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A summary of evidence and thinking on negotiated settlements in the regulation of energy network service providers

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"It is no accident that in the literature … we find a category 'market failure' but no category 'government failure'. Until we realise we are choosing between market arrangements that are all more or less failures, we are not likely to make much headway"

(Coase 1964)

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Executive Summary

This paper summarises evidence and thinking on negotiated settlements in the economic regulation of energy networks. It also briefly considers the application of this approach in Australia. In this context, negotiated settlement describes voluntary agreement between network service providers (NSPs) and end-users, in respect of the commercial terms for the provision of network services. Such settlements typically determine prices (or aggregate revenues), expenditure allowances and service standards.

The idea that the users of monopoly network services should be able to negotiate the terms of their supply from their monopoly service providers is a novel idea in Australia. Prima facie the idea offends a widely accepted axiom of monopoly – that the inability of customers to choose their supplier would render them powerless in negotiations with monopolies. The corollary is that if users of monopoly services are to negotiate with their monopoly service providers, they will be faced with "take it or leave it" propositions, and so negotiation will fail to deliver reasonable outcomes. Consequently, a widely accepted orthodoxy has been that regulation by an entity concerned with the public interest is needed to protect consumers from the exercise of such market power.

However, this position neglects a backstop role that regulators can play. In negotiations with a monopoly, if customers are unhappy with what they are offered they can seek a ruling from the regulator. The ability to fall back on the regulator protects the rights of customers, just as surely as the right to pursue a damages claim in a court, protects the rights of a victim of a civil tort.

Negotiated settlements have been used to determine prices, incentives, expenditures and so on for services provided by electricity and gas monopolies in the United States of America and Canada for many decades. In the United States it is common for the parties to enter into settlement negotiations, with the goal of presenting an agreed position on all issues (or a partial settlement on some issues) to regulatory commissions. This has been documented in detail in the federal regulation of interstate gas pipelines and electricity transmission in the United States, in the regulation of major oil and gas pipelines in Canada, and in the regulation of electricity utilities in Florida.

In Australia, negotiated settlement has also been used to determine the terms for access to services provided by businesses that have significant market power even if not monopoly power. This includes airports and freight rail services. In the case of the former, the Productivity Commission reviewed the settlements and found that while airports and airlines were unhappy with aspects of the settlements, neither wished to revert back to traditional economic regulation.

The arguments in favour of negotiated settlements are that it is quicker, less expensive, and more innovative than traditional regulation. It is also argued that it leads to a better understanding and less adversity between users and service providers; and that it delivers mutually beneficial gains because users can better determine the trade-offs that are important to them, than can regulators.

On theoretical grounds it is suggested that if economic regulation is essentially the periodic variation of long-term contracts between end-users and utilities, then in the first instance, these two parties should take primary responsibility for the establishment and on-going variation of that contract.

In the development of this research we canvassed the views of regulators and their staff, end users and their representatives, the industry and lawyers to understand concerns about negotiated settlements in its application to the monopoly energy network service sector. These concerns include that:

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

Of all these concerns, the first that came to mind to many people we spoke to, was that consumers would not be able to acquit themselves adequately in negotiations with NSPs. We found that large energy users were more confident in their ability to negotiate with network service providers, than were the representatives of smaller users. While some small consumer advocates were receptive to the possibilities of negotiated settlements, others were quite hostile to the idea. Their main concern seemed to be that users could not deal with information asymmetries (relative to utilities) and so would be unable to effectively press their interests in negotiations with network service providers.

In Britain, the energy regulator, Ofgem, had a similar concern about negotiated settlements. In 2009 it concluded "*We also have concerns regarding their current access to resources, the current levels of expertise of all but a very small number of individual consumer representatives and their appetite to engage in this way.*"

However, an equally striking finding of our research was that where negotiated settlements have been introduced (in North America) the prospect that consumers (big and small) are unable to acquit themselves effectively in a negotiation, is not evidently a concern. Indeed in the literature we reviewed, this concern was never raised.

Our examination of the experience of negotiated settlements in North America shows that the other concerns listed above have also largely been addressed. Where it has been introduced, regulators, policy makers, end users and the industry seem to increasingly choose negotiated settlements, rather than traditional regulation. The scope and predominance of negotiated settlements has expanded. For example in the

application of negotiated settlements by the Federal Energy Regulatory Commission, Professor Littlechild concluded:

"The proof of the pudding is in the eating. The parties involved have increasingly preferred settlement to litigation over the course of the last half-century. This is a remarkable record of survival in an activity – utility regulation – that has been characterised by no little reform and change over this period … Traditional litigation has become essentially a method of dispute resolution limited to novel or exceptionally difficult rate case issues".

The evidence where negotiated settlements have been successful suggests that support by policy makers in general, and regulators in particular has been important. Other factors have also been important. In the United States, the development of robust processes for settlement and the bifurcation of the regulatory staff has allowed the federal regulator to actively assist the parties in settlement. In Florida the development of an effective consumer representative body has been important. In Canada, the regulator's willingness to assess the process that lead to the settlement, rather than to second-guess the outcome, has been important.

Negotiated settlements seem to be a big change from the current arrangements for the regulation of energy networks in Australia because considerable changes are needed in institutions and attitudes. On the other hand, the same core analysis of expenditure requirements needs to be done for settlements as for traditional regulation, and in this sense the extent of change in the day-to-day activities of the regulator may be less than expected.

At the time of writing this paper, a number of reviews of various aspects of economic regulation in Australia (by the Limited Merits Review Panel, Australian Energy Market Commission, the Productivity Commission and a Senate Select Committee) have concluded that there is an urgent need to empower energy consumers so that they can participate effectively in the regulation of the industry.

It was clear to us from discussion with many consumer advocates in Australia that they generally had little confidence in their knowledge of the electricity industry, and in their ability to negotiate successfully with network service providers. A necessary condition for the success of negotiated settlements is that consumer representatives have such confidence. The technical ability and organisational depth of energy user advocacy needs to be improved to achieve this.

The energy consumer representation arrangements in Florida – an influential and effective Office of Public Counsel – merits careful consideration. This does not mean creating a monopoly in energy user advocacy in Australia, but rather ensuring that there is at least one institution that can be relied upon by other energy user advocates to contribute significant technical expertise.

A second necessary institutional development is that the AER willingly accepts a change to its approach so that preference is given to settlement. In practice this would mean AER staff assisting the parties in reaching agreement by negotiation, and only if such agreement can not be achieved, then resorting to traditional regulation.

