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INFRASTRUCTURE PARTNERSHIPS AUSTRALIA'S SUBMISSION TO THE COUNCIL OF AUSTRALIAN GOVERNMENTS ENERGY COUNCIL ON THE REVIEW OF THE LIMITED MERITS REVIEW REGIME

October 2016

About Infrastructure Partnerships Australia

Infrastructure Partnerships Australia (IPA) is an independent think tank and the peak industry body for Australia's infrastructure sector. IPA is a membership based organisation drawing together the public and private sectors in a genuine partnership to debate the policy reforms and priority projects that will build Australia for the challenges ahead.

IPA is committed to promoting genuine, cohesive and cooperative partnerships between Australia's governments and the infrastructure industry and educating stakeholders and the community about the economic and social benefits of major infrastructure projects and reforms.

Infrastructure Partnerships Australia unites key decision makers from across Australia's public and private sectors. This diverse range of skills and experiences ensures strong balance in our advocacy and a focus on getting Australia's infrastructure frameworks right - irrespective of commercial or political considerations.

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Introduction

The Council of Australian Governments (COAG) Energy Council (comprised of state, territory and Federal energy ministers) has resolved to review the Limited Merits Review (LMR) regime. The LMR exists under the National Electricity Law (NEL) and National Gas Law (NGL), providing an avenue for expert third party reviews of the regulatory determinations made by the Australian Energy Regulator (AER).

If regulatory determinations are appealed, current arrangements see a determination reviewed on its merits by the Australian Competition Tribunal (the Tribunal); an independent review body administered by the Federal Court, which includes specific industry expertise.

The current Limited Merits Review regime was adopted in 2013, on the basis of findings by an expert panel in 2012[1].

The COAG Energy Council's *Consultation Paper*[2] (September 2016) discusses the existing LMR regime, proposing four potential options for consideration by ministers:

1. retain the independent Tribunal as the review body, without legislative amendment (status quo);
2. retain the Tribunal as the review body, with legislative amendments;
3. replace the Tribunal with a new investigatory body; or
4. remove access to LMR altogether.

Scope of this paper

Infrastructure Partnerships Australia (IPA) is pleased to respond with this submission to the COAG Energy Council.

As Australia's peak infrastructure body, representing public and private infrastructure owners and operators, of all types, we are keen to contribute to this review process, as the results will no doubt carry large implications for confidence in regulatory frameworks across all infrastructure sectors.

Our submission broadly follows the structure of the COAG Energy Council's *Consultation Paper* but noting the relatively brief period for responses, we have not answered each question in sequence. Rather, our submission addresses the *Consultation Paper* in totality – and focuses on key questions of relevance.

It does not provide answers to all 26 of the questions listed in the *Consultation Paper* but it does cross reference some of those questions where our discussion is directly targeted at specific questions.

Recommendations

1. The existing LMR arrangements are relatively new and appear to be working as intended, so we therefore support Option 1 from the *Consultation Paper* and recommend that more time is needed to properly assess the effectiveness of the existing arrangements;

1 https://scer.govspace.gov.au/files/2012/10/Review-of-the-Limited-Merits-Review-Stage-Two-Report.pdf

2 http://www.scer.gov.au/sites/prod.energycouncil/files/publications/documents/LMR_Review_Consultation_Paper_0.pdf

2. We recommend that the COAG Energy Council note the critical importance of the LMR to a settled investment environment and the checks and balances it provides on the decisions of the regulator, all of which promote the long-run interests of consumers; and

3. We fundamentally oppose the removal of the LMR regime (Option 4) and therefore recommend that the COAG energy council quickly and completely rejects this option.

Our key points

A settled, stable and predictable regulatory regime is critical to maintain investor confidence in Australia's electricity networks and other national infrastructure.

Investment is important because it provides capital, asset management expertise – and competition for or within markets – all of which if well-deployed, promote the long-term interests of consumers and the objectives of government.

