The potential scope for negotiated settlements in the regulation of electricity and gas networks in Australia

For discussion

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Outline

- What are negotiated settlements (NS) ?
- Arguments for NS
- Concerns that have been raised in Australia on use of NS
- Application of NS in US and Canada
- Response to concerns
- Issues to consider in the application of NS in Australia

What are negotiated settlements (in network utility regulation)?

- No unique definition, many possibilities, but core includes:
  - Agreement, by negotiation, of various economic controls of network monopolies. Agreements can specify prices, revenues, rates of return, depreciation schedules, new investments, service standards, incentives, performance reporting.
  - Settlement occurs between monopoly service providers and various interested parties (which may include end users, end user associations, industry associations, retailers, generators, shippers, distributors, staff or divisions of regulatory authorities, staff of Attorneys General, consumer advocates).
- Regulators may or may not facilitate settlement.
- The backstop in the case of non-agreement may or may not be specified (in detail).
- Settlement may or may not be unanimous.

Arguments for NS

- Various claims have been made about the benefit of NS, relative to conventional regulation:
  - Quicker and less expensive decisions (Doucet and Littlechild (2006), Wang (2004), Morgan (1978); Littlechild (2011)
  - Better mutual understanding of network service providers and their customers;
  - More innovative (Wang (2004), Doucet and Littlechild (2006)
  - Better outcomes because customers, rather than regulators, determine traded-offs (Palast et al (2003), Doucet and Littlechild (2006), Wang (2004) , Walker (1986)
  - Reduces uncertainty about outcomes (Littlechild (2011)
  - Allows parties to achieve outcomes that they could not, or would not achieve through regulation (Littlechild (2011)

- Biggar (2012) 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 NS (that I have heard in Australia)

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

2. Consumers have different priorities, they will not be able to agree to settlements with NSPs.

3. Consumers will choose short-term gains at the expense of long term efficient outcomes

4. Large consumers benefits more than small consumers

5. Settlements lack transparency - no public explanation or justification of the terms involved

6. Perceived transfer of decision-making from regulatory commissions to utilities or effective pressure groups such as large consumers

7. NSPs will not agree to a more generous settlement with consumers than they would get from the regulator

Application of NS elsewhere: FERC (US) (covered in Littlechild (2011))

- **Industry background:** FERC regulates the rates of inter-state gas and electricity. There are 170 inter-state pipelines. Pipeline customers include producers, marketers, distributors, large end users. There are about 7 pipeline rate cases per year.

- **History of NS:** NS introduced to deal with impossible workload, from 1960s. Settlement become increasingly popular so that now its the predominant method (>90% of rate cases) in gas, understood to be similar in electricity. Law gives priority to settlement.

- **Parties to settlement:** Known as “intervenors”, includes pipelines, producers, marketers, distributors, large end users, state public utility commissions, rival pipelines, potential customers. Typically around 16 parties to a settlement (may be much more or less – 54 in one case, and 6 in another). Some parties are groups.

Organisation of settlements at FERC

- Office of Energy Market Regulation (OEMR) receives applications to increase rates; issues "suspension order"; advises Commissioners whether to approve settlements or ALJ "initial decisions".
- Office of Administrative Law Judges (ALJ) resolves contested cases through "initial decisions"; certifies settlements.
- Office of Administrative Litigation (OAL) – staff called "Trial Staff". Trial staff play a key role in facilitating settlement.
- OEMR Advisory Staff and OAL Trial Staff are prohibited from communicating with each other.

Settlement process at FERC

1. Pipeline applies for rate increase: files tariff sheets; supporting documents, cost data etc.
2. OEMR publishes application, invites interest parties to request permission to become intervenors.3
3. OEMR issues “suspension order” – starts the process, orders ALJ to be selected and set pre-hearing conference
4. Pre-hearing conference establishes about a dozen main dates in the rate proceeding.
5. Trial staff team (about 8-14 per case) establish “First Settlement Offer” (circa 100 pages) after full cost of service review. Intervenors are engaged in similar discovery process.
6. First settlement conference chaired by lead attorney on Trial Staff team. Attended by Trail Staff, pipeline and intervenors. Typically 100 participants for large cases.
7. Second settlement conference set after pipeline responds to First Settlement Offer with counter-offer. At Second Settlement Conf, Trial Staff explain their thinking to intervenors (without pipeline present). Settlement may occur (typically does by Second Settlement Conf.) or another conference arranged.
8. Trial Staff are active in settlement process, seeking to find agreement amongst intervenors and between intervenors and pipeline.
9. Once agreement in principle is reached, parties jointly file a motion to suspend procedural schedule. Pipeline then drafts Settlement Document, circulates it for comment. Agreed settlement is then filed with ALJ and ALJ invites parties to draft letter of certification, which is then circulated for comment.
10. If unanimous settlement, ALJ certifies it and refers it to Commission for approval.
11. If non-unanimous settlement (unusual) Commission may approve non-contested portions and sever contested parties or issues for resolution through litigated process.

