Options for enhancing the Australian Limited Merits Review regime

A REPORT PREPARED FOR THE ENERGY NETWORKS ASSOCIATION

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Executive summary

On 6 September 2016 the COAG Energy Council published a consultation paper entitled *Review of the Limited Merits Review Regime* (the consultation paper), which expressed some concerns about the performance of the Limited Merits Review (LMR) arrangements that apply currently to regulated energy networks in Australia. Frontier Economics and Herbert Smith Freehills have been engaged by the Energy Networks Association (ENA) to consider the concerns expressed in the consultation paper and to discuss some possible options for reform to the LMR arrangements that would:

- Be proportionate; and
- Effective in addressing the COAG Energy Council's concerns about the existing LMR arrangements.

Merits review arrangements are essential to a well-functioning regulatory system

Merits review arrangements in relation to revenue reset decisions made by the Australian Energy Regulator (AER) have been an integral part of the regulatory framework since 2008. Australia is not alone in having such arrangements. Internationally, merits review arrangements are a standard part of developed, high quality regulatory regimes that involve industries with significant private sector investment.

The acknowledged benefits of merits reviews by policymakers overseas are many:

- Merits reviews offer protection to regulated network service providers (NSPs) and to consumers against erroneous regulatory decisions that would otherwise go uncorrected. It should not be simply assumed that regulators are infallible. History shows such an assumption to be incorrect. Indeed, the use of merits review arrangements in many countries apart from Australia suggests that regulators do make mistakes and therefore some protection against material regulatory error is necessary. It is important to recognise that abolishment of the LMR regime would remove consumers' rights to challenge the merits of AER determinations as much as NSPs' rights.
- Review by an independent adjudicator can protect society against partisan regulatory decisions arising from regulatory capture, where the regulator favours the vested interests it regulates, or from a mistaken notion that it should act as a champion of consumers to the detriment of the legitimate commercial interests of the businesses it regulates.
- Merits reviews can help clarify how complex regulatory rules, and economic and legal principles, should be interpreted and applied. The regulator can use interpretive precedents to refine and improve its future decisions.

- By providing checks and balances, merits reviews can enhance the accountability of the regulator, and also promote confidence (amongst consumers and investors) in the regulatory process.
- The safeguards against regulatory errors and caprice provided by merits reviews reduces uncertainty for investors in regulated networks, who are typically making very long-lived investments, so face cost recovery over long and otherwise uncertain horizons. Such safeguards should keep regulated networks' cost of capital low and, therefore, the costs borne by consumers over the long-run.

Removal of the LMR would be a loss to society

It is normal and to be expected that LMR arrangements will be evaluated periodically to confirm if they are still fit for purpose and meeting the policy intent. Such reviews have been conducted in other jurisdictions (such as New Zealand and United Kingdom) recently. As we discuss in this report, to the extent that weaknesses or concerns were identified by those evaluations, these were addressed with targeted and proportionate measures. It is highly unusual for a jurisdiction with a well-developed regulatory framework to abolish merits reviews because that would involve foregoing many of the substantial benefits outlined above that merits review arrangements provide to society at large.

If LMR arrangements in Australia were removed, the only form of review available to NSPs, consumers and other parties affected by the AER's determinations would be judicial review. Judicial review alone is not a suitable system of review for complex decisions, made by an administrative decision-maker with specialist expertise. Judicial review is restricted to examining matters of law or process involved in the regulator's decision-making. Judicial reviews do not allow a re-examination of the substance of the regulator's reasoning, including whether the regulator has conducted its economics, financial, engineering/technical analyses appropriately. These considerations can have a profound impact on the outcome of a regulator's decisions and mistakes in these areas can result in regulatory allowances being set materially too high or materially too low, compared to the efficient level. Merits reviews do allow a re-examination of these matters and therefore should be available to parties affected by regulatory decisions.

Concerns expressed in the consultation paper and underlying causes

The underlying causes of many of the concerns expressed by the COAG Energy Council (i.e., the large number of applications for review since 2013, delays in finalising the AER's 2015 determinations) are quite unrelated the operation of the LMR arrangements per se. For instance:

- Several of the applications for review since 2013 were made because parties, quite reasonably, sought to preserve their legal positions pending the outcome of an ongoing LMR process, or because of uncertainty created by the AER's decision to seek judicial review of the Tribunal's decision in respect of recent applications by NSPs in NSW and ACT.[1]
- Major amendments to the National Electricity Rules (NER) and National Gas Rules (NGR) in 2012 also meant fundamental changes to the way in which decisions were made by the AER in 2015 and 2016. Following these fundamental changes, there was genuine uncertainty over whether the AER had applied the new rules correctly, and it was appropriate that such uncertainty be resolved. The recent LMR applications represent parties' attempts to test and clarify the AER's implementation of the new rules.
- The delays in finalising the AER's 2015 decisions for NSW and ACT NSPs has been due largely to the AER's decision to prolong the review process by seeking a judicial review of the Tribunal's decision on those matters.

It is striking that the consultation paper does not consider at any point the role the AER may have played in contributing to the concerns identified, or provide any assessment of the quality of the AER's decisions. Given the large number of past instances in which the AER has been found to have erred (including instances in which the AER itself has admitted error), it is worth considering the possibility that the LMR arrangements are actually working as intended by correcting material regulatory errors. If so, then the underlying cause of some of concerns raised by the COAG Energy Council may have been mis-diagnosed.

The effect of the 2013 legislative amendments

In 2013, some major changes to the LMR arrangements were effected through legislative change. There is good reason to think that the LMR arrangements are working as intended following those 2013 reforms.

- In relation to the NSW and ACT applications, the Tribunal upheld the AER's decisions on return on equity allowances because it considered that the AER had acted within the regulatory rules. The alleged errors in respect of the return on equity decisions amounted to over $2.4 billion in regulated revenues. This shows that the LMR arrangements do not prevent the AER from making decisions that result in significant price reductions to consumers, as long as the AER's decisions are made within the NER and NGR.
- The Tribunal's decision has helped clarify for NSPs, consumers and other parties affected by the AER's decisions how the new rules should be interpreted in respect of return on equity determinations (and in other areas).

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1 Applications by Public Interest Advocacy Centre Ltd and Ausgrid [2016] ACompT 1

In light of the Tribunal's decision, SA Power Networks withdrew its application to the Tribunal in respect of return on equity matters and Victorian NSPs chose not to seek review on return on equity matters, notwithstanding that they had expressed very similar concerns to the NSW and ACT NSPs that sought review on those matters. This demonstrates that the LMR regime can and does provide a means of clarifying how the NER and NGR should be interpreted.

- The Public Interest Advocacy Centre (PIAC), which represents the interests of consumers in NSW, was both an applicant and intervener in the NSW and ACT review process. PIAC made its submissions to the Tribunal competently and provided a clear contraposition to that of the NSPs' on a number of matters. PIAC's involvement demonstrates that consumer involvement in the LMR process has improved since 2013.
- In LMRs since 2013, the Tribunal has consulted directly with consumers without legal representation, using informal processes free of "legalism". This is a clear outcome of the 2013 legislative changes that now require the Tribunal to consult with consumers when making its decisions.
- In all instances since 2013 in which the Tribunal has not upheld the AER's original decisions, those decisions have been remitted back to the AER to remake (rather than being varied by the Tribunal). This was an intention of the 2013 reforms.

Notwithstanding these improvements, it is too early to assess reliably the full impact of the 2013 legislative amendments. This is because it takes time for major new reforms to settle down as the Tribunal gains experience applying the legislative changes. For that reason, the present review of the LMR arrangements seems premature.

Options for reform

In our view, a sound evaluation of the LMR arrangements should involve three things:

1. A clear articulation of the problems associated with the existing arrangements;
2. A proper and comprehensive diagnosis of the underlying cause of the problems, with a clear presentation of the evidence for such a diagnosis; and
3. A formulation of reforms that address the underlying causes directly and proportionately.

Unfortunately, whilst the consultation paper sets out a number of concerns about the LMR arrangements:

- it does not offer a careful diagnosis (supported by proper evidence) of the root causes of the problems; and
- some of the reform options proposed appear to be unrealistic (i.e., maintenance of the status quo) or disproportionate (i.e., complete removal of the LMR arrangements, which would be an extreme step considering the very substantial benefits that merits review arrangements offer in principle).

To the extent that the COAG Energy Council has concerns about the performance of the LMR regime, any reforms pursued should be proportionate and targeted at addressing those concerns. Some possible reforms that would be proportionate and targeted, which we explore in this report, are summarised in Table 1, and described in the sections below.

Table 1: Reform options and concerns that would be addressed

Reform option	Concerns addressed	Discussed at…
Binding and reviewable Rate of Return Methodology or Restrictions on the grant of leave on overlapping rate of return issues	Serial or overlapping applications for review on same or similar grounds	Section 4.1
Introduction of a more investigative approach to revenue resets	Airing of large number of disputes between AER and parties through LMR process (rather than early identification and resolution at the revenue reset stage)	Section 4.2
Amendments to materiality threshold	Large number of applications in relation to non-material grounds	Section 4.3
Enhancement of the investigative powers of the Tribunal	Legalism of the LMR process and restricted ability of Tribunal to explore matters fully (e.g. using experts)	Section 4.4

Source: Frontier Economics and Herbert Smith Freehills

Binding and reviewable Rate of Return Methodology

Since a large proportion of LMRs historically have related to the allowed rate of return, aligning those reviews into a single review process would potentially reduce the number of review proceedings, and therefore the duplication of review activity and costs. One way to align the reviews would be to make only the *methodology* used to determine the rate of return allowance reviewable.

This could be achieved by adapting the AER's Rate of Return Guideline into a binding Rate of Return Methodology, which would be determined upfront, outside any particular revenue reset process. The Rate of Return Methodology may be subject to merits review, and any reviews sought on the Rate of Return Methodology would be heard as part of a single process. The rate of return

decisions made by the AER when implementing the Rate of Return Methodology would only be subject to judicial review. A version of this system currently operates in New Zealand.

Restrictions on the grant of leave on overlapping rate of return issues

An alternative, more incremental reform to deal with serial or overlapping applications for review related to rate of return matters would be to revise the way in which the Tribunal grants leave to seek review. Under revised arrangements, for example, it could be provided that:

- The Tribunal must defer leave to seek review on grounds the same as or substantially similar to grounds that have been dealt with or are being dealt with in other proceedings before the Tribunal, unless the Tribunal is positively satisfied that there is a real chance that the new expert opinion or data will result in a different determination.
- Where leave has been deferred or a new application made, and the other matter determined, the Tribunal has the power, on the application of a party to the proceedings, to make the same orders in relation to the application before it as in the other matter where it is satisfied that the Tribunal has dealt with the same or substantially similar grounds (i.e., orders to affirm, vary or set aside and remit the AER's decision may be applied). The power of the Tribunal to make the subsequent orders should be discretionary so that an applicant for review does not gain the benefit arising from a successful ground claimed by another party if the applicant had not "raised and maintained" the same matter before the AER.

Introduction of a more investigative approach to revenue resets

Under the present LMR process, the Tribunal may only review materials that were before the AER at the time the AER made its revenue reset decisions. The current revenue reset process typically involves the exchanging of competing expert opinion that often does not assist in elucidating the matters generally in dispute. This raises the risk of sub-optimal decisions being made by the AER and by the Tribunal (given the restriction that it may only consider the material that was before the AER), and more AER decisions progressing to the review stage because disputes are not dealt with adequately as part of the reset stage.

This could be overcome by the more frequent and fulsome use of investigative techniques by the AER at the revenue reset stage to clarify and narrow the grounds of dispute as early as possible. Examples of such techniques include:

- "Hot-tubbing" of experts, whereby the AER convenes a forum to allow experts to engage directly with each other to clarify matters that on which they agree and disagree, and the reasons for any lack of agreement. Experts involved

in a "hot-tub" process could potentially be asked to prepare a joint report that sets out the areas of agreement or disagreement.

- Workshops convened by the AER on particular topics that would allow AER Board Members and staff to question and hear directly from NSPs, including internal technical experts such as engineers and treasury teams.
- The publication of issues papers for all NSPs (rather than electricity NSPs only), as a mandatory step in the reset process, after it has reviewed the revenue proposals submitted by NSPs but before it publishes its Draft Decision. These issues papers should set out in some detail the areas in which the AER is seeking more comprehensive analysis and evidence, or any areas of the NSP's proposal that raise particular concerns for the AER, and invite NSPs and other stakeholders to submit analysis and evidence directed at assisting the AER's deliberations on those matters. This would go beyond the analysis that the AER currently publishes in its issues papers, which is typically limited to summarising the key aspects of NSPs' proposals and signalling the way in which the AER intends to assess the proposals. The current issues papers are useful as they present in a reasonably succinct way the key matters that are likely to be relevant to revenue reset, thereby aiding consumer engagement. However, they could do more to focus attention on those areas that are likely to be contentious, and to set out what evidence and analysis would be useful to the AER's deliberations in resolving those matters of contention. This would again help narrow the grounds for possible dispute early, and encourage resolution of those issues during the course of the reset process, rather than through a review process.

All of these initiatives should be designed to include the participation of consumers groups (such as Energy Consumers Australia) to ensure that consumers have a clear voice through the revenue reset process. It would be necessary to ensure that these groups are resourced sufficiently to participate effectively.