There are many issues to consider in finding the best way to introduce negotiated settlements in Australia. Would it be better to begin settlements in gas or in electricity networks? Would it be better to start with transmission or distribution networks? Should settlements apply to weighted average prices or aggregate revenues or to tariffs? Would it be better to encourage settlement of a whole decision or some part of it – say opex or capex or specific large investments? Should parties be free to determine the term of the settlement and the conditions for subsequent re-negotiation? How should the regulator begin the process of implementing settlement? What changes to laws and institutions are needed?

Before contemplating these implementation questions, the advantages and disadvantages of negotiated settlements needs to be more widely debated in Australia. The main parties, particularly consumers and the regulator, need to be convinced that it has merit.

One of the recently approved changes to the national electricity and gas rules encourages constructive engagement between the AER and network service providers, before network service providers make their revenue and price proposals to the AER. This reflects similar arrangements recently applied in the UK, as part of their response to similar desires to strengthen consumer engagement. Such encouragement for engagement provides an ideal opportunity for serious consideration by all parties of how the benefits of negotiated settlements can be realised.

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1 Introduction

This is a research report on the potential for negotiated settlements in the regulation of network monopolies in Australia. In this context, negotiated settlement describes voluntary agreement between network service providers (NSPs) and end users about the commercial terms for the provision of their services. Such settlements determine prices (or aggregate revenues), expenditures and service standards.

The idea that the users of monopoly network services should be able to negotiate the terms of their supply from their monopoly service providers is a novel idea in Australia. Prima facie the idea offends a widely accepted axiom of monopoly – that the inability of customers to choose their supplier would render them powerless in negotiations with monopolies. The corollary is that if users of monopoly services are to negotiate with their monopoly service providers, they will be faced with "take it or leave it" propositions, and so negotiation will fail to deliver reasonable outcomes. Consequently, a widely accepted orthodoxy has been that regulation by an entity concerned with the public interest is needed to protect consumers from the exercise of such market power.

However, this position neglects a backstop role that regulators can play. In negotiations with a monopoly, if customers are unhappy with what they are offered they can seek a ruling from the regulator. The ability to fall back on the regulator protects the rights of customers, just as surely as the right to pursue a damages claim in a court, protects the rights of a victim of a civil tort.

Negotiated settlements have been used to determine prices, incentives, expenditures and so on for services provided by some electricity and gas monopolies in the United States and Canada for many decades. The evidence suggests it has been successful and that regulators, policy makers, end users and the industry seem to increasingly choose negotiated settlements, rather than traditional regulation.

This paper surveys the evidence of negotiated settlements and considers what negotiated settlements could mean for the regulation of energy network service providers in Australia. It starts by defining such settlements in the context of the regulation of network monopolies: why have negotiated settlements been adopted and how do they actually work in practice? It then sets out concerns about the use of negotiated settlements and responds to those concerns. Finally it discusses various issues that might be considered in the application of negotiated settlements in the regulation of gas and electricity network service providers in Australia.

In the development of this research, we benefitted greatly from many conversations with end users, end user advocates, regulators and their staff, industry association representatives and lawyers. We thank all those we spoke to for their interest and for contributing their opinions and ideas, and in particular we acknowledge many helpful interactions with Stephen Littlechild and Darryl Biggar.

Finally, we acknowledge with appreciation the research funding provided by the Consumer Advocacy Panel.

2 What are negotiated settlements?

In competitive markets, a negotiated settlement ("commercial agreement") is the standard approach by which buyers and sellers agree the terms of transaction. In many cases, the commercial arrangements for the exchange of products or services are standardised and through liquid markets there is little need for on-going or complex negotiation.

Negotiated settlement is also widely accepted in Australia as the standard approach for the transaction of services provided by many infrastructure facilities that enjoy considerable market power, but are not considered pure monopolies. This includes airports, some gas pipelines, air traffic control services, major freight rail operations, ports and others. Under Part IIIA of the Competition and Consumer Act, corporations that seek access to such facilities are encouraged to negotiate the terms of such access, with recourse to the Australian Competition and Consumer Commission (ACCC) for binding arbitration in the event of a dispute[1].

Before considering the rationale for negotiated settlements in gas and electricity network monopolies, it is useful to be clear what is meant by this term in this context. We use the term "negotiated settlement" to cover a broad scope of agreements, the core feature of which is agreement, by negotiation, of various factors that define the services provided by monopoly service providers and the price they charge for them.

The settled price may in fact be an average price to all consumers, or it may be tariffs to different types of consumers or it may be allowed aggregate revenues. Settlements might also cover the valuation of assets, the rates of return, expenditure allowances, the specification of service standards and so on.

The settlement occurs between the monopoly service providers on the one hand and various interested parties. Some of these parties may contest some part of the settlement but agree with others.

Interested parties could include individual end users and/or end user associations or other consumer advocates. It could also include a variety of "users" of network services that are not end users. This could include retailers, distributors or their representative associations. Finally the staff of regulatory authorities, or bifurcated divisions of regulatory authorities could be signatories.

For a settlement to be recognised, it will typically be subject to some form of assessment by a regulatory authority or tribunal. In the process of settlement, the backstop for failing to agree may be defined in detail (for example a "building block" regulation calculation may be done by a regulator). Alternatively the backstop may simply be referral to binding arbitration.

[1] In the case of "declared" facilities.

The rationale for negotiated settlements in monopoly utility regulation

The rationale for negotiated settlements is based on empirical observation and argument of its success relative to traditional regulation. Theoretical consideration of the purpose of regulation and the natural role of parties to the regulation provides another perspective.

Empirical arguments

Empirical observations and arguments on the benefits of negotiated settlements are typically stated relative to the outcomes delivered by traditional regulation. The claims in the literature are as follows:

Negotiated settlement is quicker than conventional regulation: The most comprehensive evidence of this is set out in Wang (2004). That paper examined 41 rate cases led by and against the major interstate gas pipeline companies in the United States in the period from October 1994 to December 2000. It found that settled cases (the majority of cases) were complete within a year whereas the litigated cases took more than three years in one case and more than five years in another. Littlechild (2012) examined 12 rate cases filed in the two fiscal years 2008 and 2009, and found a similar result. Evidently this difference has been sustained. For example Wang (2004 p.164) cites a paper by staff of the Federal Energy Regulatory Commission (FERC) in 1980 that found that the average processing time for general electric rate cases at FERC was 14 months for uncontested settlements, 37 months for contested settlements and 50 months for fully litigated rate cases. (Doucet and Littlechild 2006) also note that negotiated settlements were delivered more quickly than regulated decisions by the National Energy Board in Canada.