FERC NS – some observations

- Settlement started in response to administrative constraints. Those constraints no longer exist but settlement has been extended. It is the standard model and traditional “litigation” seems to apply only in complex cases, and only after settlement has failed.

- The 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, each of which have different roles in the process.

- 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.

- Why have parties chosen to settle? Quicker and less expensive; reduces uncertainty about outcome, earlier rate relief to consumers; enables parties to secure preferred outcomes that they legally could not or likely would not achieve under a litigated hearing process

Application of NS in Florida (from Littlechild (2009))

- **Industry background:** Four privately owned, vertically integrated (G+T+D+S) electricity companies supply 99% of Florida electricity customers. Market is not open to competition.
- **History of NS:** Settlement (called “stipulations”) covers “base rates” - building and operating generation plant, and distribution and transmission lines. Fuel costs are passed-through. Settlements have been the standard model since 1996, roughly one per year. Almost all have resulted in rates freezes, or rate reductions.
- **Parties to settlement:** The first stipulation was signed only by the utility and the Office of Public Counsel (OPC) which has also signed all subsequent settlements. 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 has been increasing, since 2002, the median is 8. The OPC has lead the parties in settlements, with other parties generally supporting the OPC.
- **Settlement process:** Utility or OPC or other interested parties apply for a rate review. Once the Public Service Commission (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 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.
- **Role of the regulator:** PSC staff develop the facts of the case and raise relevant issues for investigation and discussion, then advise the commissioners in the course of their deliberations. PSC staff are required to be impartial between the utility, the OPC and other interested parties (advocacy is the preserve of the OPC)

Florida NS – some observations

- Unlike FERC, saving time or cost or administrative burdens has not motivated settlement;
- Office of Public Counsel (staff of 15 and budget of $2.5m) has played a major role in leading consumer representation;
- Unlike FERC, PSC staff not bifurcated. PSC aims to be “neutral” – leaves consumer representation to OPC.
- The OPC (described as capable, innovative and energetic) seems to have been a significant factor in settlements. Staff of PSC also seemed to be very involved in negotiating settlement.
- Staff of PSC not always supportive of settlements achieved. They seemed to think that consumers sold themselves short. But the Commissioners approved the settlements (“a bird in the hand…”)
- Large users seemed to have benefitted more from settlements than smaller consumers, initially at least (although settlements endorsed by PSC)
- Consumers have gained rate reductions and refunds and innovative service quality incentives
- Utilities have gained commitments on conduct, greater flexibility on accounting policy, and the evolution from rate of return regulation to incentive regulation.

Application of NS in Canada (from Littlechild and Doucet 2006)

- **Industry background:** National Energy Board (NEB) regulates inter-state oil and gas pipelines. Three big oil and five big gas pipelines are subject to active regulation. Regulation (and settlements) determine the price for services (firm or interruptible capacity) on these pipelines. NEB also regulates designated inter-provincial electricity lines, but none have been designated.

- **Parties to settlement:** pipelines, producers, shippers, marketers, large users and their associations, provincial governments.

- **Scope of NS:** Progressively grown over time, so that now includes:
  - normal components of regulatory price controls,
  - tariffs and other terms of existing services,
  - projections of operating and capital costs,
  - rate of return on equity and deemed common equity ratio,
  - agreements to expand or discontinue services,
  - investments in new pipeline facilities based on contractually agreed-to sharing of risks between shippers and pipeline proponents,
  - multi-year incentive arrangements,
  - provisions for maintaining and improving service quality, including the development of detailed metrics associated with quality, predictability and reliability, and associated bonuses,
  - 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

NS in Canada: History

- The first settlement 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. "*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*."
- A second settlement (only initiated late in the process) was again varied by the NEB. This further discouraged settlements.
- Over the next 8 years, the NEB reversed its position and gradually 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 reachel; and required detail justification for each element of the settlement. By 1994, the settlement guidelines had been varied 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 Group 1 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.

NS in Canada: some observations

- NS started through voluntary agreement between a pipeline and its customers. *"Users of the pipelines had grown disenchanted with a regulatory process that was costly, time-consuming, and at which they felt they could not win*." The NEB reacted to that, and over eight years eventually arrived at principles that encouraged settlement. The key was to judge a settlement by the process that lead to it, rather than on the outcome of the settlement.

- The pipelines' users (gas/oil producers, shippers, major end users) and their associations are sophisticated and well resourced. Settlement has not relied on facilitation by regulatory staff or consumer advocates (as in Florida and FERC).

