Explain your view on the material produced by the AER in the 2018 Instrument process including consultation, position, issues and discussion papers as well as draft and final instrument and explanatory statements? Were they accessible? Were they clear? Were they thorough?

IV. Appendix B – AER interview Primer

AUSTRALIAN ENERGY REGULATOR

AER's Rate of Return Process Review

Background

The AER has begun a review into the process used to determine the 2018 Rate of Return Instrument (2018 Instrument). As part of this review we are interested in hearing feedback from stakeholders involved in the 2018 review. The information gathered in this review will enable us to refine future processes as well as begin planning now for the next review (leading to the publication of the 2022 Instrument).

The 2018 Instrument process took place over a 1.5 year period and implemented a number of new elements.[1] It started with a consultation paper in July 2017, followed by a stakeholder forum, a position paper and an issues paper in 2017. In the first half of 2018, we instituted concurrent expert evidence sessions to provide expert advice on key issues. Discussion papers were released ahead of the sessions to frame the discussion. The expert evidence sessions and submissions from stakeholders informed our draft decision in July 2018 which was reviewed by an Independent Panel of experts.[2] Our final decision was released in December 2018. A more detailed description is provided in the 'Timeline of the 2018 Instrument process' section below.

Objectives for the interviews

This review is to seek views on improving the process for both us and stakeholders. We are aware that there may be a wide range of stakeholder opinions on the outcome of the 2018 Instrument. However, the outcomes from the 2018 Instrument are not the focus for requested feedback; but rather the focus is the process used by the AER to determine the 2018 instrument.

Considering the information we are interested in we are of the view that an interview format may be the most effective collection method. The use of an independent external consultant will ensure that stakeholders are able to give an earnest assessment of the 2018 review. We are pleased to have engaged The Brattle Group to undertake this task.

After the interviews Brattle will provide a report setting out the results of the exercise and summarising their findings to the AER.

The AER will publish this report on its website. All feedback to Brattle will be anonymised in the report so as not to identify particular stakeholders, but may be grouped (under broader stakeholder groups—investors, consumers, networks, etc.) where it is helpful to identify differing perspectives.

[1] https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/rate-of-return-guideline-2018/initiation

[2] https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/rate-of-return-guideline-2018/draft-decision

Timeline of the 2018 Instrument process

Date	Key 2018 Instrument process steps	Key documents (linked)
Jul 2017	**Consultation paper** commenced preliminary consultation on the process for reviewing the rate of return.	Consultation paper on process for reviewing rate of return Submissions received over Jul to Aug 2017
Sep 2017	**Stakeholder forum** for stakeholders to discuss rate of return issues and engage with their main concerns.	Stakeholder forum agenda and presentations
Oct 2017	**Issues paper** on the extent our current approach to setting the rate of return remains appropriate.	Issues paper Submissions on issues paper
Nov 2017	**Position paper** on the process for reviewing the rate of return including new elements.	Position paper
Feb 2018	**Various consultation groups** established to provide additional ongoing contribution and submissions to the review process.	Group composition and meeting minutes
Mar–Apr 2018	**Concurrent expert evidence sessions** to allow detailed and natural discussion between participating experts in the presence of the AER Board. We released discussion papers on the parameters to be discussed prior to the sessions to provide background and questions to frame the discussions.	Session 1 transcript Session 2 transcript Expert joint report Session 1 discussion papers- Gearing, financial performance measures, risk and judgement, RAB multiples Session 2 discussion papers- Gamma, tax data, equity beta, MRP/risk free rate/automatic application,
Mar–May 2018	**Submissions** received on the evidence sessions, discussion papers and transcripts.	Submissions to evidence sessions and related material
May 2018	**Debt discussion paper** addressing return on debt issues.	Debt discussion paper Submissions to debt discussion paper
Jul 2018	**Draft decision** released.	Draft decision
Jul–Sep 2018	**Submissions on draft decision.** **Stakeholder forum on draft decision.**	Submissions on draft decision Stakeholder forum presentations
Sep 2018	**Independent Panel report** on draft decision provided to the AER.	Independent Panel report
Oct 2018	**Stakeholders' presentation** to the AER Board on the draft decision.	Presentations
Dec 2018	**Final decision** released.	Final instrument

V. Appendix C – Terms of reference

ATTACHMENT A

REFERENCE NO: TARGETED REVIEW OF 2018 RATE OF RETURN INSTRUMENT PROCESS

Terms of Reference

The Australian Competition and Consumer Commission (ACCC) / Australian Energy Regulator (AER) seeks experts in corporate finance (specifically the rate of return on capital) who also have experience in undertaking stakeholder engagement/feedback processes. These experts are to undertake a review of the 2018 Rate of Return Instrument **process** and advise the AER on their findings.