Negotiated settlement is more innovative than conventional regulation: The argument for this in the case of regulation by FERC is set out in Wang (2004) and Littlechild (2012). The evidence presented in these papers, is that negotiated settlements have created efficiency incentives through price caps that have been achieved through agreed moratoria on pipelines requesting a review to increase their rates.[2] With respect to outcomes in Canada, Doucet and Littlechild (2006) attribute the development of similar multi-year controls to negotiated settlement. They conclude "*The general opinion seems to be that there have been significant improvements in productivity and in service design (attributable to negotiated settlements). Attitudes, relationships, communication and understanding in the industry have changed for the better. A previous Board chairman is in no doubt that settlements were responsible for these improvements*".

Negotiated settlement delivers better outcomes because customers, rather than regulators, determine traded-offs: This argument is set out in Palast (2003), cited in (Doucet and Littlechild 2006). Their argument is that "*when the regulator makes the*

[2] Under FERC regulation rate increases (or decreases) must be applied for and if there is no moratorium on rate review requests, prices can change frequently. By placing a moratorium on request, tariff remain unchanged thus providing incentives for cost reduction).

decisions, everyone loses something, and parties have no control over what they lose. In the negotiation process, each party chooses which among the many points it is willing to lose in order to gain something else. Although this may sound like a distinction without a difference, in fact, the trade-offs arrived at voluntarily are much more stable and effective". Similar arguments can be found in (Wang 2004; Littlechild 2012) and (Walker 1986).

Wang (2004) draws attention to the flexibility of settlement relative to traditional regulation to suggest that "*The litigation process is rigid in that the regulator has to make a separate merits decision on each of the issues. The settlement process, in contrast, is flexible in that the players could make trade offs across the issues. Because of the compromises, the resolution of certain individual issues, if viewed separately, may be problematic, but the negotiated settlement as a whole makes the players better off*".

(Littlechild 2009b) suggests that in Florida the ability of consumers to offer concessions to the utility that are within their own control but beyond the remit of the regulator delivers mutually beneficial outcomes that traditional regulation can not.

Negotiated settlement reduces uncertainty about outcomes, compared to traditional regulation: This argument is set out in Littlechild (2012). The argument is that by settling, it is possible to reduce uncertainty about the outcome that would result from a subsequent regulatory decision (which would be required if settlement was not reached).

Negotiated settlement facilitates better mutual understanding of network service providers and their customers: (Doucet and Littlechild 2006) suggest that negotiated settlements engender trust between network service providers and hence greater acceptance of outcomes, better information sharing and consequentially the development of more comprehensive solutions. In his analysis of negotiated settlements in Canada, (Littlechild 2009b) concluded that settlements are not so much a way of reducing the transaction costs of achieving the same outcome as litigation. Rather, they are a means of achieving a different outcome than litigation, and one that is preferred by the parties involved.

One criticism of these empirical arguments is that that even if they have not always done so, regulators are capable of making decisions quickly; that they can provide investor and consumer certainty, and that regulators can innovate and develop incentives. By implication, empirical arguments of the benefit of settlements are not conclusive, since flaws in the design and conduct of regulation can be rectified.

Theoretical perspectives

Besides empirical arguments, is there a theoretical rationale for preferring settlement to traditional regulation? (Biggar 2011) suggests that public utility regulation can be thought of as a form of government-administered long-term contract to protect and promote sunk investments by customers. From this perspective, the natural counter-party to monopoly service providers in the determination of the "contract", is customers, not regulators: "*If … utility regulation is a form of long-term contract between the customers and the service provider, then in the first instance, these two parties should take primary responsibility for the establishment and on-going variation of that contract*".

Concerns about negotiated settlements are discussed in more detail in Chapter 4 and these theoretical perspectives are revisited there.

3 Evidence of negotiated settlements in the regulation of gas and electricity monopolies

The economic literature on negotiated settlements is sparse ((Doucet and Littlechild 2006). However there is good documented evidence of negotiated settlements in the regulation of:

- inter-state gas pipelines in the United States of America;
- vertically-integrated electricity monopolies in Florida; and
- gas and oil pipelines from Canada to the United States of America.

We understand that negotiated settlement applies as much to the regulation of inter-state electricity transmission in the United States of America, as it does to gas pipelines.[3]

Detailed documented description of the application of negotiated settlements in state-based regulation of electricity networks in the United States is, as far as we know, not available.(Doucet and Littlechild 2006) refer to other published research in 1985 and 1998 which footnotes settlements in eight states (the 1985 paper) and 16 states (the 1998 paper). They note also "*it would not be surprising if the majority of US States have now recognised settlements of some kind*".

(Regulatory Assistance Project 2011) says that in the United States:

"*Once the testimony of all parties is filed (or even before), it is common for the parties to enter into settlement negotiations, with the goal of presenting an agreed position on all issues (or a partial settlement on some issues) to the commission. This gives intervenors an opportunity to have an important influence on the final result. All parties normally participate in settlement negotiations, and having an all-party settlement is important because it increases the likelihood that the commission will approve the settlement and thereby put an end to the formal hearing process. This saves all of the parties the time and expense of the expert-witness hearings. It also typically gets the utility a rate decision sooner than going all the way through the six-to-12-month hearing process.*"

Littlechild (2012) notes that while settlements before State commissions may now be more common that litigated outcomes, they are not likely to be close to the FERC figure of 80-90%. He suggests that the immediacy and price impact of rate decisions at the State levels translates into political pressure on customer representatives before State commissions, and the State commissions themselves to be seen to be scrutinising and challenging rate increases, not simply agreeing them with the utilities.

[3] Stephen Littlechild, personal communication.

3.1 Application of negotiated settlements in the Federal Energy Regulatory Commission (FERC)

The description in this subsection is substantially based on Littlechild (2012).

The Federal Energy Regulatory Commission (FERC) regulates the rates of inter-state gas and electricity in the United States of America. There are 170 inter-state pipelines. Pipeline customers include producers, marketers, distributors and large end users. There are about 7 pipeline rate cases per year.

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

The parties to settlements are known as "intervenors". They include pipelines, producers, marketers, distributors, large end users, associations of users, state public utility commissions and rival pipelines. Typically there are around 16 parties to a settlement, although there may be many more or less. In one case there were 54 parties, and in another just six. Some parties are groups.

The organisation of settlements at FERC

The long history of settlement by FERC has led to a highly structured process for settlement, and distinct roles for different divisions of FERC. The different divisions involved include:

- Office of Energy Market Regulation (OEMR). This Office receives applications from pipelines to increase rates. It then issues "Suspension Orders". It also advises FERC Commissioners whether to approve settlements or "Initial Decisions" by Administrative Law Judges.
- Office of Administrative Law Judges (ALJ) resolves contested settlements through "Initial Decisions". Where settlements are uncontested, the ALJ certifies settlements.
- Office of Administrative Litigation (OAL). The staff of OAL are called "trial staff". The staff play a key role in facilitating settlement by analysing proposals by pipelines and recommending outcomes based on those proposals.
- OEMR Advisory Staff and OAL Trial Staff are prohibited from communicating with each other during a settlement review.