Amendments to materiality threshold

Underpinning the broader concern about too large a number of applications for LMR (compared to what was envisaged by the original policy intent), may be a concern that too many issues have been about non-trivial matters. If that is the case, one solution might be to amend the existing financial thresholds that must be satisfied before the Tribunal may grant leave to seek review.

The amendment to the thresholds for leave may be in two parts.

- Firstly, the financial thresholds relating to materiality could be raised in absolute terms.
- Secondly, the thresholds could be specified such that *each* ground of review must satisfy the threshold, rather than apply cumulatively to all grounds of review.

Enhancement of the investigative powers of the Tribunal

The consultation paper suggests that the quasi-judicial nature of the Tribunal means that it may be too legalistic. The removal of "legalism" in the merits review process may be inherently desirable. This could be achieved by permitting the Tribunal to hear from experts directly in "hot-tubs" so that all of the experts relied on by the AER, NSPs and consumer groups are called together to elucidate the areas of agreement and disagreement between the experts for the benefit of the Tribunal. Under such an approach, the Tribunal would be able to investigate the matters before it more thoroughly than is permitted under the current arrangements.

1 Introduction

1.1 Background

On 19 August 2016 the Council of Australian Governments (COAG) Energy Council decided that its Senior Committee of Officials (SCO) would conduct a fresh review of the limited merits review (LMR) regime that applies to regulated energy network service providers (NSPs) in Australia. The current LMR regime allows networks regulated under the National Electricity Law (NEL) and the National Gas Law (NGL) to seek merits reviews of the decisions made by the Australian Energy Regulator (AER). A number of such reviews have been sought recently — most notably the applications for review made by Networks NSW, Jemena Gas Networks, ActewAGL and the Public Interest Advocacy Centre (PIAC) in 2015 (the NSW and ACT applications).

On 6 September the COAG Energy Council published a consultation paper entitled *Review of the Limited Merits Review Regime* (the consultation paper), which explained that the scope of the review is to assess the effectiveness of the LMR regime by assessing whether and to what extent the LMR regime has met original policy expectations set out by the Standing Council on Energy and Resources (SCER) when the last review of the LMR arrangements was conducted in 2012.

The review conducted by SCER in 2012 led to a number of important amendments to the NEL and NGL that changed the way the AER should make its revenue reset determinations, and the way in which the Australian Competition Tribunal (the Tribunal) must conduct LMRs of the AER's decisions.

The consultation paper sets out a number of concerns about the existing LMR arrangements, some of which relate to the process itself (e.g., the legalistic nature of LMRs; and the accessibility of consumers without legal representation to the review process). Others relate to recent review outcomes (e.g., an observation that there have been a larger number of applications for review since the 2013 legislative amendments than expected; the materiality of the errors alleged by NSPs in recent applications; and delays in finalising revenue determinations made by the AER).

The consultation paper sets out four distinct reform options in response to these concerns, one of which is the removal of LMR arrangements. In the event that such an option were adopted, the AER's revenue reset decisions could be subject only to judicial review.

1.2 Role and structure of this report

Frontier Economics and Herbert Smith Freehills have been engaged by the Energy Networks Association (ENA) to consider the concerns expressed in the

consultation paper and to discuss some possible options for reform to the LMR arrangements that would:

- Be proportionate; and
- Effective in addressing the COAG Energy Council's concerns about the existing LMR arrangements.

This report is organised as follows:

- Section 2 discusses the concerns expressed by the COAG Energy Council and puts these concerns in the context of developments since the 2013 legislative amendments.
- Section 3 considers the reform options proposed by the COAG Energy Council in the consultation paper.
- Section 4 presents a menu of possible reform options, each of which are targeted at addressing one or more of the concerns raised by the COAG Energy Council.

1.3 Authors of this report

This report has been authored jointly by:

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2 Problem definition

The COAG Energy Council has set out in its consultation paper a number of concerns about the existing LMR arrangements. The COAG Energy Council suggests that fundamental legislative amendments were made in 2013 to improve shortcomings of the LMR regime, but events since 2013 may mean that these amendments have not had their desired effect.

If the COAG Energy Council's concerns are to be addressed properly, it is important to be clear what those concerns are so that the policy response may be tailored appropriately. With this in mind, we set out below our understanding of the main concerns held by the COAG Energy Council and provide a brief discussion of those concerns.

2.1 Impediment to price reduction

2.1.1 The concern

Whilst not stated in the consultation paper in these terms, some members of the COAG Energy Council have argued elsewhere that: network charges represent a very substantial proportion of electricity retail prices; the AER has sought to bring down costs to consumers; but the AER has been blocked from doing so by litigious networks seeking to preserve revenue streams using the LMR arrangements.[2, 3]

2.1.2 Discussion

Need for proper diagnosis of problem

There is an implicit assumption within this concern that prices are currently "too high". If that is in fact the case, in the context of considering major reforms to the LMR regime it is important to recognise that there may be several possible explanations for prices being too high:

1. The NSPs are presently not as efficient in their operations as they ought to be.
2. Prices today reflect legacy (sunk) costs that were considered efficient at the time they were made, but turned out to be greater than required.
3. The standards of service that NSPs are meeting currently are too ambitious, thus pushing up costs too high.

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2 Josh Frydenberg, Demands grow of an energy market in steady flux, The Australian, 19 August 2016.

3 Simon Benson, We pay for power giants' greed, The Daily Telegraph, 29 August 2016.

4. Errors made by the AER result in too much revenue being allowed to the NSPs (arguably, this is observationally equivalent to the first point on inefficiency).
5. Deficiencies in the existing LMR arrangements result in the AER's decisions being overturned incorrectly.

Or some combination of the above.

In other words, the situation where the LMR regime is a true impediment to price reductions is only one possible explanation for prices being too high.[4] Any reforms made to the LMR arrangements should be supported by a proper diagnosis of any problem that needs to be addressed. This includes investigating the role that other possible explanations may have played. It is striking that the consultation paper seems to focus exclusively on the LMR arrangements, without considering any of the other possible explanations—including the role the quality of the AER's decision-making may have played—particularly given that the AER has been found to have erred repeatedly when applying the NER and NGR.

Recent reviews show LMR is not an impediment to price reductions if AER decisions are consistent with the NER and NGR

The outcome of the recent NSW and ACT review decisions demonstrates that the LMR regime is not an impediment to AER determinations that have the effect of reducing prices, provided that those determinations are consistent with the NER and NGR. As discussed in section 2.3.2, review was sought by the NSW and ACT NSPs on four main grounds (amongst a number of other minor matters):

1. Return on equity;
2. Return on debt;
3. The AER's use of benchmarking analysis to determine operating expenditure allowances; and
4. The value of imputation credits, used for the purpose of determining the corporate taxation allowance.

Of these four matters, the Tribunal upheld the NSPs' applications in respect of the return on debt, benchmarking analysis to determine operating expenditure allowances and the value of imputation credits.

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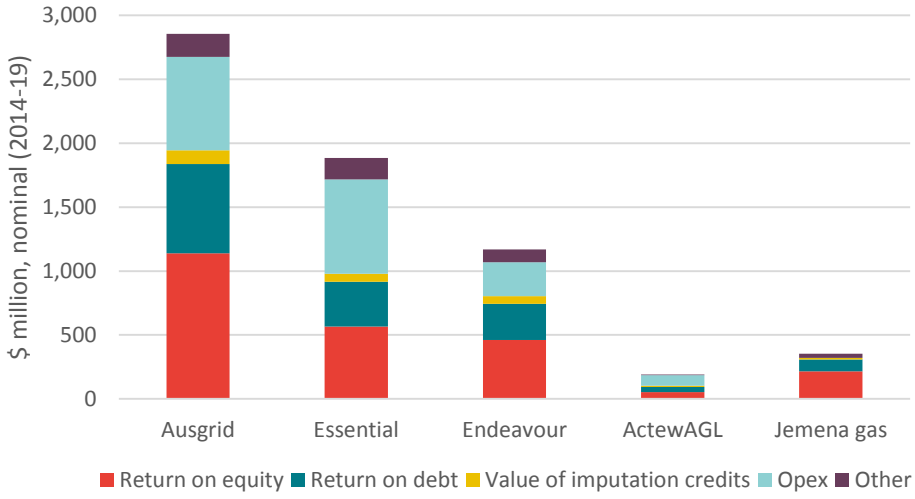
4 Of course, the proposition that that prices are 'too high' may also be questioned. If prices today largely reflect sunk investments that were historically considered efficient or necessary by policymakers and/or regulators, and NSPs invested on that basis, then they could not be considered too high under the NEL/NGL. For instance, the revenue and pricing principles set out in the NEL/NGL provide that a regulated NSP should be provided with a reasonable opportunity to recover at least the efficient costs the operator incurs in: providing direct control network services; and complying with a regulatory obligation or requirement or making a regulatory payment.

However, the Tribunal did not uphold the grounds for review sought by the NSPs in respect of the return on equity. The NSPs that were the main applicants (as well as NSPs that applied as interveners) argued that, when estimating the return on equity allowance, the AER had not had proper regard to relevant estimation methods, financial models, market data and other evidence as it was required to by the 2012 amendments to the NER and NGR. The Tribunal found that the AER had acted within the NER and NGR when making its return on equity decisions. In doing so, the Tribunal accepted the AER's return on equity decisions in full.

Figure 1 below plots the total value of the alleged errors in the AER's decision on these (and other more minor) matters over the 2014-19 regulatory period, as set out by the parties in their leave applications.

Figure 1: Total value of alleged errors in AER's decision as calculated by the parties



Source: Frontier analysis of appeal applications submitted to the Tribunal by the parties

Note: PIAC did not quantify individually the revenue impact of the AER's Decisions on the return on equity, return on debt and value of imputation credits. Instead, PIAC quantified the overall impact of the AER rate of return Decision.

As is evident from this Figure, the additional revenue sought by the NSPs in relation to the AER's return on equity decision was very substantial. In fact, the combined value of additional revenues sought by the four NSP applicants in relation to the return on equity decisions totalled over $2.4 billion — more than any of the other matters.

Removal of LMR may increase prices over the long-term

Further, it is important to recognise that removal or significant curtailment of the existing LMR arrangements may actually *increase* costs to consumers over the long-term. This is because (as discussed in section 3) LMR arrangements help reduce risk (faced by investors and consumers) associated with the regulatory system by:

- Providing appropriate checks and balances on regulatory decisions;
- Increasing the accountability of the regulator for its decisions by means of independent scrutiny;
- Providing clarity of complex rules and regulatory, economic and legal principles through interpretive precedent accumulating over time; and
- Offering a means for correcting errors that would otherwise go uncorrected.

Removal or significant curtailment of the LMR regime would increase the risk faced by investors in industry, thus driving up the cost of capital. This in turn would make it more costly for NSPs to access capital in future to make necessary investments to deliver the service reliability and quality that consumers desire. These additional costs would ultimately be borne by consumers. This would not be in the long-term interests of consumers.

A key protection offered by the LMR regime is against regulatory decisions that set revenue allowances below an efficient level. Outcomes such as this would ultimately be harmful to consumers because if NSPs do not have sufficient revenues to recover their efficient costs, an entirely rational response would be for NSPs to defer investments inefficiently.

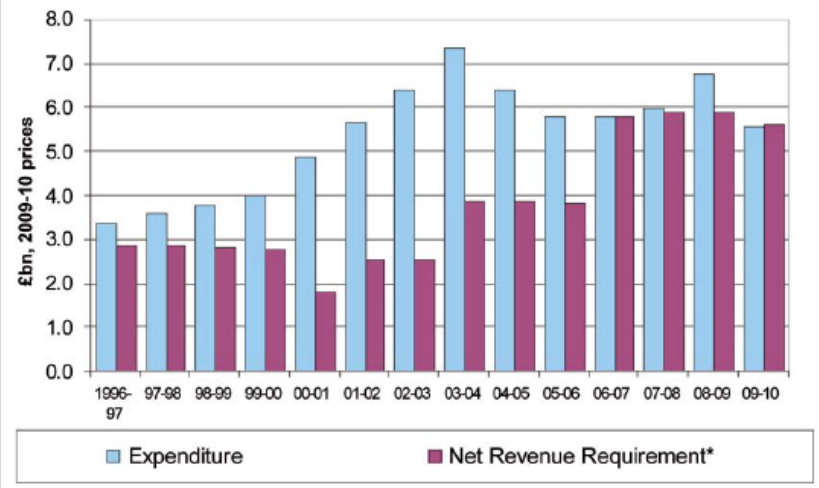
This would have two poor consequences for consumers. Firstly, the benefits associated with efficient and welfare-enhancing investments would also be delayed. Secondly, at some point it will be infeasible to defer investments any further because the quality of service would have deteriorated to an unacceptable level and/or because of safety concerns. At that point, a backlog of catch-up investment, created by inefficient deferral, would have to be made at once, and consumers of the day would have to bear a significantly higher cost burden than they would have done had those investments been made earlier, when it was efficient to do so. This would raise intergenerational equity concerns and would clearly not be in the long-term interests of consumers.

The problem of underinvestment in network infrastructure, and the price impacts on future consumers, is not a theoretical consideration — as illustrated by the example from the United Kingdom's railway industry presented in Box 1 below.