In making long-term investments in regulated assets, super fund managers and other investors will logically consider the regulatory regime that governs how much they charge and essentially every other practical aspect of their business. Uncertainty about the 'rules of the game' can increase the rate of return required by investors, which will increase the cost of new investments, as investors will need to factor in the risk that the rules may change quickly or frequently.

A range of studies show the negative impacts on investment, when regulation lacks suitable predictability and transparency (these studies are discussed later in our submission).

Our central recommendation is that a LMR process must be retained in an appropriate form.

We submit that the LMR provides an important layer of independent assessment, ensuring that the regulator is accountable for its decisions through appropriate checks and balances. Without an independent review of the merits of particular decisions, energy networks lack the opportunity to contest any erroneous or detrimental regulatory decision that could be made, as they arise.

The LMR is an essential mechanism, providing investors with comfort that the business case that guided their investment is not suddenly unpicked by unpredictable and erroneous interpretations of the National Energy Rules (NER), by the regulator. There is an extensive literature on this "time-inconsistency" problem, especially in the context of the privatisation of government-owned infrastructure businesses in the UK[3].

We offer no specific proposals for further modifications to the regime established in 2013. We submit that since the introduction of the 2013 reforms, the LMR system has worked satisfactorily.

The LMR has been important in providing investors with the required checks and balances on the implementation of the changes from established regulatory practice that the AER sought to introduce in its most recent revenue determinations for the NSW electricity network service providers.

We also note the Tribunal identified significant shortcomings in the AER's determinations on the NSW electricity networks; and overruled certain parts of the determination that it found were not in consumers' long-term interests. The Tribunal's judgement recognised that meeting long-term consumer interests requires a regulatory regime that supports efficient capital investment, which it found was more important than modest short-term price reductions.

3 The work of Professor Dieter Helm provides excellent examples. See: http://www.dieterhelm.co.uk/assets/secure/documents/The-irresistible-urge-to meddle.pdf; and http://www.dieterhelm.co.uk/assets/secure/documents/Brit-infra-oxrep.pdf.

While we recommend that the COAG Energy Council adopts Option One (status quo) – we accept that other submissions and the Energy Council itself may develop appropriate refinements to the existing LMR regime and we are open to consideration of these amendments under Option 2. The robustness of the regulatory framework is essential in providing the checks and balances for future determinations, and so a transparent debate around any proposed reform should yield the best outcome for both network service providers and consumers.

Therefore, while we note that appropriate amendments or changes may be pursued under Option 2, our overall view is that it would be preferable to postpone the adoption of additional reforms, at least until the current round of testing of the 2013 regime is fully resolved.

Regarding the prospect of creating a new investigatory body (Option 3) we have not seen any convincing proposal outlining either the failures of the structure, or purpose and composition of the Federal Court administered Tribunal.

The current approach where the Tribunal is chaired by a judge provides a high degree of independence, even though it has a cost in terms of the legalistic procedures that the Tribunal adopts.

We would have deep concerns that any new body could see a reduced level of insulation and independence from political and other stakeholders, in making determinations.

What does government policy require?

In responding to the final report from the 2012 expert panel's review of the LMR regime, the Standing Council on Energy and Resources (SCER) issued a Statement of Policy Intent regarding the review framework for electricity and gas regulatory decision making[4]. This statement shows that government policy should regard the retention of a merits review regime as desirable:

> *"… the review process should promote an accountable and high performing regulator such that material error is minimised …"*
>
> *"… a well designed limited merits review process can achieve the policy objectives …"*

The Statement clearly envisages retention of a LMR system. It states that:

> *"… the limited merits review regime should deliver the above principles through:*
>
> - *providing a balanced outcome between competing interests and protect the property rights of all stakeholders …*
> - *maximising accountability by allowing parties affected by decisions appropriate recourse to have decisions reviewed.*
> - *maximising regulatory certainty by:*
>
> *- providing due process to network service providers, consumers and other stakeholders; and*
>
> *- providing a robust review mechanism that encourages increased stakeholder confidence in the regulatory framework*
> - *maximising the conditions for the decision-maker to make a correct initial decision by providing an accountability framework that drives continual improvement in initial decision making*