The main steps in the process for settlement of an application are as follows:

Step 1. A pipeline applies for rate increases. As part of the application it files tariff sheets; cost data and other documents to support its application.

Step 2. OEMR publishes application and invites interest parties to request permission to become intervenors.

Step 3. OEMR issues a "Suspension Order". This starts the process. It then orders an ALJ to be selected and convenes a "Pre-hearing Conference". The Pre-hearing Conference sets the schedule for settlement discussion, establishing about a dozen main dates in the rate proceeding.

Step 4. The Trial Staff team (typically about 8-14 per case) establish a "First Settlement Offer" (circa 100 pages) after a full cost of service review. At the same time intervenors are engaged in similar discovery process, and can get their own sense of a suitable counter offer to the pipeline.

Step 5. The lead attorney on the Trial Staff team typically chairs the first settlement conference. Trail Staff, the pipeline and intervenors attend it. There are typically 100 participants for large pipeline cases.

Step 6. A second settlement conference is convened after the pipeline responds to First Settlement Offer with its counter-offer. At the Second Settlement Conference, Trial Staff explain their thinking to intervenors (without the pipeline present). Settlement may occur after the Second Settlement Conference (and typically does). If there is no settlement, another conference is arranged. Trial Staff are active in these conferences, seeking to find agreement amongst intervenors and between the intervenors and pipeline.

Step 7. Once agreement in principle is reached, parties jointly file a motion to suspend the procedural schedule. The pipeline then drafts a Settlement Document and circulates it for comment. The agreed settlement is then filed with ALJ and ALJ invites parties to draft a letter of certification, which is then circulated for comment.

Step 8. If the settlement is unanimous, the ALJ certifies it and then refers it to the Commissioners for approval. If the settlement is non-unanimous (which is unusual) the Commission may approve the non-contested portions and sever the contesting parties or contested issues for resolution through the normal litigation process.

Some observations on settlements by FERC

Settlements in FERC started in response to administrative constraints in the 1960s. Those constraints no longer exist but settlement has become more widespread. It is now the standard model and traditional regulatory "litigation" seems to apply only in complex cases, and only after settlement has failed.

FERC's settlement process has developed over 40+ years and is now highly organised and structured. It relies on the integrity of many "chinese walls" between different offices within the organisation.

Much (probably most) of the analytical work in response to rate applications is done by FERC staff (on the Trial Team). Parties to the settlement (other than the pipeline) rely heavily on the advice and analysis of FERC staff.

3.2 Application of settlements in the regulation of electricity utilities in Florida

The description in this subsection is substantially based on Littlechild (2009b).

In Florida, four privately-owned, vertically-integrated (generation, transmission, distribution and supply) electricity companies supply 99% of Florida's electricity. The supply of electricity in Florida is not open to competition. Settlement (called "stipulations") covers "base rates" - building and operating generation plant, and distribution and transmission lines. Fuel costs are passed-through and so do not constitute part of the base rate. Settlements have been the standard model for the regulation of electricity rates since 1996. Since 1996 there has been roughly one settlement per year. Almost all have resulted in rates freezes, or rate reductions.

The first stipulation was signed only by the utility and the Office of Public Counsel (OPC) which has also signed all subsequent settlements. The Florida Industrial Power Users Group was a signatory to all but the first settlement. Other signatories include Florida Retail Federation, Office of the Attorney General and other associations, individuals and companies. Total number of parties to a settlement has been increasing over time. Since 2002, the median number of parties to a settlement is eight. The OPC has led the parties in settlements, with other parties generally supporting the OPC.

The settlement process in Florida is simpler to that used by FERC. In Florida the utility or OPC or other interested parties can apply to the Florida Public Service Commission (PSC) for a rate review. Once the PSC opens a docket, the utility and the OPC and other parties that are accepted as intervenors file testimony. All intervenors can challenge these testimonies and seek further information. There is then a formal administrative hearing involving cross-examination of witnesses, after which the PSC makes its decision. If settlement takes place, it normally occurs after written testimony but before oral hearing. Stipulations are typically signed only a few days before the assigned date for the administrative hearing.

In assessing rate applications (and hence in the settlement process) PSC staff develops the facts of the case and raise relevant issues for investigation and discussion. If settlement is not achieved PSC staff advise the PSC Commissioners on the regulation. PSC staff is required to be impartial between the utility, the OPC and other interested parties (customer advocacy is the preserve of the OPC)

Some observations on settlements in Florida

Unlike settlements under FERC, saving time or cost or reducing administrative burdens has not motivated settlement in Florida. This is because settlements typically occur just before formal hearings, and these hearings, being at the end of the process typically do not add significantly to the total time or cost.

In Florida, the OPC (which has a staff of 15 and an annual budget of $2.5m) has played a major role in leading consumer representation in settlements. Unlike FERC, the PSC in Florida is not bifurcated. PSC aims to be neutral and leaves consumer representation to OPC.

The OPC (which has been described as capable, innovative and energetic) seems to have been a significant factor in settlements. While the role played by the staff of PSC is also significant (in helping to establish the facts) the staff of PSC has not always been supportive of the settlements achieved. PSC staff seemed to have been of the view that consumers sold themselves short. However the PSC Commissioners typically approved the settlements on the basis that they did not expect they could have a negotiated a better deal for consumers ("a bird in the hand…").

In Florida, the evidence was that large users seemed to have benefitted more from the early settlements than smaller consumers (through the design of tariffs). However, in later settlements this no longer seems to be an issue. Littlechild (2009) concludes that through settlements, consumers have gained rate reductions, refunds and innovative service quality incentives. The utilities have gained commitments on conduct (moratoria on requests for rate reviews for agreed periods), greater flexibility on accounting policy, and the evolution from rate of return regulation to incentive regulation.

3.3 Application of negotiated settlements in Canada

The description in this subsection is substantially based on (Doucet and Littlechild 2009).

The Canadian National Energy Board (NEB) regulates inter-state oil and gas pipelines. There are three big oil pipelines and five big gas pipelines that are subject to active regulation. The NEB also regulates designated inter-provincial electricity lines, but none have been designated. The parties to negotiated settlements for pipelines include pipelines, producers, shippers, marketers, large users and their associations and provincial governments.