Box 1: The impact of network underinvestment on prices paid by future consumers – Example from the UK railway industry

Chronic under-funding led to decades of underspending renewals investment in the UK's railway network, then owned by Railtrack (now National Rail). This caused a gradual deterioration in the quality and safety of rail services, which culminated in a number of major crashes in the late 1990s and early 2000s (such as the Ladbroke Grove rail crash, which killed 31 people and injured more than 520; and the Hatfield crash in October 2000, which killed four people and injured more than 70). This episode became known as "the great rail crisis".[5]

In response to this crisis, a major program of catch-up renewal investment had to be launched, to restore the safety of the railway network. This led to the National Rail's regulated asset base increasing by £29 billion between 2002 and 2010 — a period of just eight years. Over this period, National Rail's annual regulated revenue requirement more than doubled from approximately £2.5 billion to over £5.5 billion (see Figure below), resulting in a material increase in rail fares to passengers.[6]



The injuries and loss of life to passengers, and the very sharp increases in fares, could have been avoided if investments had been made earlier, when it was efficient to do so.

Source: Frontier Economics

It is precisely to avoid such outcomes that the revenue and pricing principles of the NEL provide that:[7]

> A regulated network service provider should be provided with effective incentives in order to promote economic efficiency with respect to direct control network services the operator provides. The economic efficiency that should be promoted includes— (a) efficient investment in a distribution system or transmission system with which the operator provides direct control network services;

5 See Bartle, I. (2004), Britain's railway crisis: A review of the arguments in comparative perspective, Centre for the Study of Regulated Industries, Occasional Paper 20, March.

6 Department for Transport and the Office of Rail Regulation, Realising the Potential of GB Rail: Final Independent Report of the Rail Value for Money Study – Detailed Report, (the "McNulty Report") May 2011, p.25.

7 NEL, s 7A(3).

And the revenue and pricing principles of the NGL provide that:[8]

> A service provider should be provided with effective incentives in order to promote economic efficiency with respect to reference services the service provider provides. The economic efficiency that should be promoted includes— (a) efficient investment in, or in connection with, a pipeline with which the service provider provides reference services;

The LMR regime can help ensure that regulated revenues are not set below the level of efficient costs by providing independent scrutiny of regulatory decisions, thus protecting consumers against the harmful outcomes described above.

2.2 Limited role for consumers

2.2.1 The concern

One of the shortcomings of the original LMR regime that the expert panel identified in 2012 was the limited role for consumers in the review process, as well as the regulatory process more generally. A number changes since 2012, including the legislative changes in 2013 and changes made by the AER to its revenue reset process, have led to significant improvements to consumer participation at the reset and review stages.

Notwithstanding these encouraging developments, the COAG Energy Council is concerned that the cost and legalistic nature of current LMR process may be a barrier to more effective participation of consumers in the review process, without legal representation.[9] The NEO and NGO are, after all, framed in terms of promoting the long-term interests of consumers. Therefore, it would be problematic if the existing LMR regime somehow excluded consumers.

A related issue may be the apparent asymmetry of funding and access to high quality representation by experts (legal, economic and technical) available to consumer groups and NSPs seeking review.

2.2.2 Discussion

The concerns expressed by the expert panel and SCER about limited consumer participation have been addressed through the last round of revenue resets with the AER undertaking greater consultation with consumers (e.g., through the establishment of the Consumer Challenge Panel), with evidently clearer

8 NGL, s 24(3).

9 Consultation paper, p.14.

participation by consumer groups in the resets, and also more consultation with consumers by NSPs when developing their revenue proposals.[10]

In addition, the Tribunal consulted formally with consumers as part of the NSW/ACT merits review proceedings. Finally, two consumer groups, PIAC and SACOSS, sought review of the AER's decision in relation NSPs in NSW and South Australia respectively. PIAC was granted leave as a main party, and also as an intervener in the NSW review process. PIAC put its case to the Tribunal competently, and the Tribunal noted in its decision that it was assisted by PIAC's participation. We discuss below the improvements in consumer participation at the review stage.

Consumer consultation by the Tribunal

The 2013 legislative amendments to the NEL (s 71R(1)(b)) and NGL (s 261(1)(b)) created a new requirement for the Tribunal, when making a determination, to "consult any user or consumer associations or user or consumer interest groups that the Tribunal considers have an interest in the determination". The NEL and NGL do not specify how that consultation must be conducted. However, the purpose of the new requirement was to reduce the barriers to participation by consumers in the review process.[11]

To date, the Tribunal has conducted two such consultations when considering applications in relation to determinations made by the AER:[12]

1. the review of the AER's 2015 determinations for NSW and ACT NSPs; and
2. the ongoing review of the AER's 2015 determination for SA Power Networks.

The main features of the consultation in relation to the NSW and ACT applications were the following:[13]

- The Tribunal sought from the AER a list of all individuals and consumer groups involved in the reset process.

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10 The greater consultation by NSPs with consumers was assisted greatly by the AER's publication of the Consumer Engagement Guideline Network Service Providers in November 2013.

11 SCER Regulation Impact Statement, Limited Merits Review of Decision-Making in the Electricity and Gas Regulatory Frameworks Decision Paper, 6 June 2013, p.8; see also: Australian Competition Tribunal, Information for participants in the Tribunal's community consultation process.

12 In addition to the two consultations mentioned below, which relate to reviews of AER determinations, the Tribunal has also undertaken consumer consultation in relation to a recent review of the ERA's determination for ATCO Gas (ACT 10 of 2015 ATCO Gas Australia Pty Ltd) and has also published notice of a consumer consultation in October 2016, relation to recent applications for review by Victorian NSPs and ActewAGL Distribution (gas).

13 Applications by Public Interest Advocacy Centre Ltd and Ausgrid [2016] ACompT 1, pp.19-22.

- The Tribunal wrote to all of these parties individually, inviting them to the consultation. The process was open to individuals and groups, and was not restricted to just large energy users.
- The consultation was conducted over two days (6-7 August 2015) and was scheduled before oral hearings with the applicants and interveners, who were not involved in the consultation process. This meant that consumers had the first say.
- The consumers that participated could address the Tribunal directly, in an informal way, *without legal representation*. These persons or entities were able to make oral or written submission to the Tribunal.
- The Tribunal used the opportunity to ask consumers what their concerns were, and to seek clarification and supplementation of submissions provided to the AER by those parties.

The consultation was a meaningful exercise.

- The Tribunal absorbed the submissions made by consumers and summarised these in its decision (see Table 2).
- The Tribunal noted that price impact was the biggest concern expressed by consumers, but also identified that some consumers had argued for the need to balance price against other considerations, such as: quality, safety, reliability and security of the supply of electricity.
- The Tribunal used this insight of trade-offs between price and non-price considerations to interpret the meaning of the NEO in the context of the decisions it had to make. For instance, the Tribunal noted the following:[14]

> It is also important to acknowledge, as was very clearly demonstrated by the consultation undertaken by the Tribunal, that the elements of the NEO – in the long term interests of consumers – are potentially in conflict. In particular, the price at which electricity is supplied to consumers is presently (and will continue to be under the new regulatory regime) one which many consumers find confronting. There are significant numbers of consumers or potential consumers who either cannot pay, or have great difficulty in paying, that price. The difficulty in paying that price was also reported by some small and medium sized businesses, so that alternatives to using the electricity network or a focus on minimising that usage, were explained. On the other hand, for obviously good personal or commercial reasons, there were a significant number of consumers who expressed the need to have a very reliable and secure supply of electricity, and others who emphasised the need for safety in the structure and operations of the network.
>
> Where the line or lines are to be drawn between price on the one hand, and quality service, reliability and security of supply (or some of those elements) on the other, is not an easy question. The line nevertheless is clearly one which must be drawn. The

14 Applications by Public Interest Advocacy Centre Ltd and Ausgrid [2016] ACompT 1, paras.1180-1181.

consultation process, and the submissions of all parties, made it clear that some compromise is necessary.

Table 2: Issues raised by consumers through the LMR consultation process

Topic	Sub-topic
Consumer engagement and understanding	The Tribunal's approach to engagement
	Consumer education and access to information
	Participation in the AER processes
Impact of electricity prices on consumers	General consumer impact
	Vulnerable customers
	Rural and regional customers
	Price stability (including pace of any change)
	Long-term interests of consumers relating to price
The regulatory framework	Success of previous regimes
	Policy observations regarding the framework
Balancing the NEO and NGO for the long-term interests of consumers	The meaning of "long term interests of consumers"
	The price and reliability trade off
	The disconnection 'death spiral'
Operating expenditure	AER benchmarking approach
	Adherence to operating expenditure guidelines
	Impact of industrial agreements
	Vegetation management and bushfire risks
Rate of return	Adherence to the Guideline
	Estimation of return on debt
	Estimation of return on equity
	Ultimate pricing impact of the rate of return
Demand and energy forecasts	Inflation of demand and energy forecasts
Demand management and innovation	Expenditure on innovation
Materially preferable NEO/NGO decision	

Source: Applications by Public Interest Advocacy Centre Ltd and Ausgrid [2016] ACompT 1, pp.20-22

Whilst it is true that prior to 2013, consumers' accessibility to the review process (or, perhaps just as relevantly, the Tribunal's ability to access consumers' views directly) was limited, the experience from review processes since 2013 suggests that the situation has improved considerably. Indeed, it is fair to say that this model of consumer consultation is quite unique amongst merits review bodies overseas tasked with examining the decisions of economic regulators.

The consultation process outlined above worked well because it was, by design, not legalistic or adversarial but, rather, investigative—in the sense that the Tribunal was able to engage directly with consumers.[15] In our view, SCER's 2013 objective of improving the access of consumers without legal representation to the review process has clearly been met.

However, part of the COAG Energy Council's concern in this regard is that it is unclear what impact the Tribunal's consultation with consumers had on the final outcome of the review decision. As demonstrated by the quote above, the Tribunal's consultation process clearly did impact on its reasoning. However, whilst it is valuable for the Tribunal to hear directly from consumers (not least to put in context the real-world consequences of both the AER's and the Tribunal's decisions) it is, in our view, somewhat unrealistic to expect the Tribunal's decision to turn on the representations made by consumers through this consultation process. This is particularly so if consumers are not in a position to argue the technical and substantive points of the AER's or the NSPs' analysis that go to the specifics of the grounds of review.

If the COAG Energy Council's real concern is that consumers were unable to influence meaningfully the Tribunal's deliberations and, ultimately, its decision, then the solution is to find a way for a consumer champion to make the case on consumers' behalf. In our view, this consumer champion should:

- Be engaged deeply (making substantive submissions) much earlier, at the revenue reset stage, rather than relying on individual consumers or small groups, at the review stage, to carry the day.
- Frame its analysis and submissions in a meaningful way that assists the AER when it makes its revenue reset decisions.
- Be resourced properly so that it can make substantive and technical arguments cogently, and participate meaningfully (either as an intervener or as an applicant) at the review stage.

15 It is worth noting that the process of consumer consultation described above would have no role in a judicial review-only model, which would be the prevailing model if LMRs were removed, per Option 4 in the consultation paper.

Consumer participation

Consumers and users as interveners and applicants

Under the present LMR arrangements, there are two ways in which user or consumer groups can participate in the LMR process as a *party* to a review (within the meaning of s 71N NEL/s 257 NGR):

- Apply for leave to *apply* for a review

  The Tribunal must not grant leave to apply if the user/consumer:

  - did not make a submission or comment in relation to the making of the decision following an invitation by the AER to do so under the NEL/NGL or NER/NGR;
  - did do so, but that submission was not made within the time required under the NEL/NGL or NER/NGR following that invitation, and the AER chose not to take that submission/comment into account in making the decision.

  The user/consumer may not raise in relation to the issue of whether a ground for review exists or has been made out, any matter that was not raised by it in a submission to the AER before the reviewable regulatory decision was made.

- Apply for leave to *intervene* in a review

  The Tribunal may grant leave to intervene if the Tribunal is satisfied:

  - the user/consumer intervener, in its application for leave to intervene, raises a matter that will not be raised by the AER or the applicant;
  - the information/material/submissions the intervener wishes to present is likely to be better presented if submitted by the user/consumer rather than another party to the review; or
  - the interests of the user/consumer or its members are affected by the decision being reviewed.

In relation to the NSW and ACT applications, PIAC was both an applicant and an intervener. PIAC put its submissions to the Tribunal competently, and the Tribunal noted that it was assisted by PIAC's involvement in the review process:[16]

> As also noted, in relation to this decision (and those concerning Essential and Endeavour), the Tribunal has had the benefit of the applications by PIAC and its helpful submissions. That has enabled the Tribunal to be acutely aware of its obligation ultimately to ensure that its decisions in relation to these applications are those which, in its view, best serve the long-term interests of consumers in terms of the NEO. It has also, by the grounds of review raised by PIAC alleging error on the part of the AER,

16 Applications by Public Interest Advocacy Centre Ltd and Ausgrid [2016] ACompT 1, para.63.

> led to a focus on those particular matters where, it is said, the AER itself has failed to respond appropriately to s 16(1)(d) of the NEL or has otherwise fallen into error to the detriment of consumers.

PIAC was the first user or consumer group to be granted leave to apply for review since 2008. Other user or consumer groups have sought leave to apply but have not been successful. For instance:

- In 2009 the Energy Users' Association of Australia sought leave to apply but was refused because the applicant could not satisfy the requirement that the amount that is specified in or derived from the decision exceeds the lesser of $5 million or 2% of the average annual regulated revenue of the regulated network service provider.
- In 2015/16 SACOSS sought leave to apply but was refused leave because SACOSS had not raised the matter in a submission to the AER before the reviewable regulatory decision was made. The Tribunal held that as a consequence, there was no serious issue to be heard and determined as to whether a ground of review exists under s 71C of the NEL.[17] SACOSS had one other ground of review that it withdrew following the resolution of the NSW and ACT merits review cases.