[4] http://www.scer.gov.au/sites/prod.energycouncil/files/publications/documents/LMR-Statement-of-Policy-Intent-December-2012.pdf

- *achieving the best decisions possible by ensuring that the review process reaches justifiable overall decisions against the energy objectives*
- *minimising the risk of "gaming" through balancing the incentives to initiate reviews with the objective of ensuring regulatory decisions are in the long-term interests of consumers*
- *minimising time delays and cost by placing limitations on the review process that avoid or reduce unwarranted costs and minimise the risk of time delays for reaching the final review decision."*

We submit that none of this envisages terminating stakeholders' rights to seek merits reviews of the regulator's determinations. It does however suggest that modifications to the then existing regime might improve its efficacy. Consistent with this, reforms were introduced in 2013.

Have the 2013 reforms been successful?

The 2012 expert panel report and the subsequent 2013 changes to the LMR regime were necessary and served to improve the regime; however they have not yet been through even one complete round of determinations. We also note that the expert panel favoured the retention of the LMR regime – while recommending some changes to:

- simplify its procedures;
- ensure that the focus of any review was holistic in the sense that the review findings resulted in a decision that was likely to result in an amended decision that is materially preferable to the decision under review in terms of the long-term interests of consumers; and
- improve the access of consumer groups to participation in reviews.

The COAG Energy Council *Consultation Paper* raises questions relating to the perceived success of the 2013 reforms. The main test case is the Tribunal's February 2016 review of the AER's revenue determinations for the NSW electricity distribution businesses for the period 2015-16 to 2018-19.

The *Consultation Paper* notes, with apparent concern, that:

> *"Since 2013, twelve of the AER's twenty decisions on electricity network revenue and gas access arrangements have been subject to applications by network businesses for review by the Tribunal."* (p.4)

Noting that the AER substantially changed the method and approach of the NSW determinations, the merits reviews actually show the regulatory system works as intended.

It is entirely unsurprising that those adversely affected by the substantial changes, would want to fully test whether the AER's determinations were consistent with the relevant legislation and with established principles of regulatory economics.

The outcomes of these reviews will establish precedent and serve to achieve settled agreement of the approach for future determinations. We see no reason to infer from recent experience that stakeholders will continue to appeal regulators' decisions at similar frequency once the transitional issues have been resolved.

We do not believe that reviews are "generally considered a routine part of the determination process". (Consultation Paper, question 2).

We also note that the Tribunal upheld several aspects of the appeals against the AER's recent determinations – showing that the regulator can make errors; and showing the benefit of the review process.

In doing so the Tribunal paid close regard to the need to consider the long-term interests of consumers[5]. We note, in particular, the Tribunal's discussion of the need to balance consumers' *short-term* interests in low prices against the need for prices to be high enough to ensure that investment in the networks is sufficient to guarantee future levels and cost of service that are in consumers' long-term interests.

The Tribunal was not convinced that the AER's determinations struck an appropriate balance. According to the Tribunal's judgement, acknowledgement of the need to focus on this balance is common to all participants, including the AER.

As mentioned above, a robust regulatory framework with necessary checks and balances, is essential in providing both networks and consumers with confidence around the system and ultimately a greater degree of protection around their interests.

We submit that the current framework does enable "reviews to focus primarily on the long-term interests of consumers". (Consultation Paper, questions 3 and 4).