Background

The AER is responsible for the economic regulation of electricity networks and gas pipelines in Australia.[1] In undertaking this role, the AER sets the allowed revenues or prices for these monopoly service providers[2] over a fixed period determined in advance (usually 5 years),[3] in accordance with the relevant legislation.[4] As part of determining the total revenues or prices that a service provider may earn, the AER applies a 'building block' framework that includes a return on capital building block which is derived from a regulated rate of return and a income tax building block.[5]

The rate of return instrument sets out the approach the AER uses to estimate the efficient rate of return on equity and debt given the risk of providing regulated energy network services. We published the first rate of return instrument in December 2018 (2018 Instrument). As part of this we implemented a number of new elements including:

- Concurrent expert sessions for independent rate of return experts to discuss key issues.
- An Independent Panel to review the draft decision.
- Establishing various reference groups (to represent a range of stakeholder groups) to provide feedback and advice to the instrument process.

---

1 Excludes Western Australia and the Northern Territory.

2 A list of these service providers can be find at: https://www.aer.gov.au/networks-pipelines/service-providers-assets

3 This period is known in an electricity context as a regulatory control period or in a gas context as an access arrangement period.

4 For electricity networks, this means the National Electricity Law (NEL) and National Electricity Rules (NER). For gas networks, this means the National Gas Law (NGL) and National Gas Rules (NGR).

5 That is, the rate of return on capital is multiplied by the regulated asset base (for electricity networks) or the capital base (gas networks) to derive the return on capital building block for a given year.

The review process embedded these new elements in a multi-stage decision making process that allowed multiple opportunities for stakeholder consultation. This process included:

- A consultation paper on the process for the 2018 review, followed by submissions, a stakeholder forum and position paper
- An issues paper on the current approach to setting the rate of return, with submissions
- Information papers on specific rate of return areas
- Concurrent evidence sessions, accompanied by discussion papers on the specific rate of return areas
- Submissions to the AER after our draft decision

We consider now would be an appropriate time to review the 2018 Instrument process and seek views on areas of strength and potential improvement from stakeholders involved in the process. The outcomes from the 2018 Instrument are not the focus for this process review; but rather the process used by the AER to determine the 2018 instrument (for example - decision making stages, consultation rounds, methods of stakeholder interaction, use of reference groups and independent panel review).

The AER is required to update the rate of return instrument every four years, so outcomes from this process review will inform the process used to set the 2022 instrument. The consultant is not expected to make recommendations to the AER on the process that should be adopted in the 2022 review. The consultant's report will be used as an input when the AER considers what process should be used at the 2022 review.

Services required

This request is for a capped-price contract. The quote should be based on the time to be spent on providing the services.

The AER requires the consultant to undertake a review of the 2018 Instrument process by:

- Collecting key stakeholder views on the process including areas of strengths and potential improvement through a series of interviews. To assist with this:
    - A list of stakeholders (including possible allocation to overall groups) is provided in Attachment B.

    - A consultant primer (including interview framework guide) is provided in Attachment C to provide context on the sort of feedback we are seeking.

- Collating stakeholder views to identify key themes and providing the AER with a written report that summarises these findings. The AER intends to publish this report. To this end, the report should:
    - List those stakeholders who took part in the interview process
    - Present the feedback in such a way that no individual respondent's answers can be attributed to them such as by allocation into broader overall groups. Examples of such groups may be:
        - Investors
        - Networks
        - Retailers
        - Consumer groups
    - Be brief (no more than 40 pages) and present summarised outcomes (not transcripts) from the series of interviews.

In collecting stakeholder views, it is envisaged that the consultant conducts a series of interviews (can be in person or on the phone; and not necessarily one-on-one) with no AER staff present. We expect that this will involve up to 25 interviews of up to one hour each.

BOSTON
NEW YORK
SAN FRANCISCO

WASHINGTON
TORONTO
LONDON

MADRID
ROME
SYDNEY

THE Brattle GROUP