The first settlement for inter-state occurred in 1985. It arose spontaneously when the pipeline (TQM) agreed the terms of proposed rates (tolls) with its customers (gas producers and shippers). TQM and its customers then jointly presented a non-severable agreement to the NEB for approval. NEB insisted on a point-by-point assessment and varied the agreement. NEB was accused of "cherry-picking" the settlement and this discouraged settlement.

Littlechild and Doucet (2009) note that:

"*Pipelines and interested parties were the instigators of negotiated settlements, unfortunately for them ahead of the Board having considered the role of settlements and its approach to them, and enunciated a settlement policy. The language in the decisions, to the effect that a settlement cannot be the "vehicle" or the "sole basis" for determining tolls, discouraged parties from putting time and effort into settling issues.*"

The NEB also varied the second settlement. This further discouraged settlements. Over the next 8 years, the NEB gradually reversed its position (on point by point assessment of settlements) and began to actively promoted settlements. It introduced settlement

guidelines in 1988. But these guidelines said the NEB would not recognise "package deals"; insisted on full hearings even if settlement had been reached; and required detail justification for each element of the settlement.

By 1994, NEB had changed the settlement guidelines so that: "*consensus of the affected parties as to what was fair and reasonable did not need to be subjected to further scrutiny in accordance with some higher ideal of the public interest that existed in the eye of the regulator. In other words, the consensus of the affected parties was a good measure of the public interest*".

By 1997 all six of the major pipelines had entered four or five-year negotiated incentive-based settlements. Negotiated settlements are now taken for granted as the most suitable mechanism for arriving at toll proposals to be submitted to the NEB.

The scope of settlements has grown over time so that they now include the normal components of regulatory price controls, tariffs and other terms of existing services, agreements to expand or discontinue services, investments in new pipeline facilities based on contractually agreed-to sharing of risks between shippers and pipeline proponents, provisions for maintaining and improving service quality; the development of information and publication requirements that are less burdensome to the pipelines and more appropriate to the needs of their users than standardised regulatory requirements.

4 Concerns about the application of negotiated settlements in the regulation of energy networks

This section describes various concerns about negotiated settlements that were raised by people that we consulted with in Australia in the course of developing this research. The people we met with included regulatory commissioners, staff at regulatory commissions, consumer advocates, some large power users, a retired Chief Justice, staff at network service providers and staff at network service provider associations.

Concern 1: Negotiated settlements transfers decision-making from regulatory commissions to utilities or effective pressure groups such as large consumers

Negotiated settlements do transfer decision-making to end users and network service providers (to the extent to which they are able to reach agreement). However, as the evidence of settlements in the U.S. and Canada shows, it would not be fair to say that it transfers decision-making exclusively to effective pressure groups (whether they be large users or others). In addition regulatory authorities typically retain the right to veto a settlement even if the utility and the consumer representatives have agreed it unanimously.

Furthermore while negotiated settlements do empower consumers and their representatives, regulators and their staff typically retain an active role in facilitating and guiding those negotiations. In this respect the transfer of authority to consumers is a little more nuanced than appears to be the case on first inspection.

Concerns about the transfer of authority from regulators to the industry and its customers seems to belie a view that regulators alone are able to determine the public interest in the regulation of monopolies. This point was considered by Thomas Morgan, one of the earlier researchers (and proponents) of settlements in the regulation of gas pipelines and electricity transmission service providers. In a paper (Morgan 1978) he promoted negotiated settlements as one of several solutions to the problem of slow and inordinately complex regulatory decisions.

His suggested that "*few administrative agency opinions are so memorable that the resources could not be spent better than in litigating issues to judgment when they could be settled sooner*".

He recognised that some would suggest that results argued by settlement, would be, by definition, wrong. He said that underlying this was the notion that " *... the public has an interest in the rate level and that allowing private negotiators to determine the price of a regulated firm's product fails to protect that interest*".

His response is so relevant to the debate in Australia (and indeed the arrangements for settlement at FERC discussed in the previous section), that it merits repeating his response in full:

- *"The first fallacy in this analysis is the assumption that a rate is correct simply because it was set after full hearing. Ambiguity is an inherent characteristic of the ratemaking process. The determination of actual, experienced costs, for example, is relatively easy,*

but even there, questions such as the appropriate rate of depreciation can affect the final result enormously. Differences of only a few tenths of one percent in the rate of return can likewise produce a difference of thousands of dollars in rates. Similarly, the technique chosen to value the firm's invested capital can greatly affect the rate set. In short, then, the system does not pinpoint a single correct level of earnings for a regulated firm. The most that can be hoped of any process, whether formal or compromised, is that the result will fall within a range of reasonableness."

- *"The second fallacy in the "public interest" argument is its assumption that most rate cases reach the litigation stage as a result of some public concern. Earlier discussion indicated that the vast majority of cases that reach formal adjudication do so because of a private controversy between the firm whose rates are in question and its competitor or customer. Because rate cases reach litigation largely because of adversary positions, compromise and conciliation become substantially more rational solutions than traditional rhetoric would indicate."*
- *"Third, part of the commission's staff should act as a surrogate for identifiable interests that are not parties to the formal proceeding. If particular large commercial customers were objecting to telephone rates, for example, part of the commission's staff might assume the role of protecting the interests of residential customers. In a particularly large case, the agency might play multiple roles, assigning them to different members of its staff. Admittedly, defining the groups to represent and knowing when represented positions should be "compromised" would present problems. But the problems would be no greater than those of directing the activities of the consumer protection bureaus often used and advocated today."*
- *"Finally, the danger that one or more decisions reached by settlement might be unfair in significant ways is always present. To deal with this problem, the administrative law judge and the commission should have to assume at least the responsibility that a trial judge must assume in class actions and in many negotiated guilty plea cases. That is to say, the burden of initiating discussions and of defining settlement terms should fall on the affected parties, but the agency should have a significant residual burden of guaranteeing a fair result. The analogy between class action cases, guilty pleas, and the process of proper rate regulation is really quite close. In each instance the details of a resolution can probably best be understood and worked out by the parties themselves, but the court must ensure that the public interest (or the interest of missing class members) does not go unrecognized."*

To paraphrase Thomas Morgan's arguments, the instinctive preference for regulation (rather than settlement) is a fallacy because:

1. The right answer lies in a range and there is no reason to believe that regulators are uniquely able to determine the right point in that range.
2. Regulatory decisions are not always concerned only the public interest.
3. The staff of regulators would be involved in negotiated settlements anyway.
4. Regulators should retain the right to veto settlements if they do not properly reflect a fair negotiation between the parties.