As noted above, the Tribunal may not grant leave if the ground on which leave to apply is sought was not raised by the user or consumer group before the AER. Therefore, the prospects of securing leave to apply are diminished greatly if the user or consumer has had limited participation in the revenue reset process. Strengthening participation at the reset stage is therefore critical to users' and consumers' chances of securing leave to apply.

It is worth noting that a larger number of users and consumer groups have intervened successfully in the past on reviews relating to the AER's decisions. These include the Energy Consumers Coalition of South Australia (2008), Southern Sydney Regional Organisation of Councils (2009), Nyrstar Australia (2009) and AGL (2011).

The current involvement of consumers in the reset and review processes indicates that the 2013 reforms to the NEL/NGL have had their intended effect. Nevertheless, a key reason for the relatively poor track record of past consumer participation may be lack of resourcing. Proper financial resourcing of consumer groups would allow more effective involvement in both the revenue reset process and at the review stage.

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17 SACOSS withdrew its application to intervene in respect of the return on equity following the Tribunal's decision in the decision in the NSW and ACT merits review cases.

Energy Consumers Australia

In January 2015, ECA was established by the COAG Energy Council. ECA incorporated the Consumer Advocacy Panel (CAP), which used to undertake consumer advocacy functions on behalf of the COAG Energy Council.

The objective of ECA reflects the NEO and the NGO, namely:

> To promote the long term interests of consumers of energy with respect to the price, quality, safety, reliability and security of supply of energy services by providing and enabling strong, coordinated, collegiate evidence based consumer advocacy on national energy market matters of strategic importance or material consequence for energy consumers, in particular for residential and small business customers.

ECA aims to meet this objective by engaging in regulatory and policy development processes that affect energy consumers, direct advocacy work, funding other consumer bodies to engage in advocacy work through grants, funding of research, and undertaking community education activities.

ECA is funded by electricity and gas market participants.

The creation of ECA provides potentially a very effective vehicle for enhanced consumer participation at all stages of the regulatory process, including:

- Rule Changes (e.g., by acting as a proponent of Rule Changes, or making submissions on behalf of consumers through Rule Change processes);
- AER revenue resets (e.g., by scrutinising NSPs' proposals and the AER's analysis, and making submissions); and
- LMR processes (e.g., by acting as an intervener or a party seeking merits review). It is worth noting that ECA was formed in January 2015, which was near the end of the revenue reset processes of the NSW and ACT NSPs that sought review in May 2015. ECA's non-involvement in the reset process would have precluded it from acting as an intervener or an applicant in those review proceedings.

It will be necessary for ECA to be funded adequately in order for it to participate effectively through all stages of the regulatory process. Specifically, ECA's funding should be adequate for it to:

- Engage high quality experts (legal, economic and technical) to assist it to participate robustly in Rule Change, revenue reset and LMR processes. In other words, its funding should be sufficient to provide effective 'competition for ideas' against NSPs — a situation that is somewhat asymmetric at present.
- Carry out effective advocacy, communication and education work in support of this new role.

2.3 Gaming

2.3.1 The concern

There are a number of strands to this concern. Firstly, the NSPs in Australia are viewed by some as having historically been quite prolific in appealing against the AER's decisions. The consultation paper notes that since 2013, more than half (i.e., 12 of the 20) of decisions made by the AER have been subject to applications by NSPs for review by the Tribunal.[18]

As a result, the use of the LMR regime may be viewed by some policymakers (and the AER) as a strategy employed by networks to forestall or neuter the AER's decisions, which would otherwise benefit consumers. This may be reinforced by a perception that networks are not using the LMR process as a last resort as it was intended:[19]

> … reviews were only intended to be used rarely and only to address issues with a material consequence on the operation of the network business.

Another concern stated by some policymakers is that networks may be able to cherry-pick the matters on which they seek review under the current LMR regime, because the parties can seek review on narrow matters, and the Tribunal is unable under the current arrangements to re-examine the entire decision. The issue of cherry-picking was raised in 2012 by the expert panel that conducted the previous review of the LMR arrangements, and the panel suggested that the solution to this issue would be a more holistic approach to error correction by the review body.

However, the COAG Energy Council considers that the 2013 legislative changes to the LMR did not go far enough towards addressing that concern:[20]

> Key areas identified as requiring consideration through the Review include the apparent 'cherry picking' of issues for review by network businesses and 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.

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18 Consumer groups have sought applications for review in relation to four of the AER's decisions since 2013.

19 Consultation paper, p.9.

20 Consultation paper, p.4.

2.3.2 Discussion

Link between rule and legislative changes and 'testing' of AER determinations

The COAG Energy Council notes that more than half of the determinations made by the AER since 2013 have been subject to applications for review. It is important to view this fact in the context of:

- major changes to the NER and NGR in 2012; and
- major changes to the NEL and NGL in 2013,

which altered the way in which the AER must make its revenue decisions for NSPs.

The applications for merits review since 2013 were attempts by NSPs and consumers to test and resolve uncertainty surrounding the new rules and legislation—just as the significant revenue reductions, exclusive reliance on benchmarking to establish efficient expenditure levels, and judicial review by the AER may be characterised, in some senses, as a 'testing' of its new powers.

While there have been 18 applications for review relating to AER and ERA decisions made to the Tribunal since 2015, as we discuss below, that number needs to be considered in the following context:

- four of those applications for review were made by consumer groups;
- the grounds for review relied upon by the applicants relate to the proper interpretation of provisions in the NER and NGR which had been amended in 2012;
- the considerable commonality of grounds relied upon by the NSPs (particularly in relation to rate of return allowances, estimated cost of corporate income tax and use of benchmarking) reflected the significant industry-wide implications of the AER's interpretation of the NER and NGR;
- that NSPs whose AER determinations were made after the NSW and ACT proceedings were heard, but before they were determined by the Tribunal, made applications for review on largely similar grounds and abandoned the grounds relating to the return on equity once the Tribunal upheld the AER's approach in the NSW and ACT merits review cases; and
- the NSPs whose AER determinations were made after the Tribunal published its decisions in the NSW and ACT proceedings made applications to the Tribunal for review of the AER's decisions because the AER had failed to apply the reasoning of the Tribunal in the NSW and ACT determinations (we note that the AER has applied for judicial review of the Tribunal's decision on the NSW and ACT applications).

2012 changes to the NER and NGR

Significant reforms to the NER and NGR were made by the AEMC in November 2012. In the case of NSPs regulated by the NER, these included reforms to the approach for the determination of the return on equity, return on debt, forecast capital and operating expenditure, and certain incentive schemes along with other amendments to the regulatory process and transitional arrangements. The amendments to the NGR were more limited and only addressed the return on equity and the return on debt along with transitional arrangements. These reforms included the establishment of the rate of return guideline by the AER (and the ERA, in the case of Western Australian gas pipelines).

Collectively, the reforms gave significantly greater discretion to the AER (and the ERA) when determining the building blocks for each regulated NSP in accordance with the guidance provided in the NER and NGR. For example, whereas prior to 2012 the NER and NGR prescribed very tightly how the AER should determine the allowed rate of return for NSPs, under the new rules the AER was given greater discretion to set the allowed rate of return that achieves the rate of return objective and in doing so was required to have regard to (amongst other things):[21]

> …relevant estimation methods, financial models, market data and other evidence

The first NSPs for which the AER made determinations following these rule changes were Ausgrid, Endeavour Energy, Essential Energy and ActewAGL (the NSW and ACT DNSPs), Jemena Gas Networks, TransGrid and Transend. These NSPs (other than Jemena Gas Networks) were also subject to transitional arrangements that meant that their final determinations were not made until one year into their regulatory control period.

The reforms to the NER and NGR in November 2012 led to significant industry-wide uncertainty and genuine dispute over the approach that the AER used when determining the building blocks, and whether this approach led to a materially preferable NEO decision. This was in the context of substantial reductions in allowed revenue proposed by the AER in those final determinations for the NSW and ACT DNSPs,[22] and a concern about weaknesses in the evidential basis for those decisions. Apart from NSPs, PIAC also brought its own merits review application in respect of the NSW DNSPs, and intervened in their merits reviews. In doing so, PIAC argued that the AER had erred in its decisions.

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21 See, for example, NER, r 6.5.2(e) and r 6A.6.2(e).

22 For example, in Ausgrid's case, for example, the reduction in revenue amounted to $2.85 billion over the five year regulatory control period, which was approximately 24% of the revenue sought by Ausgrid in its revised regulatory proposal. This uncertainty and material financial impact led to several NSPs (i.e. the NSW and ACT DNSPs and Jemena Gas Networks) seeking merits review of the AER's final determinations in May and June 2015.

2013 changes to the NEL and NGL

Along with the amendments to the merits review provisions of the NEL and NGL, amendments were also made to the provisions in the NEL and NGL dealing with the AER's decision-making functions following the expert panel's review.[23] These amendments required the AER to specify the interrelationships between elements in its decision and the manner in which those interrelationships had been taken into account. In addition, the AER is required to make the decision that the AER is satisfied will, or is likely to, contribute to the achievement of the long term interests of consumers to the greatest degree.

Under the reforms, the AER was also required to ensure that users or prospective users and user or consumer associations or interest groups are informed of the material issues under consideration and given a reasonable opportunity to make submissions. In addition, the AER must compile a record of the information considered during its decision-making process, which provides the starting point of the information to be considered by the Tribunal.

These reforms were intended to ensure that the AER and the Tribunal made decisions on the same basis and that consumer associations, interest groups and users have a meaningful and structured opportunity to participate in the decision making processes of both the AER and Tribunal. Further the amendments to the NEL and NGL requiring the AER to specify and take into account the interrelationships between elements in its decision had the purpose of ensuring the Tribunal was properly and fully informed in any applications for merits review of the AER's decisions to reduce the risk of regulated networks "cherry picking" specific issues or grounds which may, in isolation, support an increase of allowed revenues.

Merits reviews following changes to the NEL/NGL and NER/NGR

The merits reviews in 2015 involving the NSW and ACT NSPs were the first heard by the Tribunal since the changes to the NER and NGR in November 2012 and the reforms to the NEL and NGL in December 2013. The common grounds in the NSW and ACT merits reviews were the determination of:

- the return on equity where the AER adopted a "foundation model" approach rather than a multi-model approach (which the NSPs argued was more consistent with the new requirements in the NER/NGR);
- the return on debt, where the AER adopted a 10-year transition when implementing the trailing average;

[23] These changes also applied to the ERA in Western Australia.

- the use of a benchmarking technique to determine allowances for operating expenditure;[24] and
- the corporate income tax allowance, which the AER did not determine on the basis of the market value of imputation credits to investors.

Other components of the building blocks reviewed by one or more of the NSPs included the determination of forecast capital expenditure (brought only by Jemena Gas Networks) and the application of certain incentive schemes. These merits reviews addressed most of the components of the building blocks and their breadth reflected the significance of the reforms made to the NER and NGR in November 2012 and the subsequent changes in the AER's approaches. A number of other NSPs intervened in the proceedings given their industry-wide significance.

These were complex proceedings involving detailed arguments on determinations and the Rate of Return Guideline made by the AER over a lengthy timetable. Due to the transitional arrangements put in place following the November 2012 amendments to the NER and NGR, the AER was required to make final determinations for SA Power Networks, Ergon Energy and Energex on 31 October 2015 before the NSW and ACT proceedings could be resolved by the Tribunal. Similarly, the ERA made a final determination of ATCO Gas's access arrangement. The compressed timetable between final determinations that was the result of the transitional arrangements in the NER and NGR did not allow sufficient time for the Tribunal to resolve the complex NSW and ACT merits review cases prior to the making of the next suite of final determinations by the AER and ERA.

ATCO Gas and SA Power Networks applied for merits reviews of their final determinations. Both NSPs alleged similar errors in the AER's and ERA's approach to the return on equity and the valuation of imputation credits as were considered by the Tribunal in the NSW and ACT merits review cases, and SA Power Networks also alleged errors relating to the return on debt on a similar basis to those already considered by the Tribunal.

Prior to hearings in the ATCO Gas, and SA Power Networks merits review applications, the Tribunal's decisions in the NSW and ACT merits reviews were released. The applicants in the NSW and ACT merits review cases succeeded in relation to the determination of the return on debt and the estimation of the cost of corporate income tax (as well as forecast operating expenditure and forecast capital expenditure), but not on the question of the return on equity. Given this, both ATCO Gas and SA Power Networks did not press their return on equity grounds of review in their subsequent merits reviews (although ATCO Gas did argue one ground of its return on equity case that was not considered by the Tribunal in the NSW and ACT merits review cases). That is, the NSW and ACT

[24] Jemena Gas Networks did not make an application for review in relation to its opex allowance.

merits review cases largely dealt with and determined the industry-wide concerns on the AER's approach to determining the return on equity following the 2012 amendments to the NER and NGR.

The AER has sought judicial review of the Tribunal's decisions in relation to the return on debt and valuation of imputation credits (and forecast operating expenditure) in the Full Federal Court. As a result, the Tribunal was required to rehear largely the same arguments on the return on debt and the estimation of the cost of corporate income tax for SA Power Networks and ATCO Gas that it had already considered and determined in the NSW and ACT merits review cases. To date, only ATCO Gas's merits review application has been decided with the Tribunal reaching the same conclusion on the estimation of the cost of corporate income tax as it had previously (ATCO Gas did not challenge the ERA's determination on the return on debt, which was made under different guidelines applying in Western Australia).