We interpret the recent level of review activity and the fact that the Tribunal found in favour of significant parts of applicants' case as evidence that there is a continuing need for a LMR regime. This is for several reasons, including:

- It gives current and potential investors in regulated infrastructure businesses a degree of protection against the possibility that the regulatory regime could impinge on their legitimate business interests. Consistent with the Tribunal's expressed focus, protection of investors' legitimate business interests is necessary to ensure protection of the long-term interests of consumers. The absence of such protection would inhibit Australia's ability to attract the debt and equity capital required to build essential infrastructure. At the very least it would raise potential investors' perceived costs of capital.
- The existence of merits review opportunities increases the acceptability to stakeholders of the regulator deciding to depart from established regulatory practice, as the AER opted to do in the recent revenue determinations. We recognise that there may be occasions on which there are good reasons for the regulator to make such departures but we regard it as important that such initiatives are thoroughly testable. We note that in discharging their statutory duties, regulators (including the AER) are often subject to political pressures and often have their own agendas in terms of the size and prestige of their regulatory institutions. These factors can inhibit the regulators' success in acting as dispassionate guardians of consumers long-term interests.
- Merits review provides a key avenue for consumer participation in the process. Significantly, judicial review would not be well placed to take consumers' long-term interests into account and it would not allow individuals or advocacy groups to participate in a meaningful way, without large financial costs and time delays during decision making.

[5] Discussion of the relevant issues can be found at paragraphs 65-71, 77-86, 90-105, 1169, 1176-83, 1199-20, 1205-6, 1218 and 1220.in the Tribunal's decision (http://www.judgments.fedcourt.gov.au/judgments/Judgments/tribunals/acompt/2016/2016acompt0001).

We recognise that the 2013 reforms do not seem to have succeeded in substantially simplifying the Tribunal's review procedures. However, we note that the issues generally in contention in merits reviews (including in the recent review of the AER determinations) are highly technical, economic and legal issues and that there are practical limits to how much a review can be simplified. We also note that the Tribunal itself is subject to Judicial Review – an additional check and balance.

We do not support any move to impose up-front limits on ***"the scale and scope of material that can be brought forward in relation to reviews" (Consultation Paper, question 7)*** (other than those implied by the "limited" nature of the existing review regime); or on ***"the regulatory impost of maintaining a record of decision making" (Consultation Paper, question 8)***.

The necessary scale and scope and the recording requirements will be naturally driven by the scale and scope of the regulatory determination being reviewed.

We do not accept that appellants seek to focus on ***"minor matters" (Consultation Paper, question 6)*** – generally they focus on matters that have substantial implications for allowable revenues. In any case as noted above, we submit that the requirement for the Tribunal to take a holistic approach is sufficient to ensure that appropriate weight is given to the individual points of review.

The participation of the Public Interest Advocacy Centre (PIAC) in the recent Tribunal reviews, shows there is consumer-group participation under the current review regime. We note the Tribunal's emphasis on the importance of PIAC's role at paragraphs 58 and 63 of its recent decision.

We also note that as part of its review process the Tribunal undertook an extensive program of stakeholder consultation as described in paragraphs 51-57 and 59-62 of its recent decision.

Potential options

The *Consultation Paper* presents four options for the outcome of the current review. In this section of our submission, we comment on each of the options.

Option 1: Retain the Tribunal as the review body without legislative amendment (status quo)

We submit that ***"the impact of maintaining the current regime" (Consultation Paper, question 15)*** is likely to be positive and that this option should not be discarded lightly. We note that the regime was subject to expert review, centred on the Tribunal, only recently (2012) and that amendments to the regime were introduced in 2013 as a consequence of that review.

As outlined in the previous section, there is nothing in historical experience since the introduction of those reforms to suggest that the amended regime is unnecessary or that it is fundamentally unsatisfactory. In our view, the high level of review activity experienced in this recent historical period is exactly what should be expected, given the AER's decision to introduce fundamental changes into its revenue-determination processes with the explicit intention of bearing down more heavily on the infrastructure providers than had previously been the case.

In adjudicating on limited merits reviews over the period, the Tribunal did attempt to take a holistic view focussed on an appropriate view of the long-term interests of consumers. It identified that the 'legitimate' business interests of the infrastructure providers should align with the long-term interests of consumers, even though those 'legitimate' business interests might appear to be in tension with the short-term interests of today's consumers in the form of lower prices in the short term.