On the second of these points, (Biggar 2011) presents evidence to suggest that economic regulators' claims that their primary focus is to protect the public interest by promoting efficiency (through the minimization of deadweight losses) is not borne out by a critical examination of their decisions:

"*We are forced to conclude that the standard rationales for public utility regulation that are conventionally offered are inadequate. Economists have for many years argued that the primary economic rationale for public utility regulation is the reduction of the harm known as deadweight loss. On closer inspection, however, this turns out to be unsatisfactory. Despite the exhortations by economists, regulators and regulatory policy-makers have systematically ignored or downplayed this rationale in practice. There must be some other explanation for why we regulate public utilities. The other suggestions – that we regulate to promote productive efficiency or to promote competition – are either irrelevant or even less plausible.*"

A similar discourse is well established in North America. (Vickers and Yarrow 1988) describe a "theory of regulation" (i.e. a theory to explain the supply of and demand for economic regulation) in explanation of the diverse outcomes pursued by economic regulators.

This is relevant to the assessment of the merits of negotiated settlements, relative to traditional regulation: if economic regulators do not pursue the public interest as some say they do, then the argument that negotiated settlements is concerned with the resolution of private interests, while traditional economic regulation pursues the public interest, is diminished.[4]

There seems to be some lack of confidence that the economic regulation of monopoly energy networks in Australia has been effective in delivering efficient outcomes. The Energy Users Rule Change Committee, in a publicly available briefing (Energy Users Rule Change Committee 2012) to the Minister for Energy and Resources in Australia, suggested that in the National Electricity Market in Australia:

"*Regulation has become bureaucratic, inflexible, drawn-out, opaque, adversarial and susceptible to lobbying. The regulator and the industry have become focussed on each other, rather than the needs of users. Despite the fact that the industry and its regulator claim to be acting in our best interests, both do little to ask us what we want, and neither seem to value our participation.*"

Littlechild (2012) observes that customers, regulators and utilities are increasingly choosing settlement, and that is evidence of its advantage relative to traditional regulation:

"*The proof of the pudding is in the eating. The parties involved have increasingly preferred settlement to litigation over the course of the last half-century. This is a remarkable record of survival in an activity – utility regulation – that has been characterised by no little reform and change over this period. Indeed, settlement is now actively chosen by all parties – utility,*

[4] Furthermore a widely accepted precept of independent (economic) regulation is precisely that it should be focussed not on the *public* interest, but only on the long term interest of the end users (indeed this is the objective established in the electricity and gas laws in Australia.) This being the case, the objection that negotiated settlements will not deliver the public interest, while traditional regulation will, is an irrelevant objection.

customers, interstate and state regulators … Traditional litigation has become essentially a method of dispute resolution limited to novel or exceptionally difficult rate case issues."

Concern 2: Consumers are unable to master the complexity needed to successfully negotiate. Therefore negotiated settlements will be unbalanced at consumers' expense

This was a concern that we heard several times from regulators, consumer advocates and the industry. Some made the comment in general while others were more focussed on small consumer representation. Typically this would be the first concern that came to mind, amongst the people that we spoke to.

Ofgem had the same concern in Britain. In justifying its rejection of negotiated settlements, Ofgem noted in relation to the capacity of consumers to represent their own interests *"We also have concerns regarding their current access to resources, the current levels of expertise of all but a very small number of individual consumer representatives and their appetite to engage in this way".*(Ofgem 2009)

Concerns that residential and other small customers would not be adequately represented in a negotiated settlement or constructive engagement process is probably the biggest single obstacle to its adoption in the energy (and water) sectors (Littlechild 2011(a)).

However it was striking that in the literature on settlements – where it has been implemented - we did not find any reference to concerns about the ability of consumers whether small or large to negotiate effectively.

It would seem that this is explained by the active role taken by regulatory staff and/or consumer advocacy bodies in leading in the analysis and assessment of utility proposals. Adequately resourced consumer advocacy has long been a feature of utility regulation in North America. Littlechild (2009) noted a survey for the Florida senate that of 45 states in the United States, 17 had an independent agency representing consumer interests, in 15 states this activity was undertaken by the Attorney General, 7 had other executive agencies, and in 6 states the public service commission was the consumer representative entity. Consumer representative institutions and adequate consumer advocacy funding, combined with the active participation of regulatory staff in settlements seems to have meant that consumers' ability to participate in negotiated settlements has not been an issue in the United States and Canada where negotiated settlements have been implemented.

Genuine consumer empowerment is also likely to be a significant factor. In Britain (Littlechild 2011(a)) notes:

"Is there the "appetite of customer representatives to engage"? Hitherto, UK price control processes have not been conducive to customer engagement in this way. Why should companies and customers spend time negotiating settlements if the regulatory body would ignore the outcomes? And it is understandable that customer representatives might be apprehensive about taking on the magnitude of the present regulatory task. But surely there would be an appetitive to engage under more suitable conditions. With appropriate encouragement and access to

expertise and information, and an understanding that arrangements negotiated with utilities would be respected, customer representatives could be as keen to engage in the UK energy sector as they have been elsewhere."

Concern 3: Consumers have different priorities and so they will not be able to agree to settlements with NSPs

This was a concern that we heard from some regulatory staff, but we did not hear it from consumer advocates. From those that raised this concern, it was not clear how they thought priorities differed amongst consumers. Presumably what was in mind would be the traditionally contentious issues such as tariffs, or perhaps that some consumers might be prepared to pay more for a network that delivers higher reliability while others might consider prices to be more important.

As shown in the previous section, the evidence in North America seems to be that contested settlements are infrequent. However, this issue has attracted attention in the literature (see in particular (Doucet and Littlechild 2006) for a review of this literature). It is clear that in designing the settlement arrangements it is necessary for the regulator to be clear how it will treat contested settlements, and the rights and obligations of those that settle and those that dispute the entire, or part of the settlement.

The likelihood of non-unanimous settlement will also reflect the extent to which the issues to be settled will have a disproportionate impact on some consumer groups. Revenue or price controls as currently implemented under the gas and electricity rules, do not involve the specification of tariff structures. In this sense, one of the contentious areas would not necessarily form part of a negotiated settlement in Australia.

Concern 4: Consumers will choose short-term gains at the expense of long term efficient outcomes

This was a concern raised by some staff at regulators. In earlier consideration of the scope for negotiated settlements in Britain, the regulator, Ofgem, had also expressed concern that, given the chance to settle with network service providers, current consumers would put their own interests ahead of those of future consumers (Ofgem 2009).

This is a general concern, evident also in traditional regulation. For example, the National Electricity Objective – the long-term interest of consumers – reflects a policy objective that in its decisions, regulators should not trade-off short-term price reductions for lower efficiency or reliability in the long term.