A similar situation arises in the case of the Victorian electricity DNSPs (United Energy, Jemena, CitiPower, Powercor and AusNet). The AER made final determinations for these NSPs in April 2016 following the Tribunal's determination of the NSW and ACT merits review. However, when making these determinations the AER did not apply the Tribunal's decision on the return on debt or the estimation of corporate income tax that had been made in the NSW and ACT merits review cases. As a result, all of these NSPs have filed merits review applications on the estimation of corporate income tax alleging similar errors and making similar arguments to those considered by the Tribunal in the NSW and ACT merits review proceedings and two NSPs (Jemena and ActewAGL) have also challenged the AER's determination of the return on debt for similar reasons as already considered by the Tribunal.[25]

Summary

In summary:

- The AER's and ERA's approach following the amendments to the NER and NGR in 2012 led to industry-wide uncertainty and dispute on the proper application of the new rules.
- The compressed timetable for the AER's determinations under the transitional arrangements following the amendments to the NER and NGR in 2012

[25] Further, DBNGP (WA) Transmission has filed a merits review application in relation to the ERA's determination published in July 2016 of the return on equity and the estimated cost of corporate income tax. Again, the arguments in relation to the estimated cost of corporate income tax are similar to those considered originally by the Tribunal in the NSW and ACT merits reviews. The return on equity challenge is different from the 'foundation model' arguments considered previously by the Tribunal. This application by DBNGP was an attempt to clarify the proper implementation of the changers to the NGR in 2012.

resulted in the AER being required to make new determinations before these industry-wide issues were resolved by the Tribunal.

- NSPs that have sought merits review since the determination of the NSW and ACT merits review by the Tribunal have sought to apply that decision to their determinations in circumstances where the AER has not done so. The NSPs have accepted the Tribunal's decision where it found in favour of the AER on the return on equity.
- The disputes in relation to the determination of the return on debt, operating expenditure and the estimation of the cost of corporate income tax are now being considered by the Full Federal Court.

Holistic consideration of interlinked parts of a decision

The 2012 review suggested that a solution to the cherry-picking problem would be to have a more holistic approach to the review, whereby the Tribunal would need to give consideration to the interlinked parts of the decision. The intention was that to the extent that the AER may have balanced offsetting considerations about constituent components of a reviewable decision, the Tribunal should have the ability to take those other considerations into account when making its review decisions.

The 2013 legislative changes introduced new requirements for the AER to explain in its final determinations any interlinkages between different component parts of this decision.[26] Further, following the 2013 legislative changes, when the Tribunal considers whether varying or setting aside and remitting a determination would, or would be likely to, result in a materially preferable NEO or NGO decision it must consider the interrelationships between the components of the determination and the determination as a whole (amongst other things) under section 71P(2b) of the NEL and section 249(4b) of the NGL.

When considering this in the NSW and ACT merits review cases in 2015, the Tribunal had the benefit of advice developed by the AER setting out these interrelationships.

The purpose of the obligation on the Tribunal to consider the interrelationships between components of the determination includes the purpose of assessing any aspects of the AER's determination that may be considered "generous" (for example, by choosing an estimate at the end of the range that favours the NSP). Any component that may be considered "generous" will necessarily offset any potential benefit to the regulated network from correcting an error found by the Tribunal. In these circumstances the effect of the statutory regime will be that

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26 SCER, Regulation Impact Statement: Limited Merits Review of Decision-Making in the Electricity and Gas Regulatory Frameworks, Decision Paper, 6 June 2013.

notwithstanding material error the Tribunal is likely to conclude that there is not a materially preferable NEO or NGO decision.

By way of example, in the NSW and ACT merits review cases, the NSPs had argued that the AER had determined equity beta (a parameter that the AER estimates in order to determine the rate of return allowance) too low at a value of 0.7, and that had it given proper regard to the evidence available before it, ought to have determined an equity beta above 0.7. However, PIAC argued that the AER had been too generous in its equity beta estimate on the grounds that the AER's own expert had advised that the best statistical estimate of beta was 0.5 (i.e., materially lower than the estimate it had finally selected). The equity beta that PIAC argued was appropriate would have resulted in material reductions in the NSPs' revenue allowances relative to the AER's original determinations (all else remaining equal).

This suggests that applying for a merits review necessarily involves a real risk that the proceedings may result in the allowed revenues of the regulated network being reduced below that allowed by the original AER determination.

Consumer participation

Fels (2012) also argues that if cherry-picking is a real concern, one solution would be to strengthen the capacity and ability for consumers to participate more effectively in the reset and review processes to provide a contraposition to NSPs. A sufficiently resourced and skilled consumer representative that is alive to the scope for cherry-picking would, as interveners, be able to expose to the Tribunal any areas where the NSPs seeking review have benefitted too much, and would contest those areas where the NSPs are seeking more favourable outcomes.

As section 2.2.2 discusses, since 2013 there have been a number of encouraging developments in this regard, including:

- greater participation of consumer interest groups through the AER's revenue reset processes;
- the establishment of ECA, a national consumer body tasked with promoting the long-term interests of consumers of energy;
- comprehensive consultation of consumers by the Tribunal in recent review processes; and
- direct involvement of consumer groups as interveners and applicants for reviews.

These developments mean that the merits review provisions are not a one-way bet for NSPs. User and consumer groups and associations, along with users and consumers themselves, may and have made applications for merits review of the AER's and ERA's decisions. In addition, these parties may apply to intervene in the application of a merits review by a regulated network. PIAC for example, was granted leave to proceed with its own merits review applications for the AER's

2015 final determinations for Ausgrid, Endeavour Energy and Essential Energy, and was also granted leave to intervene in the hearing of the applications for merits review made by those NSPs.

The presence of user and consumer groups and associations, and users and consumers themselves, as applicants and interveners in merits review proceedings means that grounds in addition to those brought by the regulated networks are considered by the Tribunal. Generally the grounds and arguments brought by consumer groups and users will be adverse to the commercial interests of regulated networks. Once the Tribunal is seized with jurisdiction (because it has granted leave to a network business, a user or consumer group) the Tribunal's power to make orders is only constrained by the requirement to be satisfied that there is a materially preferable decision. That is, there is nothing that prevents the Tribunal adopting the arguments of consumer groups or users to reduce the allowed revenues of the regulated network.

The materially preferable test

One of the ways in which the 2013 amendments to the NEL and NGL sought to address concerns about gaming and cherry-picking was by introducing the "materially preferable" test. Under this test:[27]

- The Tribunal may only grant leave to a party making an application for review if it is satisfied that the party has established that there is a *prima faci*e case that there is a materially preferable outcome in the long term interests of consumers; and
- The Tribunal may only set aside or vary the AER's original decision if it is satisfied that there is a materially preferable decision to the original decision in the context of the long term interests of consumers as set out in the NEO or NGO.

In its consultation paper, the COAG Energy Council notes that an objective of the 2013 legislative changes was to make it evident that the purpose of decision-making, whether by the AER or the Tribunal, was to meet the long-term interests of consumers. The consultation paper goes on to suggest that it is unclear from the Tribunal's written reasons how the long-term interests of consumers were advanced by the Tribunal's application of "materially preferable". Specifically, the consultation paper implies that the Tribunal may have fallen back to simple "error correction" rather than proper application of the materially preferable test.[28]

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27 SCER, Regulation Impact Statement Limited Merits Review of Decision-Making in the Electricity and Gas Regulatory Frameworks Decision Paper, Decision Paper, 6 June 2013, pp.40-41.

28 Consultation paper, p.11.

The way in which the Tribunal approached and applied the materially preferable test properly is a matter that is likely to be adjudicated on by the Full Federal Court as part of the judicial review proceedings sought by the AER of the Tribunal's decisions in relation to the NSW and ACT applications. It would be, in our view, premature and inappropriate to form policy recommendations and introduce major reforms to the LMR regime based on how competently the Tribunal applied and explained its interpretation of the materially preferable test, prior to the resolution of a legal process that is still pending.

The Tribunal's consideration of the materially preferable test

However, it is manifestly clear from those decisions that the introduction of the materially preferable test, via the 2013 legislative amendments, did influence the way in which the Tribunal formulated its decisions. For instance, we note that the Tribunal:

- Included in its Augrid-PIAC decision a subsection that explained the 2013 legislative amendments, including the introduction of the need for regulatory decisions (either by the AER or on review by the Tribunal) to reflect the "materially preferable NEO decision";[29]
- Devoted an entire section in that decision to discussing the meaning of the materially preferable test and the Tribunal's role on review in applying the test;[30]
- Devoted another section in the same decision that discussed whether the Tribunal was satisfied that varying or setting aside the AER's original decisions would result in a "materially preferable NEO decision";[31] and
- Explained in another subsection of its decision how it had applied the prescribed test in the legislation.[32]

Further, it is clear from the Tribunal's decision that it was fully cognisant that the introduction of the materially preferable test meant that the mere identification of errors by the AER (if there were any) was insufficient to set aside or vary the AER's determinations. Indeed, the Tribunal recognised this explicitly in its decision.

For instance, the Tribunal noted that:[33]

> It is clear enough from those legislative provisions that, if it is established that in one or more respects the AER has fallen into reviewable error, that is that a ground or

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29 Applications by Public Interest Advocacy Centre Ltd and Ausgrid [2016] ACompT 1, pp.13-18.

30 Applications by Public Interest Advocacy Centre Ltd and Ausgrid [2016] ACompT 1, pp.23-33.

31 Applications by Public Interest Advocacy Centre Ltd and Ausgrid [2016] ACompT 1, pp.304-311.

32 Applications by Public Interest Advocacy Centre Ltd and Ausgrid [2016] ACompT 1, pp.313-315.

33 Applications by Public Interest Advocacy Centre Ltd and Ausgrid [2016] ACompT 1, para.66.

> grounds of review have been made out, it will not be a materially preferable decision simply to provide for the correction of that ground of review. Section 71P(2b)(d)(i) and s 259(4b)(d)(i) respectively make that plain.

The Tribunal also stated the following:[34]

> Consequently, the correction of error or errors in a decision under review will not necessarily lead to a materially preferable decision. Whether there is a preferable decision to the decision made by the AER depends upon an assessment of the decision as a whole, and a comparison of that decision with a putative alternative decision; it does not depend simply on an assessment of errors in individual components of the decision under review.

And, finally, the Tribunal explained that the legislative changes of 2013 meant that its role was no longer to simply correct errors made by the AER:[35]

> The 2013 Legislative Amendments reflect a deliberate policy decision to change the NEL and NGL and, in particular, to change the scope of the Tribunal's limited merits review function. They introduce a series of steps which require the Tribunal, even if it is satisfied of one or more grounds of review arising from one particular aspect of the AER's decision, to consider whether and how the potential consequences of that ground being established may be reduced, counterbalanced or rendered immaterial following the processes mandated by ss 71P(2a), 71P(2b)(a) and 71P(2b)(c) of the NEL and ss 259(4a), 259(4b)(a) and 259(4b)(c) of the NGL.

The consultation paper, and a number of other commentators appear to be critical of a failure of the Tribunal to grasp and incorporate into its decision-making the 2013 reforms. However, as the analysis above demonstrates, this is a position that is not supportable based on a review of the Tribunal's recent decision.

It is likely that the outcome of the judicial review proceedings concerning the NSW and ACT applications, which are currently before the Full Federal Court, as well as accumulating precedent in any future reviews conducted by the Tribunal, will help clarify further, and refine the application of, the materially preferable test.

Constraints on gaming

Whilst concerns about use of an appeals regime to game a regulatory system are potentially legitimate concerns, it is important to note an important countervailing consideration: appeals are costly to businesses. Specifically, they:

- Occupy valuable management time that may be spent more productively on other activities;
- Involve potentially significant financial cost and can be risky because the outcome of appeals is by no means certain; and

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34 Applications by Public Interest Advocacy Centre Ltd and Ausgrid [2016] ACompT 1, para.91.

35 Applications by Public Interest Advocacy Centre Ltd and Ausgrid [2016] ACompT 1, para.92.

- Can involve large reputational costs—recognising that the regulation involves repeated interaction between the business and the regulator, and appeals do little to enhance relationships between counterparties to a litigation matter.

All these considerations mean that, in practice, the decision to proceed to merits review is by no means a trivial one.

2.4 Delays and regulatory uncertainty

2.4.1 The concern

The consultation paper argues that the effect of the reviews sought by NSPs since 2013 has resulted in considerable delay in the finalisation of revenue resets, and that this in turn has created prolonged uncertainty about regulatory outcomes:[36]

> 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. Taken together, these twelve network businesses asked the Tribunal to increase their revenue by around $7 billion over a five year period. Legal challenges mean revenue determinations finalised by the AER more than 16 months ago (April 2015) will likely remain uncertain until at least early 2017.

2.4.2 Discussion

In the NSW and ACT merits review cases, leave was granted to the parties in July 2015. The Tribunal handed down its determination seven months later, in February 2016—i.e., four months after the standard period of three months. The Tribunal extended the standard period twice during these proceedings (once in October 2015 and then in December 2015). At each extension, the Tribunal complied fully with the requirements set out in the NEL and NGL.