We interpret the fact that the Tribunal found in favour of the appellants on a number of issues as demonstrating the importance of the regulator being accountable for the technical substance of its

implementation of the regulatory regime as well as for the legality of its implementation. This is especially important when the regulator is proposing substantial changes to established regulatory practice, as has been the case in the AER's recent determinations. The LMR regime should continue to be available in all circumstances but we would not expect the recent high level of review activity to be evident in periods in which no fundamental changes in regulatory practice are being proposed.

We note that there is nothing in the decisions made by the Tribunal in its recent reviews of AER determinations to suggest that those determinations would have failed a pure judicial review. Judicial review is limited to testing the regulator's competence in ensuring that its determinations are permitted by the relevant legislation. It does not test the regulator's judgement or technical competence on key issues of regulatory economics.

Option 2: Retain the Tribunal as the review body with legislative amendments

As indicated by our comments on Option 1, we do not believe that experience since the introduction of the 2013 reforms suggests that the current LMR regime is fundamentally flawed. Hence, we are not proposing any amendments ***"to achieve the policy intent of the 2006 and 2013 LMR reforms" (Consultation Paper, question 16).*** It is too early to consider drastic modifications to the existing regime. We note that one full cycle of LMR deliberations has not yet been completed since implementation of the 2013 reforms.

The relatively high recent level of review activity and the complexity of the relevant appeals reflect mainly the sharp changes in established regulatory practice that the AER has proposed. The recent experience establishes that the current regime has coped appropriately with the consequent environment. We expect that cases taken in more normal regulatory environment would be correspondingly less complicated.

Nevertheless, we remain open to suggestions for amendments that would further improve the operation of the regime. We would be pleased to work collaboratively with COAG to identify and develop such appropriate and balanced modifications. After all, this is a necessary part of the ongoing structural reform of the regulatory framework and is in the interests of all stakeholders.

We are not convinced that the ***"existing Tribunal review process should be made more investigatory in nature" (Consultation Paper, question 17)***. Rather, the focus should be on reducing overly adversarial and legalistic aspects of the process in order to streamline potential decisions. If it were necessary for the merits review regime to operate in a more investigatory way, it is likely that an alternative review body would be necessary. We address this possibility in its comment on Option 3 (below).

Option 3: Replace the role of the Tribunal with a new investigatory body

We do not believe that recent experience has exposed deficiencies in the performance of the Tribunal as the review body sufficient to suggest any urgent need to replace the Tribunal with a new investigatory body. The review body should remain subject to judicial review but this implies that careful judicial processes will remain a feature of the review regime.

We do not favour the suggestion that the Tribunal should be replaced by a panel of stakeholder-nominated experts. In our view, stakeholder nominations are unlikely to produce a panel that would take a properly independent view of issues likely to be reviewed, for example, WACC-related issues. It is more likely that the panel would be internally adversarial, with the business-nominated representative taking views opposed to those advocated by the consumer-nominated representative. In this circumstance, panel decisions are likely to be determined essentially by the casting opinion of the member nominated by a party (the government, say) whose financial interests

are not directly affected by the panel's decision. We submit that this is one of the major ***"risks of establishing a new review body" (Consultation Paper, question 18)***.

We are also concerned by the proposal that the regime be amended to include a new investigatory body. This would significantly restrict the grounds for a review compared with the current arrangements. We are concerned that a new body would be much more prescribed in terms of its conduct, the material it is allowed to consider, the information provided to it, the decisions it could make and the timing of its reviews. Rather than promote efficient consideration of what are often complex and technically difficult issues, such an approach is likely to arbitrarily limit the necessary information that is available to the decision making body and place it at risk of making ill-informed decisions that may not be in the long-term interests of consumers.

We submit that any need to ***"increase the clarity of grounds for review, and their relevance to the long-term interests of consumers" (Consultation Paper, question 19)*** is largely independent of whether a new review body is established.

We do not accept the implication of **question 20** in the *Consultation Paper* that the existing review body does not ***"provide an appropriate balance between access to reviews where necessary and ensuring the long-term interests of consumers are delivered"***.

