Submission to COAG Energy Council LMR review
3 October 2016

> *This is not to dispute the fact that regulatory delay itself carries cost for both industry and end-users. However, bad decisions taken quickly are not preferable to ensuring good decisions are taken, especially given the role those decisions play in determining the future of Australian telecommunications. Moreover, the panel believes that even were there reviews initially, and associated delays, the decisions reached in those reviews would help guide the process from then on, so that delays would not persist.*
>
> Dr Michael Vertigan AC, *et al*[1]

This submission to the COAG Energy Council's review (the review) of the limited merits review (LMR) arrangements applying to certain energy sector regulatory decisions has been prepared by the undersigned without involvement, prior review or financial support from any interested party. The views expressed are those of the individual signatories and not the organisations or firms with which they are associated. The motivation for our submission arises from our concern that several premises on which the review appears to be proceeding lack a strong evidence base, and so place the review at risk of departing from the principles of sound public policy development.

We urge the Senior Committee of Officials (SCO) and Ministers to be cautious about reaching premature judgements in relation to the issues arising from the prevailing appeals of the Australian Energy Regulator's (AER's) recent electricity and gas network determinations, as variously instigated by network businesses, consumer groups and the AER itself.

The existence of effective and efficient arrangements for merits-based review of administrative decisions is fundamental to the long term success of any regulatory regime. Review mechanisms encourage clarity as to how a regulatory framework is to be applied and strengthen the accountability and legitimacy of decisions made under it. The option identified in the SCO's Consultation Paper[2] (the consultation paper) of eliminating access to the energy sector LMR arrangements cannot be justified by reference to the post-2013 performance of the present arrangements – a point on which we expand below.

Sound public policy decisions need to proceed from a firm evidentiary basis and a clear, balanced characterisation of any 'problem' that is to be addressed. Only then can options for change be appropriately framed, and the costs and benefits of any potential change properly evaluated.

The fundamental role of the existing LMR regime was recognised in the context of last year's independent Review of Governance Arrangements for Australian Energy Markets (the governance review), also commissioned by the COAG Energy Council. The governance review described the merits review function as one of three central tenets of the current governance of the energy market which help establish credibility with investors and provide them with confidence to invest in the sector.[3] The principles of sound policy formation would suggest that changes to a fundamental

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[1] Comments on the role of merits review of regulatory decisions, *Independent Cost Benefit Analysis of broadband and review of regulation*, Statutory Review under section 152EOA of the Competition and Consumer Act 2010, June 2014, p 59.
[2] COAG Energy Council, *Review of the Limited Merits Review Regime, Consultation Paper*, 6 September 2016.
[3] *Review of Governance Arrangements for Australian Energy Markets, Final Report*, October 2015, Dr Michael Vertigan AC, Professor George Yarrow, Mr Euan Morton, p 42.

pillar of any institutional arrangement should only proceed in the face of clear evidence of shortcomings, and a careful and considered weighing of alternatives.

In our opinion, it is too early to conclude that the current LMR regime is not working to promote the long-term interests of consumers. In particular, there is no sound basis for concluding that the experience to date of the arrangements as revised in 2013 is inconsistent with policy expectations articulated at the time. Indeed, there are grounds for optimism that those arrangements hold a real chance of delivering better future regulatory decisions, providing they are allowed to run their course.

Matters of concern identified in the consultation paper

The consultation paper observes that twelve of the twenty revenue or access arrangement determinations made by the AER since the 2013 changes to the LMR regime have been the subject of applications for review by the Australian Competition Tribunal (the Tribunal). The consultation paper also observes that matters the subject of review involve revenues of around $7 billion over five years, and that determinations made by the AER in April 2015 will likely remain uncertain until at least early 2017.

In that context, the consultation paper identifies four 'key areas' as requiring consideration through this most recent review, namely:

1. the apparent 'cherry picking' of matters for review by network businesses;
2. the focus on correcting individual errors without sufficient consideration of whether a different decision would lead to a materially preferable decision that is in the long term interests of consumers;
3. the LMR regime not delivering timely and predictable revenue determinations; and
4. the LMR regime continuing to present barriers to the participation of key stakeholders, such as consumer groups.

A careful examination of the evidence, however, does not uphold any of these apparent shortcomings and leads us to the view that it would be premature to instigate any substantive changes at this phase in the evolution of the regime.

Apparent 'cherry picking'

A contextual fact of much relevance for the performance of the LMR regime since 2013 is the substantive changes that were made to the rules governing electricity and gas network determinations (the rules) in 2012. An important theme of these changes was an increase in the extent of discretion available to the AER and the Energy Regulation Authority (ERA) under the rules in relation to the two most substantial elements of the revenue allowances to be derived by the regulators, ie, allowed operating expenditure (opex) and the allowed rate of return on capital.