Whilst delays and regulatory uncertainty are not desirable for consumers or NSPs, given the complex nature of the applications heard by the Tribunal, and the number of parties and interveners involved, it is not surprising that the these extensions were sought.[37]

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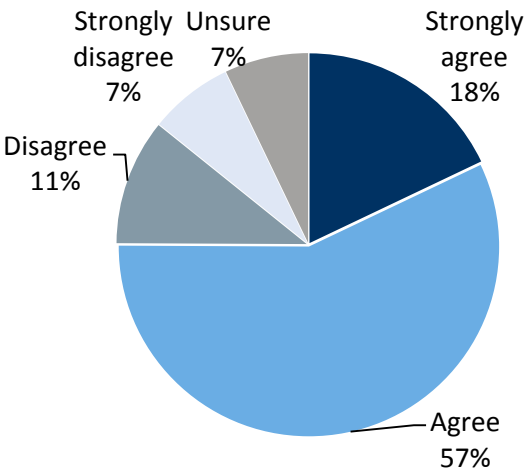
36 Consultation paper, p.4.

37 By way of comparison, the first and most recent merits review of determinations made by the New Zealand Commerce Commission, heard by the New Zealand High Court, involved a review process that took approximately 34 months, with the first applications submitted to the High Court in February 2011 and the High Court handing down its decision in December 2013. Merits reviews in Germany have also involved very lengthy processes, with some decisions taking years to make. For instance, an application for a merits review on a 2008 decision by the Federal regulator in Germany on cost of equity matters was settled only in 2013 (i.e., five years after the original decision). This decision was then subject to a judicial review, which was resolved only in 2015. By comparison to the review processes in these jurisdictions, the Tribunal's most recent review process, lasting seven months, was not inordinately long—particularly given the breadth and complexity of the issues that the Tribunal was asked to consider.

It is worth noting that the AER has contributed to long delays in settling the AER's revenue determinations that the COAG Energy Council is concerned with. Specifically, following the Tribunal's decision in February 2016, the AER sought in March 2016 a judicial review of the Tribunal's decision from the full Federal Court.[38] That review process is ongoing and, as the consultation paper notes, the outcome of that judicial review process "will likely remain uncertain until at least early 2017". This represents a delay of at least nine months (from the time of the Tribunal handing down its decisions) in settling the determinations for the NSW and ACT NSPs that sought review originally.[39]

A recent survey of institutional investors in Australia found that 75% of those investors surveyed considered that the AER's recent application for a judicial review of the Tribunal's decision in relation to NSW and ACT NSPs raised regulatory uncertainty (see Figure 2).

Figure 2: Impact of AER's judicial review application on investors' perceptions of regulatory uncertainty



Source: Royal Bank of Canada research

Whilst it is clear from the discussion above that the delays and uncertainty described in the consultation paper are not entirely a failure of the LMR regime, it is worth examining whether there are options that could streamline the LMR process, for instance by avoiding serial applications for review on the same matters. We explore some possible options in section 4. In addition, amendments to the NER have been sought by the NSW and ACT DNSPs to ensure that there are

38 AER media release, AER appeals against electricity and gas price decisions, 24 March 2016.

39 If the Tribunal's decision is upheld, the delay would be even longer than nine months as the AER would then have to remake the original decisions in line with the Tribunal's orders from February 2016.

arrangements in place to correct prices where there has been a delay. The proposed amendments are intended to mitigate the impact of any delay.

2.5 Cost and inefficient diversion of AER resources

2.5.1 The concern

There is a somewhat ill-specified concern that merits reviews are "costly".[40] Usually, this is interpreted as the direct financial cost (e.g., fees paid to legal and other experts) faced by the AER when responding to merits reviews sought by networks. Further, the Federal Minister for the Environment and Energy has argued recently that these costs are an unfair impost on taxpayers.[41]

A related concern may be that merits reviews tie up staff resources at the AER, and potentially lead to even worse regulatory decisions because the AER's resources are stretched too thinly. This may in turn mean that the AER does not have the capacity to focus properly on live revenue resets. This could partly be a consequence of the fact that:

- The AER operates under a regime of staggered regulatory decisions for different businesses;
- Sequential decision-making under these arrangements could lead to multiple, sequential merits reviews by multiple parties (particularly if the AER fails to reflect in subsequent revenue determinations the Tribunal's decisions in relation to earlier determinations);[42] and
- This could result in the AER being in court continuously, or "fighting fires on multiple fronts", which might restrict its ability to deal properly with ongoing resets, and with the development of its regulatory approaches (e.g., according to the AER, the Guideline process has been delayed because of the Tribunal's review decision in relation to the NSW/ACT matter).

A third possible dimension to the concern about the cost of the LMR regime may be that when the AER's decisions have been overturned, that has been interpreted by some as a lost opportunity to reduce the costs faced by consumers. This essentially a concern about the LMR regime being an impediment to price reductions, which was discussed in section 2.1.

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40 See, for example, statements made about the ACCC in relation to merits reviews against AER decisions in: ACCC, Review of Water Charge Rules: Draft Advice, November 2015, p.137.

41 Simon Benson, 'Power companies in $150 million legal fight to protect price hikes', Daily Telegraph, 28 August 2016.

42 This occurred most recently when the AER decided not to reflect the Tribunal's decision on gamma in its subsequent decisions (e.g., for Victorian and South Australian networks) — presumably to preserve its position in its judicial review appeal to the Full Federal Court.

2.5.2 Discussion

It is important to recognise that merits review systems anywhere in the world are not entirely costless, either to the parties seeking review or to the original decision-maker. And nor should they be because that would either encourage gaming by regulated businesses (e.g., by making frivolous/vexatious applications costless) or reduce the discipline exerted on the regulator to be accountable for its decisions.

Further, good regulatory decision-making is not free. This is self-evident: a well-resourced regulator is likely to make better, well-reasoned decisions than a poorly-resourced one. By the same token, the benefits of checks and balances on regulatory decisions are not free either. The existence of a merits review body will necessarily involve some cost, and will necessarily involve some duplication of the work of the original decision-maker in the sense that in order to be effective, the review body must be able to scrutinise properly the original decisions.

Society accepts these costs in other areas, the most obvious example being the judicial system, where higher courts scrutinise the decisions of lower courts. This is because the alternative system, in which no appeal rights on judicial decision-making exist, would likely produce errors that are so large that they would be considered too costly for society to bear.

The key question is, what level of cost is acceptable? This involves weighing up the benefits of good regulatory outcomes promoted by accountability against the costs of independent scrutiny by a review body. Of course, this is not a binary choice. There are many possible design options available when designing a LMR regime (as indicated by the variety of models found overseas). Australia has adopted a particular model. It may be possible to choose a slightly different model that produces a more desirable trade-off between cost and accountability.

One of the reasons identified in the consultation paper for the high cost of the LMR regime is the large number of reviews sought. At present, because the reviews themselves are staggered, they can be quite duplicative—as evidenced by the multiple applications for review recently on common matters, such as the value of imputation credits, and the method for determining the return on debt allowance. As discussed in section 2.2, the multiple applications on very similar matters have occurred either because:

- NSPs have sought to preserve their legal positions pending the outcome of matters before the Tribunal (in the case of SA Power Networks); or
- the AER sought a judicial review of the Tribunal's decision in respect of the NSW and ACT NSPs, which meant that it did not implement the Tribunal's decision in subsequent resets. This effectively forced the Victorian DNSPs to seek review.

If such outcomes are judged too costly, ways of streamlining the LMR regime to avoid duplicative reviews, and more investigative processes at both the revenue

reset and review stages to clarify and narrow the areas of disagreement between different parties, should be explored. A less duplicative review process would help address the problem of merits reviews diverting the AER's scarce resources away from core activities such as conducting revenue resets, refinement of regulatory approaches and better engagement with stakeholders. We examine a number of such options that could help streamline merits reviews in section 4.

3 Options for reform proposed by the COAG Energy Council

The COAG Energy Council has proposed four options for reforming the LMR regime:

1. Option 1 – Status quo
2. Option 2 – Retain the Tribunal with legislative amendments
3. Option 3 – Replace the Tribunal with a new investigatory body
4. Option 4 – Remove access to LMR

As discussed in section 2, the COAG Energy Council has raised some fundamental concerns, which should not be dismissed out of hand. There are areas for potential improvement, including at the revenue reset stage. Hence, maintaining the status quo (Option 1) does not seem realistic or appropriate.

By the same token, a well-designed merits review regime can provide enormous benefits to society and can enhance the overall regulatory framework. In section 3.1 we discuss these benefits. The existence of these benefits means that removal of the LMR regime altogether (Option 4) would not be a proportionate response to the concerns set out by the COAG Energy Council.

In our view, therefore, the preferred course should be to keep the LMR regime but make targeted reforms that seek to address the COAG Energy Council's concerns. Options for such reforms are discussed in section 4.

3.1 Benefits of a merits review regime

In principle, merits review regimes offer significant benefits to society and can enhance the effectiveness of the regulatory system:

- It should not be simply assumed that regulators are infallible. History shows such an assumption to be false. Indeed, the use of merits review arrangements in many countries apart from Australia suggests that regulators do make mistakes and therefore some protection against material regulatory error is necessary. It is important to recognise that abolishment of the LMR regime would remove consumers' rights to challenge the merits of AER determinations as much as NSPs' rights.
- By providing checks and balances, merits reviews can enhance the accountability of the regulator, and also promote confidence (amongst

consumers and investors) in the regulatory process. The expert panel appointed by the SCER to examine the LMR regime observed in 2012:[43]

> We are convinced of the contribution that merits review can make to better regulatory decision making, and, more specifically, we consider it to be an important component of a system of checks and balances that supports the independence of delegated regulation. It is because the Australian Energy Regulator (AER) can exercise significant discretionary powers that merits review has such an important potential role to play.

- Review by an independent adjudicator can protect society against partisan regulatory decisions arising from regulatory capture, where the regulator favours the vested interests it regulates, or from a mistaken notion that it should act as a champion of consumers to the detriment of the legitimate commercial interests of the businesses it regulates.
- Merits reviews can help clarify how complex regulatory rules (in this case the NER and NGR), and economic and legal principles, should be interpreted and applied. The regulator can use interpretive precedents to refine and improve its future decisions. In addition, if incorporated into regulatory decision-making, the precedents provided by merits review decisions also help clarify to consumers and NSPs how the rules and regulatory principles should be interpreted and applied. This helps the advancement of regulatory thinking, and the development of regulatory frameworks, over time.
- The safeguards against regulatory errors and caprice provided by merits reviews reduces uncertainty for investors in regulated networks, who are typically making very long-lived investments, so face cost recovery over long and otherwise uncertain horizons. Such safeguards should keep regulated networks' cost of capital low and, therefore, the costs borne by consumers over the long-run.

3.1.1 Recognition of the benefits of merits reviews overseas

For the various reasons set out above, most countries with developed and mature regulatory systems have some form of merits review arrangements and do not rely exclusively on judicial review arrangements alone to provide scrutiny of regulatory decisions.[44] Case studies of the merits review arrangements operating in a number

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43 Prof George Yarrow, Hon. Michael Egan and Dr JohnTamblyn, Review of the limited merits review regime: Stage two report, 30 September 2012, p.3.

44 Ontario is an exception to this with appeals of Ontario Energy Board (OEB) decisions being limited to errors of law or jurisdiction under the Ontario Energy Board Act 1998 (Ont). However, the regulatory arrangements in Ontario are substantially different from those in Australia. In Ontario, the OEB is provided a broad discretion to set "just and reasonable" rates whereas the AER must make determinations under detailed rules that set out the building block methodology to be applied. Appeals of the OEB's decisions are heard by the Divisional Court, which sits without experts given the nature of the review undertaken. There have been a number of judicial reviews of decisions by the OEB and the timeframes for the resolution of these judicial reviews far exceed the target three month time

of countries (New Zealand, the United Kingdom and Germany) with similar, incentive-based regulatory systems to Australia's are provided in the Appendix to this report.

The merits review regime that currently exists in New Zealand was introduced in 2008. When policymakers were considering the economic reforms that resulted in the introduction of the New Zealand merits review system, the Ministry of Economic Development (MED) noted that:[45]

> Regulatory decisions are complex and often require difficult judgements. A key design parameter of an effective regulatory regime is therefore to ensure that accountability mechanisms provide strong incentives for high-quality decision making by the regulator, error correction, and guidance to the regulator and stakeholders (so that the quality of decisions improves over time, and the regime is more predictable for those affected by it).
>
> While judicial review provides an important check on the regulator's decision and process, it can be argued to be insufficient because it does not provide for a check of the substance and reasoning of the decision itself.

MED went on to note that:[46]

> Availability of merits review, in addition to judicial review, may result in the following benefits:
>
> - strengthening incentives for high quality analysis and decision-making by the regulator;
> - correcting poor quality decisions in individual cases;
> - providing principles and guidance for future cases; and
> - reducing the incentive or need for resort to political processes/lobbying.

MED noted explicitly in its regulatory impact statement relating to the legislative amendments that introduced merits reviews in New Zealand that judicial reviews were insufficient protection against errors in regulatory decision-making, and that such errors could have an adverse effect on investor confidence:[47]

> The Commission's regulatory decisions are subject to judicial review only. There is a general perception that the accountability regime for the Commission is weak, as judicial review applies to questions of law and process only and not the substance of

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frame for LMR under the NEL and NGL. For example, in the three most recent cases, the shortest time for the resolution of a review was just under one year and in the other two cases was over two years.