Finally, we stress the importance of ensuring that any new review body that may be established is transparent and independent of political pressures.

Option 4: Remove access to LMR

We are strongly opposed to this option, believing that the ***"consequences of removing access to merits review of revenue determinations and access arrangements"* (*Consultation Paper*, question 23)** are likely to be negative – in particular, they would be seen by investors as increasing significantly the regulatory risk associated with investing in regulated infrastructure through loss of transparency and predictability of outcomes under the regulatory framework. In our view this applies to areas of regulated infrastructure industries generally and not just to ***"electricity revenue determinations and gas access arrangement decisions"* (*Consultation Paper*, question 25)**

This is supported by a recent publication by Moody's Investor Services[6] (Moody's Investor Services, 2016) which noted:

> *"The networks' ability to contest the regulator's decisions evidences limits on the latter's increased discretionary power, which was conferred by a 2013 rule change, a factor that reinforces the transparency and predictability of the regulatory framework."*

and

> *"In addition, the precedent created by the outcome of the legal challenges will enhance the transparency of the regulatory regime."*

Similarly RBC Capital Markets conducted a survey of institutional investors to gauge views on the regulation of ASX-listed network utilities[7] and found that most respondents to the survey strongly supported retention of merits review which was considered to be *"…crucial in terms of ensuring accounting and transparent decision-making by the AER".*

[6] Moody's Investor Services. (2016). *Global Credit Research.* Sydney: Moody's Corporation.
[7] RBC Capital Markets. (August 2016). ASX Network Utilities: Investor survey on regulation. Sydney: Royal Bank of Canada.

We support the conclusion of the 2012 expert review that continuation of a limited merits review regime is desirable. We submit that experience subsequent to the introduction of the consequent 2013 reforms reinforces the expert review's conclusion.

We do not believe that judicial review would be an adequate substitute for limited merits review. We do not accept that the *main* deficiencies of judicial review relate to obstacles to ***"consumer and user participation"*** **(*Consultation Paper*, question 24)**, although we do concede that this is *a* deficiency. It seems clear that a pure judicial review would not have disallowed the serious deficiencies that the Tribunal identified in the AER's implementation of its proposed toughening of the approach to determining allowable revenues for energy network service providers.

Access to merits review is important to protect the legitimate business interests of investors in regulated infrastructure businesses, and hence the long-term interests of consumers. In particular, it is necessary to protect against an approach to regulation that focuses too heavily on restraining prices in the short run. We note that uncertainty about investors' ability to protect themselves against such regulatory risks is likely to be a significant deterrent to efficient investment in the regulated infrastructure sector or the promotion of innovation which is likely to benefit all parties.

Other Issues

We submit that the current review should confine itself to the issue of the necessity for and operation of the limited merits review regime. We recognise that the regulator needs a substantial degree of discretion to address what it believes is necessary to advance the long-term interests of consumers. We are not convinced that it is desirable or feasible to pre-specify "levels of prescription or discretion around the AER's decision making, or the treatment of regulatory tools such as benchmarking".

For example, in its recent determinations the AER decided that it should increase the extent to which it relied on benchmarking in specifying allowable operating costs. It then embarked on the substantial technical task of specifying and implementing appropriate benchmarking studies. It also exercised its regulatory discretion to decide what weight to assign to the benchmarking relative to other factors to which it is required to have regard or which it has previously relied on. We recognise that the AER has resources appropriate to such tasks and that it is unlikely that legislators could adequately pre-specify how such tasks should be undertaken.

We note that there is nothing in the Tribunal's recent decision to suggest that the AER erred in deciding to embark on these tasks. Rather, the errors that the Tribunal identified relate to details of how the technical tasks were undertaken and the outcome of the exercise of the AER's legitimate discretion. We stress that these errors would not have been addressed without the availability of limited merits review.

Conclusion

We hope that you have found IPA's submission a useful contribution to the review of the LMR regime and look forward to engaging further with the COAG Energy Council as the review process unfolds.