The applications for review of the first AER and ERA decisions to follow the 2012 rule changes can reasonably be characterised as part of the inevitable 'bedding down' of those changes. Across *all* of the applications for review since 2013, a large proportion of the revenue allowances the subject of dispute concerns four core issues, ie:

- the allowed return on equity;
- the transition to revised arrangements for determining the allowed return on debt;
- the treatment of tax imputation credits (gamma); and

- for the NSW/ACT electricity distribution determinations, the use of benchmarking approaches to determine allowed opex.

Each of these issues has been the subject of multiple applications for review, and turns on elements of the rules that were changed significantly in 2012.

Not only have the rules in relation to these elements recently changed, but also the AER's subsequent approach in relation to them has challenged the limits of the discretion that may be open to it. For example:

- although the amended rules require the AER to consider a range of different financial models for establishing the cost of equity, the AER's guideline and determinations continue to draw almost exclusively on a single model (the SL-CAPM); and
- the revised rules clarified that the AER is able to draw on benchmarking analysis (amongst other factors) to determine appropriate opex allowances, and on this basis it applied the results of a new benchmarking model to set opex allowances more than 30 per cent below the costs presently incurred by some electricity distribution businesses.

Clarification of the approaches that are to be adopted in light of the revised rules will establish a body of precedent as to how the 2012 changes are to be interpreted and applied going forward. For the two examples above, the Tribunal's decision in relation to the AER's 2015 NSW/ACT determinations was:

- that the AER does have the discretion under the rules to determine the cost of equity primarily on the basis of the SL-CAPM; and
- that the data on which the AER's opex benchmarking model draws were not sufficiently robust to warrant the degree of reliance that the AER placed on its benchmarking analysis in determining opex allowances.

The establishing of precedent on these core issues will make future applications for review less likely and so, in due course, increase both the predictability and certainty of the regulatory regime and the quality of regulatory decisions at first instance. As *Vertigan et al* opined, any delays in the initial regulatory decision making as the result of LMR 'would not be expected to persist'.

That the predictability and certainty many parties seek has not been achieved to date is principally a consequence of the concurrent nature of many of the determinations made by the AER – four in April 2015 and a further five in May 2016. Given the inevitable bedding down of the significant rule changes made in 2012, it is much too early to conclude that the post-2013 LMR arrangements are vulnerable to cherry picking.

Insufficient consideration of whether a different decision is materially preferable

The consultation paper suggests that the focus of even the post-2013 review processes have been on correcting individual errors, rather than whether a different decision would lead to a materially preferable decision in the long term interests of consumers. We think the facts do not bear out this concern.

Of fundamental importance to an evaluation of the LMR regime is that the review process for the AER's April 2015 NSW/ACT determinations – which were the first to consider the four core issues we identify above – is still to be completed. This central fact warrants explicit recognition in assessing the performance of the post-2013 LMR regime, and particularly its ability to give sufficient consideration to the materially preferable question.

In its February 2016 decision, the Tribunal remitted the April 2015 NSW/ACT determinations back to the AER to be remade, after consideration of whether – once all the potential changes are weighed – there is a different, 'materially preferable' decision. The routine remittal of Tribunal decisions back to the AER is expressly in line with the policy intent of the 2013 amendments to the LMR regime, and is a critical step for addressing potential concerns in relation to 'cherry picking'.

In discharging that further step in the process, the AER is required to consider the interlinkages between elements of its re-made determination, and is not restricted to reconsidering those matters on which LMR was sought or the Tribunal has given its opinion.

Since the AER is still to remake its determinations in light of the Tribunal's findings, at this stage it cannot be said that either:

- the outcome of the current process will, or even is likely to, result in 'cherry picking'; or
- the current process will not give sufficient consideration to whether there is a materially preferable decision that is in the long term interest of consumers.

In its still-to-be-remade determination, the question of whether a different decision would indeed be materially preferable remains with the AER, supported by guidance from the Tribunal as to particular linkages that it believes should be considered in that process.

Regime not delivering timely and predictable revenue determinations

The AER's April 2015 determinations for the NSW/ACT electricity distribution businesses have special relevance because, as we explain above, they were the first determinations to be made by the AER following the 2012 rule changes. We have already emphasised that the review process for these determinations remains on-foot.

We note also that the extended nature of this particular review process is influenced by decisions taken by the AER following the decision handed down by the Tribunal in February 2016, and is not an inevitable product of either the Tribunal process or the LMR regime itself.

The Tribunal's timeframe for considering the LMR applications in relation to the 2015 NSW/ACT determinations was extended twice. The time taken by the Tribunal in addition to the default allowance was not clearly unreasonable, given the materiality of the decisions it was reviewing and the fact that (as described above) the core issues turned on material changes in the rules.

The elongated review timetable, and the continuing uncertainty that has engendered in relation to future permitted revenues and so network prices in those jurisdictions, is principally a consequence of:

- the AER's decision to seek judicial review of the Tribunal's findings; and
- more significantly, not to progress the remaking of its 2015 determinations until that process is complete.