45 New Zealand Ministry of Economic Development, Review of regulatory control provisions under the Commerce Act 1986: discussion document, April 2007, paras.47-48.

46 MED, Review of regulatory control provisions under the Commerce Act 1986: discussion document, April 2007, paras.221.

47 MED, Regulatory impact statement: Review of Parts 4 and 4A of the Commerce Act, p.39.

Options for reform proposed by the COAG Energy Council

> a decision. Thus the regime is less capable of correcting regulatory error or improving the regulator's decision making over time. This can impact on business/investor confidence in the regime.

In 2013, when the United Kingdom's merits review arrangements were re-examined, the Department of Business, Innovation and Skills (BIS), which led the reforms of the review arrangements, observed that:[48]

> The right of firms to appeal regulatory and competition decisions is central to ensuring robust decision-making and holding regulators to account in the interests of justice. Where firms are materially affected by regulatory decisions, they should have an effective right of challenge if they consider that the regulator has made a mistake or has not acted reasonably.

BIS went on to note that:[49]

> Appeals form a vital part of the regulatory decision-making framework.
>
> First, appeals are a way of holding regulators to account. Particularly where decisions have been delegated to independent public bodies, firms need to have a mechanism for challenging regulatory decisions in the interests of justice. This is necessary in order correct regulatory mistakes, and to ensure regulators are behaving in a reasonable and consistent way. Appeals are not the only form of accountability. For example, effective consultation and sharing of information during decision-making plays an important role. Nevertheless appeals are a key element.

3.1.2 Reviews of merits review arrangements overseas

From time to time, it is appropriate to consider whether the particular design of the merits review framework is fit-for-purpose, and whether it is meeting the original policy intent. The review of the LMR regime in 2012 is an example of this, and resulted in material changes aimed at improving the effectiveness of the regime. Similar assessments have occurred recently in other countries, including New Zealand and the United Kingdom, which we discuss briefly below.

New Zealand

In New Zealand, following the first merits review judgements handed down in 2013, the Ministry of Business, Innovation and Employment (MBIE)—the Ministry that took over the MED's functions—conducted an evaluation of the effectiveness of the New Zealand merits review arrangements. MBIE concluded that:[50]

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48 BIS, Streamlining Regulatory and Competition Appeals: Consultation on Options for Reform, 19 June 2013, p.4.

49 BIS, Streamlining Regulatory and Competition Appeals: Consultation on Options for Reform, 19 June 2013, p.10.

50 Ministry of Business, Innovation and Employment (MBIE), Part 4 of the Commerce Act 1986: Merits Review Regime Evaluation Summary Findings from Interviews with Stakeholders, April 2016, p.6.

> …the fundamental policy goals for instituting the merits review regime appear to have mainly been realised; in particular, to make the Commission more accountable for its IM determinations and to improve regulatory certainty.

However, MBIE's evaluation identified three areas for possible improvement:

1. The level of engagement of consumers in the regulatory process;
2. The effectiveness of the rules and processes followed by the review body (i.e., the High Court[51]) in assessing the review related material; and
3. The decision-making test that the High Court must apply when deciding whether the regulator's original decision should be amended or substituted.

Having identified these three issues, MBIE noted that further exploratory work may be required in three areas:

1. Improving targeted consumer engagement processes at the revenue reset stage (particularly to capture the views and participation of consumer groups and individual consumers, rather than just large users of energy);
2. Assessing whether hot-tubbing of experts should be employed by the High Court (to allow clearer elucidation of the technical evidence and issues that the High Court must assess as part of the review), and potential relaxation of the requirement that the review must be conducted only on the material that was available to the regulator that made the original decision; and
3. Assessing whether the 'materially better' test that the High Court must apply when considering whether the regulator's decision should be amended or substituted.

United Kingdom

Prior to November 2011 holders of licenses to supply regulated energy network services had the right to reject a price determination made by the Great Britain's energy regulator, Ofgem. Ofgem would then refer the regulatory determination to the appeal body, the Competition and Markets Authority (CMA),[52] for redetermination against a public interest test (i.e., whether the decision of the regulator operates, or may be expected to operate, against the public interest).

In 2011 the review arrangements were amended such that Ofgem now has the right to impose its decision on licensees (i.e., there is no longer a right to a *de novo* review), subject to the right of appeal by licensees to the CMA on specified

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51 Whilst these reviews are heard by the High Court, these proceedings are very clearly not judicial review processes (although judicial review is also open to parties affected by the regulator's decisions). The High Court is able to examine the merits of the Commerce Commission's Input Methodologies decisions by way of rehearing.

52 Prior to October 2013, the Competition Commission.

Options for reform proposed by the COAG Energy Council

grounds, a set of arrangements that might be described in summary as focused and merits based.[53]

The change from full *de novo* redetermination to limited reviews did not arise out of any expressed dissatisfaction on the part of stakeholders or policymakers with the previous system. The trigger for the change was solely the need for the appointed National Regulatory Authority, as specified under the European Commission's Third Package for energy, to be able to take "autonomous decisions"[54] and to be "functionally independent from any other public or private body."[55, 56]

The Department for Energy and Climate Change, which was responsible for implementing the Third Package, took the view, after receiving appropriate legal advice, that the previous arrangements did not comply with these requirements, as the ability of individual entities/the industry to force Ofgem to reconsider its decision or to have to revert to another party before proceeding did not provide sufficient autonomy and/or independence. The revised appeal arrangements allowed Ofgem to take the decision it considered appropriate unfettered, with the interests of licensees protected by the ability to appeal subsequently.

The identification of concerns should lead to targeted responses

It is noteworthy that, to the extent that shortcomings were identified in the design of the review arrangements in New Zealand and the United Kingdom, the response by policymakers was to make improvements to the arrangements that were targeted at addressing those concerns, thereby improving the effectiveness of the regime. Neither of these countries have sought to remove their merits review arrangements in response to concerns identified.

3.2 Transformation of the NEM and the need for investor confidence in the regulatory framework

The National Electricity Market (NEM) is currently facing transformational change, driven by Australia's commitment to the international climate change agreements (such as the 2016 Paris Agreement) and the emergence of renewable

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53 Northern Ireland's devolved authority has now adopted essentially identical appeal provisions, as of February 2015 (The Gas and Electricity Licence Modification and Appeals Regulations (Northern Ireland) 2015).

54 See Electricity Directive 2009/72/EC, article 35(5)(a), Gas Directive 2009/73/EC, article 37(5)(a).

55 See Electricity Directive 2009/72/EC, article 35(4)(a), Gas Directive 2009/73/EC, article 37(4)(a).

56 For discussion of the rationale for change, see for example "Implementation of the EU Third Package, Consultation on licence modification appeals", Department for Energy and Climate Change September 2010.

generation technologies. Electricity networks will need to play their part in facilitating this transformation through appropriate grid investments. However, these investments will only happen if investors are confident that the regulatory framework governing the NEM is stable and has built-in safeguards against material regulatory error.

3.2.1 Paris Agreement and the effects on grid capacity

The Climate Change Authority's recently released report on recommended mechanisms to be used to reduce greenhouse gases says that to achieve the obligations under the Paris Agreement:[57]

> The Authority recommends that an emissions intensity scheme should be introduced for electricity generators in 2018 to drive cost-effective emissions reductions in Australia's electricity supply (Chapters 5 and 9). The emissions intensity baseline should decline linearly to reach zero well before 2050 consistent with Australia's Paris Agreement obligations.

The Authority's modelling shows that to achieve this challenging emission reduction target there will need to be a transformation of the generation sector, moving from one dominated by coal fired generators to one that is supplied only by renewable generation. This transformation has to occur in a generation.

The topography of the current transmission system reflects the relatively slow evolution of the generation sector over the past hundred years. In the post-World War II period power stations have been located close to where the fuel was located rather than fuel being moved to power stations located near the source of demand (i.e., cities). The progressive addition of power stations since World War II has determined the topography and capacity of the high voltage grid. Transmission lines have been largely developed to transport and secure power transfers from power stations to the highly urbanised centres in each State. In more recent times transmission capacity has been developed to share power between the States through interconnectors.

One significant consequence of the Australian Government signing the Paris Agreement and committing the country to deep cuts in emissions from the electricity sector, is that the existing stock of power stations will close over the next 35 years. New low and zero emission power stations will need to be built to service growing demand.

As occurred in the post war period these new power stations will be located where there is low cost 'fuel' (wind and solar resources) and power generated at these sites will be transported to consumers. While it is likely that in the future a greater share than today of energy production will come from local and behind the meter

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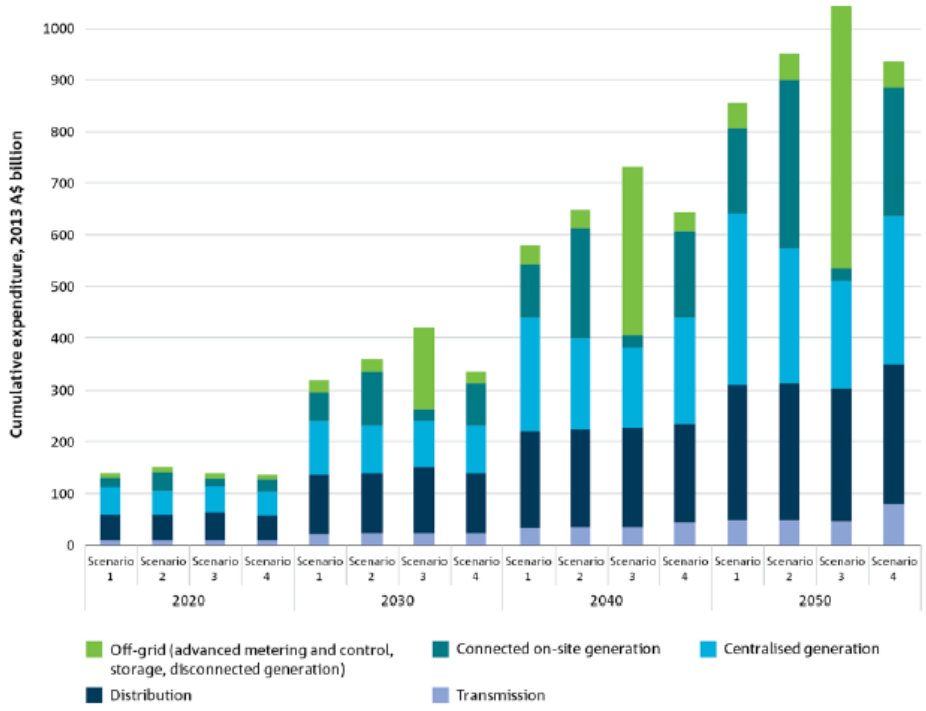
57 Climate Change Authority, Towards a Climate Policy Toolkit: Special Review on Australia's Climate Goals and Policies, August 2016, p7.

sources (e.g. on roof solar and micro wind), large scale grid connected renewable generators are likely to provide the bulk of power supplies.

There is no reason to believe that the existing power sites will be the best site for locating future wind and solar generators. To the extent that these new sources of renewable supply will be located in different areas than existing power stations, large investment in new grid infrastructure will be required. Recently, CSIRO presented analysis in its Future Grid Forum report that showed that cumulative expenditure on distribution and transmission network infrastructure is forecast to increase substantially under a range of scenarios, including a scenario in which investment in renewable generation increases materially.[58]

Figure 3: CSIRO's forecasts of cumulative system expenditure by scenario



Source: CSIRO, Change and choice: The Future Grid Forum's analysis of Australia's potential electricity pathways to 2050, December 2013, p.44
Notes: The four scenarios considered by CSIRO were: (1) Set and forget; (2) Rise of the prosumer; (3) Grid disconnection by users; and (4) Renewables thrive.

While some of this new network will be connection assets (the costs of which will be paid for by new generators), over time, more and more of this new grid capacity will be considered to be part of the meshed network (the costs of which will be borne directly by consumers). In any case, large amounts of new investment in

58 See: CSIRO, Change and choice: The Future Grid Forum's analysis of Australia's potential electricity pathways to 2050, December 2013.

networks systems will be required to support the Federal Government's commitment to the Paris Agreement.

3.2.2 The LMR regime promotes investor confidence

To ensure that the generation system can be transformed at least cost it will be important to ensure that there is an environment conducive to new transmission investment to support this transformation of the supply sector, including from private-sector investors.

Investors in electricity networks are typically committing capital that will be recovered only over very long timescales. Therefore, investors need to have confidence that the efficient capital they commit today will be recoverable. Safeguards built into the regulatory framework that protect against material regulatory error offers that confidence and is valued by investors.

In 2013, around the time of the legislative amendments concerning the LMR arrangements occurred, Royal Bank of Canada (RBC) conducted a survey of institutional investors in the Australian energy market. As Figure 4 shows, the survey found that 45% of respondents considered that regulatory uncertainty in Australia was "high" or "very high". It conducted the survey again in 2016, following the outcome of the Tribunal's merits review decision in respect of NSW and ACT networks, and found that the proportion of investors surveyed perceived regulatory uncertainty to be "high" or "very high" had declined to 29%.