The evidence on short-termism in settlement is that settlements do seem to reflect the desire for lower prices possibly, but not certainly, at the expense of higher prices in future. In Florida Littlechild (2009) documents how settlements reflected price reductions, whereas previous regulatory decisions had used surpluses to amortise stranded assets. (Fellows 2011) documents outcomes in Canada where depreciation practises that occurred in settlements resulted in lower prices.

Is this evidence of a concern that short-term price cuts have been delivered at the expense of less efficiency in the long run? The evidence does not seem to suggest that this is the case. The treatment of reserves and depreciation are matters of accounting, they do not affect expenditure on operations, maintenance or capacity expansion. We are not aware of any claim in the literature that settlements have reduced the reliability of supply (or threatened to reduce reliability).

Other counter-arguments to the short termism proposition are that the utilities themselves will resist settlements that jeopardise the long-term efficiency of their businesses, or that jeopardise security of supply.

In addition the proposition that regulation alone is able to deliver prices that ensure long-term efficiency, has little following in market economies. Why should it be different in utilities?

Concern 5: Negotiated settlements lack transparency, with no public explanation or justification of the terms involved.

This is not a concern that we have heard in Australia. We suspect that we did not hear this concern in Australia because the concept of negotiated settlement (for the regulation of energy networks at least) is not yet well explored.

However it has been mentioned in the literature in the US, and elsewhere (see (Doucet and Littlechild 2006)). In the UK Littlechild (2012) reports that interest in the concept of settlements has been tempered by a concern that some parties (particularly smaller customers) would thereby lose access to regulatory information, opinion, guidance and support.

The concern is that large parts of negotiated outcomes are typically confidential. Often agreement is achieved if outcomes are negotiated as package deals. Often conditions of settlement include that the settlement doesn't establish precedents for the treatment of particular costs.

For example in the case settlements arranged by FERC, Littlechild (2012) reports that *"to the outsider, and indeed to FERC personnel not part of that Trial Staff team, almost all settlements may appear to be a black box insofar as the Settlement Document gives no details of the calculations"*.

This reduces the level of transparency and publicly available explanation that is considered standard practice in traditional regulation.

Littlechild (2012) responds to this concern by noting "*settlements where the parameters are agreed but not made public are not 'true' black boxes to those involved in the negotiations. Indeed, even 'true' black boxes are the result of a series of earlier proposals that start from Staff cost of service calculations and begin to narrow down the differences between the parties. (By the same token, lack of transparency is not a major issue in practice since any party with an interest in the case and a concern about information can become an intervenor and get access to all the information disclosed in the course of negotiations.)"*

There may be a residual concern that while the information may be available to all parties to a settlement, it will be lost to subsequent settlements. Perhaps this can be ameliorated through the arrangements for the ongoing reporting of expenditures and other outcomes.

Concern 6: Network service providers will not agree to a more generous settlement with consumers than they would get from the regulator

This was a comment that we heard several times, from consumer advocates and also from staff of regulatory authorities. The comment was typically made in the context of concerns about asymmetry of information and expertise – i.e. that NSPs held all the information and that since consumers could not match their expertise, they would not get a fair deal through negotiation.

There are several counter-arguments. This first is that neither party is forced to settle – if they think they are able to obtain a better outcome they can refuse to settle. The fact that settlements occur is evidence that the parties consider the negotiated outcome is preferable to the regulated outcome.

The experience in settlements negotiated between airlines and airports in Australia is instructive. The Productivity Commission's review of settlements (Productivity Commission 2011) noted that airlines and airports had many complaints about settlements, and both felt that they had not always been able to negotiate reasonable outcomes. Yet neither wished to return to traditional regulation.

A second counter-argument is that NSPs may be willing to exchange lower prices for other outcomes they value such as certainty, moratoria on requests for rate reviews, consumer agreement to things that would otherwise not be included in regulatory decisions, better relationships with consumers, less time from senior management on regulatory issues.

Such benefits were identified in the previous section as having been influential in settlements in Florida, and for inter-state gas pipelines in the US and Canada. In Australia, benefits such as moratoria on requests for rate reviews are less relevant (five yearly resets are prescribed in the laws). Nevertheless, the international evidence on settlements that have been agreed suggest that NSPs value more than just the negotiated price, and that the ability to negotiate allows for a settlement that better meets the wishes of consumers for lower prices, and NSPs' wishes for other non-price outcomes.

A third counter-argument is that in the role that regulators play, they are able to encourage better outcomes through settlement. For example, Littlechild (2012) described the Top Sheet developed by Trial Staff of FERC, which is regarded by some as the First Settlement Offer.

"*The first Settlement Offer is a 'first cut' at the issue, usually close to what Trial Staff's position would be in the event of a hearing. That is, it represents a relatively tough assessment of the pipeline's filed proposal. It is generally assumed that a company's filing contains an element of 'fat' that could be subject to challenge or bargaining. But the top sheet will be tailored to the*

specific circumstances. The pipeline's section 4 filing and Trial Staff's first Settlement Offer then typically constitute the range within which negotiations proceed. However, it is necessary to take account of the views of all parties, some of whom might argue for an outcome outside of this range". (Littlechild, 2012)

By providing clarity on the likely backstop, should negotiations fail, regulators are able to encourage NSPs to settle.

5 Implementing negotiated settlements in Australia: some considerations

This final section sets out some initial thoughts on the issues to be considered in the implementation of negotiated settlements in the regulation of energy networks in Australia. Our research and analysis to this point lead us to conclude that negotiated settlements seems to be at once a big change from current arrangements (considerable changes are needed in institutions and attitudes) and a small change (essentially the same core analysis needs to be done in settlements as in traditional regulation).

The main purpose of this section is to identify some of the main issues that would need to be considered in order to begin to deliver negotiated settlements in the economic regulation of gas and electricity networks. It considers institutional developments and then changes to the law, rules, guidelines and procedures. It then examines the possible scope for settlements (the types of issues that could be settled, which industry segments might be more amenable to settlement, and various stepping stones).

5.1 Institutional developments

At the time of writing this paper, a number of reviews of various aspects of economic regulation in Australia (by the Limited Merits Review Panel, Australian Energy Market Commission, the Productivity Commission and the Senate) have all concluded that there is an urgent need to empower energy consumers so that they can participate effectively in the regulation of the industry. The Standing Council on Energy and Resources is currently considering the design of an energy consumer advocacy body to be funded by the governments and/or energy users via levies.