Moreover, the AER's decision not to progress the re-determinations means that the uncertainty engendered in relation to the NSW/ACT reviews has had flow-on consequences in other jurisdictions. The subsequent applications for review by South Australian, Victorian and ACT (gas) network service providers continue to focus primarily on the same few core issues[4] – each

[4] The Victorian applications include issues relating to the transitional arrangements for the allowed return on debt and gamma; the South Australian review involves the transitional arrangements for the allowed return on

concerning the appropriate interpretation of the 2012 Rule changes – and are a direct consequence of:

- the hiatus that has emerged in relation to the NSW/ACT appeal process; and
- the fact that, subsequent to the Tribunal's February 2016 decision, the AER has continued to make determinations that do not take into account the precedential findings of the Tribunal.

The approach that the AER has taken in responding to the applications for review of its determinations, and to the Tribunal's February 2016 decision, is of course one that is open to it under the regime. Our comments above should not be taken to imply any criticism of the AER exercising its discretion in the way it considers best serves the long term interests of consumers.

Rather, our point is that the elongated timetable of the current reviews appears not to be a product of the LMR regime itself, but rather the outworking of decisions made by the AER within that regime. Moreover, the commonality of the matters in the twelve AER determinations that have been subject to review mean the eventual resolution of the 2015 NSW/ACT determinations can also be expected to lead to the prompt resolution of the remaining eight review processes.

Continued barriers to participation by consumer groups

The final key area of concern identified in the consultation paper is that the LMR regime continues to present barriers to participation by consumer groups.

This observation does not adequately acknowledge the fact that consumer groups have actively participated in Tribunal review processes as a result of the 2013 reforms, and have themselves brought applications for review in relation to four AER determinations, with legal representation funded by the Energy Consumers Association.

Several elements of the Tribunal decision for the 2015 NSW/ACT determinations referred to and incorporated perspectives put by the consumer group participating in that process, suggesting its active involvement did 'make a difference'.

Moreover, the decision by the Tribunal to disallow a consumer group's application for review in the South Australian determination was based on the fact of new information being presented that had not already been put before the AER. This particular limitation can be overcome in the future by interested parties bringing forward relevant information earlier in the process, and does not reflect an enduring barrier to participation arising from the LMR framework itself.

It remains unclear how the process could be restructured so as to strengthen the opportunities for consumer (or other stakeholder) involvement, although it should be expected that the ability for consumers to participate will improve with experience. We recognise that most or all parties would prefer that the review process was less legalistic – but this aspiration seems most likely to be achievable once authority is obtained as to how the framework of rules is best interpreted and applied, through the processes currently on foot.

It also appears inevitable that the option of removing access to LMR and so relying solely on judicial review as the means for ensuring regulatory accountability would deny consumer groups the ability to participate meaningfully in the review process, and entrench a highly legalistic approach. The adequacy of resourcing to support participation by consumers may also be a matter that could be

debt, gamma and the cost of equity; the ActewAGL (gas) application involves the transitional arrangements for the allowed return on debt and gamma.

reviewed, but again the best approach may be clearer once the regime has had further opportunity to 'bed down'.

Summary

It is simply too early to conclude that the LMR regime is not operating as intended, following the amendments made in 2013. In contrast to the key areas of concern alluded to in the consultation paper in relation to the performance of the current regime, the LMR review process to date:

- holds open the task of addressing whether or not a different decision would indeed be materially preferable, through a process that is still to be undertaken by the AER and which is open to consider all elements of the initial determination, thereby addressing head-on the scope for 'cherry-picking';
- holds open the prospect of establishing important precedent in relation to the material changes to the rules that were made in 2012, thereby informing the conduct of future network determinations and improving regulatory outcomes – providing the framework is allowed to run its course; and
- has been conducted with active and influential participation by consumer groups, as intended.

We echo the sentiment of Vertigan *et al* that '*bad decisions taken quickly are not preferable to ensuring good decisions are taken'*. This statement is no less valid for the energy sector, particularly given the significant role played by the AER and ERA in guiding the efficient development of electricity and gas networks, for the long term interests of consumers.

Beyond measures to address the procedural hiatus that has developed, and perhaps other minor process or consumer resourcing changes that might be identified through the course of the review, there is no apparent evidentiary basis for making further substantial changes to the LMR framework at this time. Rather, we urge the Energy Council to allow the current LMR regime to drive better regulatory decision-making, in line with the framework established in the rules, for the long term benefit of consumers.

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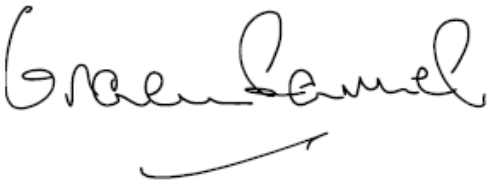

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