- Settlements have set controls that are longer than regulated controls; have significantly reduced processing time and cost and delivered efficiency incentives.

- The general opinion seems to be that there have been significant improvements in productivity and in service design. Attitudes, relationships, communication and understanding in the industry have changed for the better. (D&L 2006)

Response to concerns

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

- In FERC and Florida, regulatory staff and/or consumer advocate organisations do much of the heavy lifting in the analysis and critique of a rate application. Many consumer advocates rely heavily on analysis and advice by leading advocates or regulatory staff. The literature does not suggest any concern about the ability of consumers to negotiate effectively.

- In Canada, this has not apparently been an issue in inter-provincial or international oil and gas pipelines (very large and sophisticated users).

- In all cases, settlements are voluntary and so if there was an enduring concern that settlements were unbalanced, they might be expected to have become less popular, whereas the opposite seems to be the case.

- Littlechild suggests that settlements are easier with less complex cases and decisions that do not result in large price increases.

Response to concerns

2. Consumers have different priorities, they will not be able to agree to settlements with NSPs

Non-unanimous settlements has been actively debated in NS literature. Morgan (1978), Drom (1991), Krieger (1995), Buchman and Tongren (1996), Doucet and Littlechild (2006).

Scope for disagreement will depend on issues to be settled (e.g. consumers more likely to have different views on tariff structure, than on aggregate revenue controls)

Where settlements have occurred in US States, state regulators in the US have allowed non-unanimous settlements to be challenged (Doucet and Littlechild 2006). FERC allowed settlement to continue for consenting parties and severed the contesting parties to litigate their interests separately. Non-unanimous settlements has not been an issue in Canada or Florida.

Response to concerns

3. Consumers will choose short-term gains at the expense of long term efficient outcomes

Ofgem has expressed some reservation about NS citing this reason. Littlechild (2009) suggests in Florida consumers were focussed on getting rate reductions as soon as possible (although this does not suggest at the expense of rate increases in future). Fellows (2011) suggests (on a limited examination of one decision for two years) that rate reduction associated with NS were achieved by deferring depreciation.

This argument, if valid, suggests a preference for regulation rather than settlement in all circumstances. But the future is uncertain and long term efficient outcome are not known. Also, not clear why networks would always agree to defer depreciation (higher risk of non-recovery).

In the case of egregious inter-temporal cost-shifting, Commissions can reject a settlement as against the public interest. No evidence that they have done this.

Response to concerns

4. Large consumers benefits more than small consumers

- Littlechild (2009) noted that distribution of benefits under settlements initially more favourable to large users than small in Florida. But settlements approved by the Commission, was subsequently changed for later settlements, and not clear that small consumers were worse-off relative to no settlement.
- Commissions typically retain right to reject settlement
- For many elements of NS, the interests of large and small consumers are likely to be aligned (e.g. revenue cap/weighted average price cap, service standards etc.)

Response to concerns

5. Settlements lack transparency - no public explanation or justification of the terms involved

Some lack of transparency of the final settlement is inevitable (settlements are “package deals”).

Interested parties have access to whatever information they need in the process of negotiating a settlement.

Response to concerns

6. Perceived transfer of decision-making from regulatory commissions to utilities or effective pressure groups such as large consumers

Final decision (to reject or accept a settlement) does rest with regulatory commissions.

Typically, regulatory staff retain significant influence by facilitating settlement and providing analytical advice.

Need to guard against excessive control by any single consumer/representative group.

Response to concerns

7. NSPs will not agree to a more generous settlement with consumers than they would get from the regulator

- As described, settlement does occur (and has been stable and progressively more pervasive where it has been allowed)
- Evidence suggests NSPs have valued: the ability to trade issues that would not be possible through regulation; quicker and less costly resolution; certainty; incentives; innovation; better relations with consumers.
- If consumers think they will get a better deal through regulation they don't have to settle.

Issues to consider in the application of NS to Australia

- The NEL and NGR will need to be amended to give priority to settlements, with decisions by AER as the fall-back if no settlement. A big change in mindset is needed for this to occur. What process of inquiry/review needs to be followed to decide whether to make this change?

- How to achieve effective consumer representation:
  - Statutory entity responsible for consumer representation?
  - Bifurcation of AER?
  - Involvement of non-statutory consumer advocates and other interest groups?

- Where to start:
  - covered gas pipelines, electricity transmission, gas/electricity distribution?

- Scope for settlement:
  - Regulated revenues, prices, tariffs, cost of capital, opex, routine capex, augmentation capex, service standards, performance and cost reporting?

- Definition of arrangements:
  - Treatment of contested settlements by AER?
  - Criteria for acceptance of contested and uncontested settlement by AER?
  - Criteria for participation in negotiation by consumer advocates or others?
  - Organisation of NS process (discovery, conferences, timelines etc.)?