It was clear to us from discussion with many consumer advocates that they generally had little confidence in their knowledge of the electricity industry, and their ability to negotiate successfully with network service providers. A necessary condition for the success of negotiated settlements is that consumer advocates have such confidence. The technical ability and organisational depth of energy user advocacy needs to be improved to achieve this.

The advocacy models in Florida – an influential and effective Office of Public Counsel – merits emulation. This does not mean creating a monopoly in energy user advocacy, but rather ensuring that there is at least one institution that can be relied upon by other energy user advocates to contribute significant technical expertise.

A second necessary institutional development is that the AER willingly accepts a change to its approach so that preference is given to settlement. In practice this means AER staff (and its Commissioners) assisting the parties in reaching agreement by negotiation, and only if such agreement can not be achieved, then resorting to traditional regulation.

It is not obvious to us whether the approach adopted by FERC – bifurcation of the regulatory staff, with "chinese walls" to ensure integrity - would be better than the

approach adopted in Florida (where the regulatory staff act as impartial advisors and analysts, and the running is made by the Office of Public Counsel).

The choice between these approaches will depend on the strength of the consumer advocacy arrangements currently being developed, and whether the resulting institution is able to lead the negotiation (without the active support of the regulator in undertaking analysis, helping to resolve differences and so on). Regardless, the available evidence suggests a proactive approach by regulatory staff is likely to enhance the prospects for settlement. This was the clear advice in Morgan (1978) and again in Littlechild (2012).

5.2 Changes to the laws, rules, guidelines and procedures

The National Electricity Law and National Gas Law and the electricity and gas rules will need to be changed to give primacy to settlement, as occurs federally in the United States and Canada and in several states of the U.S. and provinces of Canada.

In Florida and federally in the U.S., arrangements have been designed so that primacy is given to settlement but the traditional regulatory approach can resume quickly if settlement is not achieved.

In FERC this occurs by starting with the traditional regulatory approach – proposals from network service providers are made in the usual way – but the process of traditional regulation is then suspended to allow for a structured settlement process. In Florida the traditional regulatory approach is followed (data acquisition and analysis by regulatory staff) and will proceed to formal testimony and hearings unless settlement occurs in advance.

In the NEM, the procedures are established in the Rules and are currently being adapted through guidelines currently in development by the AER. The concurrent operation of the traditional regulatory procedure (regulatory proposals, draft decisions, revised proposals and final decision) with a settlement negotiation, is likely to mean that one the benefits of settlement – quicker decisions and lower transaction costs – is not likely to be realised. This is because the existing process (proposal, review, draft decision, revised proposal, final decision) is highly time and data intensive for all parties. Running a settlement negotiation alongside the existing regulation will therefore not avoid the high cost of the existing process. Perhaps the arrangements at FERC (suspending traditional procedures until settlement negotiations have run their course) would be a preferable approach in Australia.

Consideration will need to be given to changes to the current regulatory process so that it is able to facilitate settlement. For example, as we discussed earlier, in FERC the "top sheet" or "First Settlement Offer" is interpreted by some as the lower bound to the settlement, and in this sense helps to frame settlement discussions. A similar approach would be useful in Australia

In Australia, (Bordignon S. and Littlechild 2012) explain how in the settlement of access to the Hunter Valley rail track, "*ACCC staff played a pro-active role acting where necessary*

as mediator and seeking to build consensus", although the coal producers felt that the ACCC could have done more in "*getting the parties to the table and stimulating negotiations*". Facilitating negotiation and also running a traditional regulatory process will have obvious tensions and these are likely to become increasingly evident if settlement becomes the preferred approach.

The AER will also need to develop guidelines on the criteria it will apply to decide whether to accept settlements. Under Part IIIA of the Consumer and Competition Act, the ACCC has considerable discretion in deciding whether it will accept access undertakings.

In Canada, we noted earlier how important the National Energy Board's guidelines on the criteria it would apply in accepting settlements, had been in encouraging settlement. In Canada, it took some time for the NEB to have the confidence to be comfortable in assessing the *process* of the settlement and not judging the outcome, and it was trust that the NEB would not try to second-guess the outcome that gave the parties the confidence to settle.

The same challenges will need to be addressed in Australia. It is understandable that starting from such a low base in Australia (in the sense of highly disempowered users, and very rigid regulatory procedures) it will take time for the AER to have confidence to judge a settlement by the *process* of the negotiation, rather than second-guessing the outcome.

Finally the AER (and policy makers) will need to define criteria for eligibility as a party to the settlement. Should parties only include end users and their representatives? How will eligibility be assessed? Should distribution network service providers be eligible for recognition as a party to a settlement for transmission network service providers? Should energy retailers be eligible parties in settlements?

5.3 Implementation considerations

There are many issues to consider in the progressive implementation of settlements. Choices may include:

- Sector – would it be better to begin settlements in gas or electricity networks? Would it be better to start with transmission or distribution networks?
- Scope – should settlements apply to weighted average prices or aggregate revenues or to tariffs? Would it be better to encourage settlement of a whole decision or some part it – say opex or capex or specific large investments? For example in 2006 Professor Littlechild suggested consideration of negotiated settlement to decide large augmentations in transmission networks in Australia? Should the regulated rate of return be an issue for settlement (as in settlement under FERC or in Florida), or should the regulator determine this independently of the settlement (as applies in Canada)?
- How should the regulator begin the process of implementing settlement? Recent developments in the regulation of the Water Industry in Scotland is instructive: The regulator, government, water industry and consumer representatives have recently signed a formal agreement describing the role and process of a new

> Customer Forum, making it clear what the functions are (to carry out research into customer preferences and to represent these to company and regulator). Formal decisions on price controls remain with the regulator, with important direction from the Government. The regulator is in the process of providing guidance on opex, capex, cost of capital etc. There is also to be a set of tramlines published by the regulator, indicating what it considers to be reasonable outcomes over the next price control period. The Customer Forum will monitor and discuss/agree with the company what to do if outcomes look like they will wander outside the tramlines. Processes are established for independent expert review.[5]

It is tempting to explore these implementation questions in greater detail, and even to ponder a "grand plan" for the progressive implementation of negotiated settlements in the regulation of energy networks in Australia. But first the advantages and disadvantages of negotiated settlements needs to be more widely debated in Australia. The main parties, particularly consumers and the regulator, need to be convinced of its merits.

One of the recently approved changes to the national electricity and gas rules encourages engagement between the AER and network service providers before network service providers make their revenue and price proposals to the AER. This reflects similar arrangements recently developed in the UK. Such encouragement for engagement provides an ideal opportunity for consideration by all parties of how the benefits of negotiated settlements can be realised.

[5] Stephen Littlechild, personal communication.

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