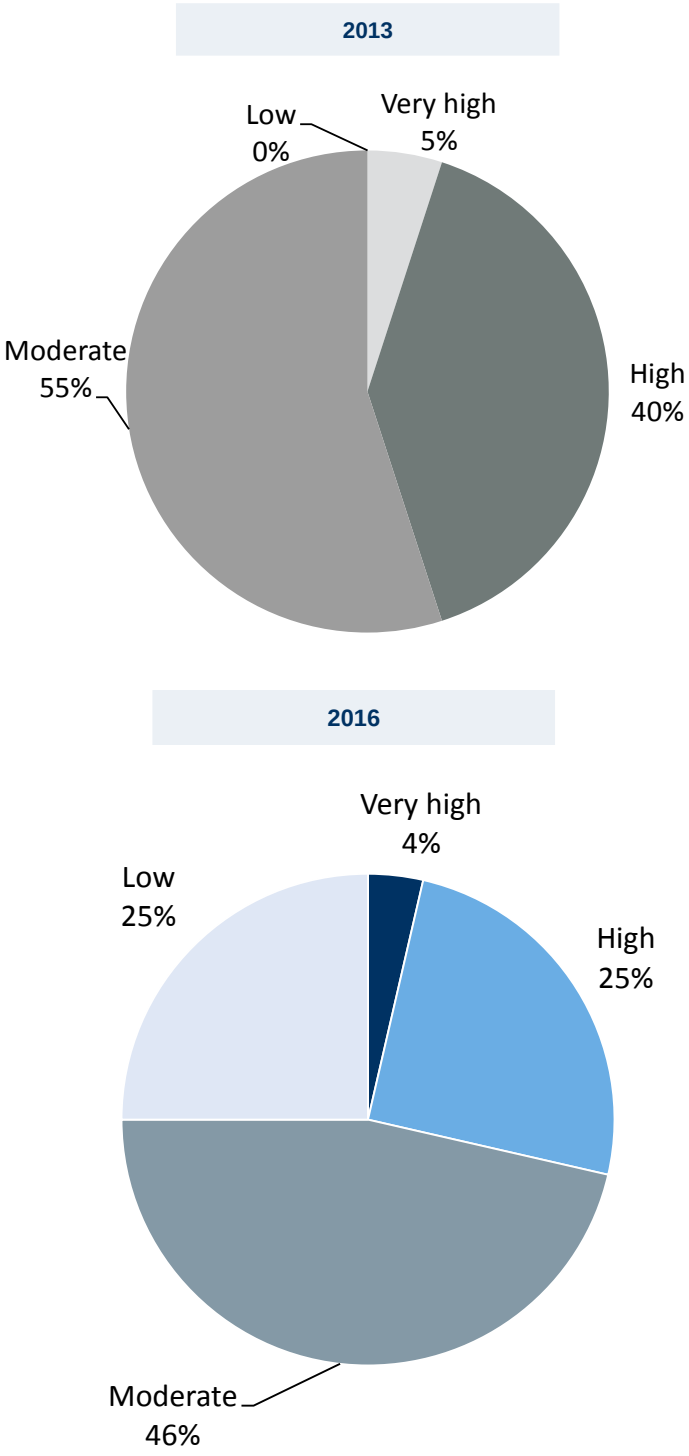
This figure is still worryingly high. However, the significant decline since 2013 is some evidence that investors considered that the LMR regime was working appropriately, by providing important checks and balances, correcting material errors, increasing the accountability to which the AER's decisions are held, and providing greater clarity over the interpretation of the NER and NGR. Current suggestions that the LMR regime should be removed is likely to undermine the confidence that has been gained since 2013.

As Figure 5 shows, in the 2016 survey, the overwhelming majority of investors (85%) said that the "agree" or "strongly agree" with the statement that:

> …a form of merits review crucial in terms of ensuring accountable and transparent decision-making by the AER

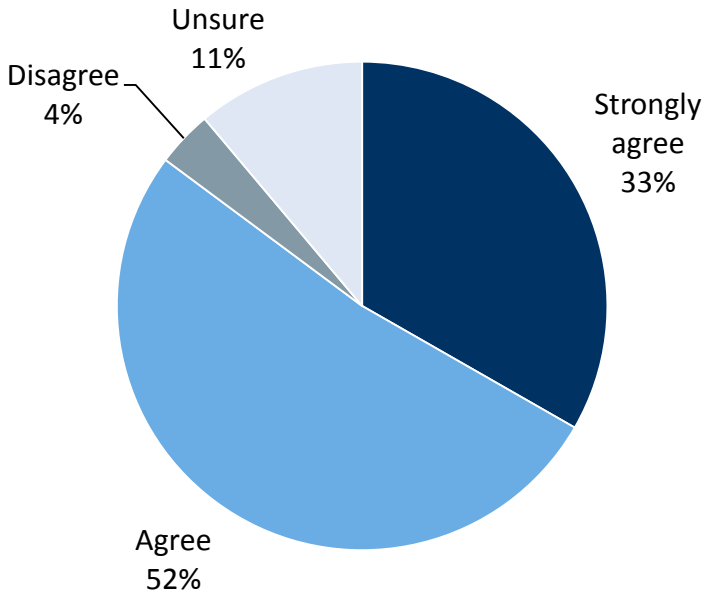
(In 2013, 61% of investors said that they "agree" or "strongly agree".) This once again highlights the value that investors place in the LMR regime in providing appropriate safeguards.

Figure 4: Investors' views on regulatory uncertainty in Australia 2013 vs 2016



Source: Royal Bank of Canada research

Figure 5: Is a form of merits review crucial in terms of ensuring accountable and transparent decision-making by the AER?



Source: Royal Bank of Canada research

This sentiment was supported in a June 2016 assessment by ratings agency Moody's:[59]

> Appeal process balances the Australian Energy Regulator's (AER) discretionary powers. The ability of the networks to contest the regulator's revenue/tariff decisions evidences limits on the increase since 2013 in the AER's level of discretionary power, and reinforces the transparency and predictability of the regulatory framework, a fundamental credit support for the networks.

In our view, the removal of the LMR regime would undermine seriously investor confidence and threaten the delivery of the investments that networks in the NEM must make in order to support the Government's commitment to meeting international climate change agreements.

3.3 Conclusion on status quo versus abolishment of LMR

Our key conclusions on the reform options put forward by the COAG Energy Council are the following:

59 Australian Regulated Electricity and Gas Networks – 2017 Outlook", Moody's, 14 June 2016

- The COAG Energy Council has raised some fundamental concerns about the existing LMR arrangements and these concerns should not be dismissed lightly.
- It is very unlikely that those concerns could be addressed if the LMR arrangements were to continue in their current form. In the face of those concerns, maintenance of the status quo (Option 1) is neither desirable (because that would do little to increase confidence in the existing LMR regime) nor a realistic prospect. It is necessary to put forward reforms that tackle squarely the concerns expressed about the existing LMR arrangements.
- However, abolishment of the LMR regime (Option 4) would not be a proportionate or effective response to the concerns raised by the COAG Energy Council. Adoption of such an option would remove some key benefits offered by the LMR arrangements at a time when increased confidence in the regulatory arrangements (through stronger accountability and robust decision-making) is needed in order to deliver the transformational investments required in the NEM, including by NSPs.
- The reform solutions pursued should be targeted at addressing the concerns identified. Some possible options are discussed in the remainder of this report.

4 Possible options for reforms

Section 2 discussed in some detail the concerns about the LMR regime raised by the COAG Energy Council in the consultation paper. This section discusses a number of reform options that could potentially address those concerns. The key reform options we discuss are the following:

1. Introduction of a binding and reviewable Rate of Return Methodology or restrictions on the grant of leave on overlapping rate of return issues;
2. Introduction of a more investigative approach to revenue resets with a view to clarifying and narrowing much earlier in the process any potential grounds for dispute, and elucidating complex and technical issues in a way that would promote better decision-making;
3. Amendments to materiality threshold to prevent applications concerning immaterial matters; and
4. Enhancement of the investigative powers of the Tribunal.

Some of these options relate predominately to changes to the revenue reset process, whilst other options relate to reforms to the merits review process. All of these options have strengths and limitations. This simply reflects the fact that the task of designing a merits review regime involves trade-offs.

We present below a menu of different options, which could be adopted individually or collectively. We do not set out prescriptive recommendations on which options should or must be adopted or preferred. However, we note that all of these options could potentially improve certain facets of the existing LMR regime, and help address the concerns expressed by the COAG Energy Council.

In developing these options, we have had regard to experience from different types of merits review regimes and regulatory systems in three different countries: New Zealand, the United Kingdom and Germany. Case studies from these countries are provided in the Appendix to this report, and where appropriate in this section, we refer to the relevant lessons from those review regimes.

4.1 Binding and reviewable Rate of Return Methodology

4.1.1 The problem

Of all successful applications for review since 2008, a relatively large proportion have related to rate of return matters. This is not surprising, given the typically large impact that the relatively small changes to the rate of return allowance has on NSPs' overall revenue allowances (by virtue of being applied to fairly large asset

values to calculate the return on capital).[60] As discussed in section 2.2, a fairly large number of recent applications for review (i.e., since 2013), related to rate of return matters, have occurred because the timing of review applications has been misaligned. As discussed above, this adds to the cost of LMRs.

4.1.2 The solution

Since a large proportion of reviews have related to the allowed rate of return, aligning those reviews into a single review process would potentially reduce the number of reviews sought, and therefore the duplication of review activity and costs. One way to align the reviews would be to make only the *methodology* used to determine the rate of return allowance reviewable.

There is currently a process that separates the development of rate of return methodologies and implementation of those methodologies—namely, the Rate of Return Guideline (which was introduced by the 2012 rule change process). However, the Guideline is not reviewable and is not binding on the AER.

One option would be to change the nature of the Guideline so that it would be binding and would be reviewable in its own right. There is precedent for such an approach overseas: the Input Methodologies (IMs) approach that the New Zealand Commerce Commission must follow. The IMs involve the setting of upfront methodologies by the regulator, which may then be subject to merits reviews. The implementation of those methodologies (once settled) may only be subject to judicial review.

Example: New Zealand Input Methodologies system

When the current regulatory arrangements in New Zealand were introduced in 2008, a merits review regime was introduced concurrently. The principal objectives of the merits review regime were to make the Commission more accountable, and to strengthen incentives for it to make well-considered and high-quality decisions.

However, given the relatively large number of businesses regulated by a relatively small agency such as the Commission, policymakers were acutely aware of the scope for:[61]

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60 Appeals in relation to the rate of return are not uncommon in other jurisdictions either. As the Appendix to this report notes, merits reviews conducted in New Zealand, the United Kingdom and in Germany particularly have featured disputes over the rate of return issues.

61 Under Part 4 of the Commerce Act 1986, the Commission makes price-quality determinations for 17 electricity distribution businesses; 1 transmission business; 4 gas distribution pipelines; and 1 gas transmission business. Under the same piece of legislation, the Commission is responsible for monitoring the performance of all of the businesses above, as well as 12 further 'consumer-owned' electricity distribution businesses that are exempt from price-quality regulation, and 3 major New Zealand airports.

- A proliferation of expensive merits reviews that would tie up inefficiently the Commission's valuable resources; and
- The use of merits reviews as a gaming tool (e.g., to slow down the regulatory process).

It was an explicit objective of policymakers to ensure that the new regulatory system was as streamlined and as low-cost as possible.

A key part of the solution developed by policymakers was the explicit separation between two parts of the decision-making process that all regulators follow and almost universally combine:

- The development of IMs, which specify the "regulatory methodologies, rules, processes, requirements and evaluation criteria" that the Commission must follow when making its price-quality determinations; and
- The implementation of those IMs to make regulatory decisions.

Under this framework, much of the Commission's work is front-loaded into developing the IMs. These IMs are intended to be extremely detailed and prescriptive, setting out how it will make each constituent part of its overall price-quality decision, as well as the processes it will follow in making those decisions. The IMs are binding on the Commission. The binding and prescriptive nature of the IMs are important points of difference from the AER's Rate of Return Guideline, which is neither.

The IMs must, by law, be reviewed by the Commission at least every seven years to ensure that they continue to be fit for purpose. The Commission can initiate more frequent reviews, and has done so. However, it was not envisaged that fundamental revisions would occur less frequently than the seven-year cycle. A key objective of setting up-front rules in this way was to provide consumers, regulated businesses and other stakeholders a high level of certainty about the regulatory process (including being able to predict with a high degree of confidence the way in which the Commission would make decisions).

Two critical aspects of the New Zealand system are the following:

- The IMs that apply to all businesses regulated under Part 4 are developed simultaneously, through a single process; and
- Only the IMs (and not the subsequent regulatory decisions that apply those IMs) may be subject to merits review. The regulatory decisions that relate to individual businesses may be subjected to a judicial review process if the relevant stakeholders consider that the Commission has failed to apply the IMs correctly. In such a process, only matters of law may be examined. Certain other regulatory decisions relating to individual or customised price-quality paths may also be appealed.

Possible options for reforms

The process for merits reviews of the IMs is set out in Subpart 3 of Part 4 of the Commerce Act 1986 (NZ). While the merits review is heard by the High Court of New Zealand, the process is not one of judicial review. In particular, the High Court must sit with two lay members (unless the court considers that only one is required) and must be by way of rehearing conducted solely on the basis of the documentary information and views that were before the Commission when determining the IMs.[62] These reviews are very clearly merits reviews.

The composition and function of the High Court when determining merits reviews of IMs is therefore very similar to the composition and function of the Tribunal when considering merits reviews of the AER's determinations. Indeed, some of the lay members of the Tribunal are also appointed as lay members to the High Court.

The merits review function was given to the High Court in New Zealand rather than a specialist body, such as the Tribunal in Australia, because of the expected lower volume of cases given the limited jurisdiction in New Zealand for a specialist body (where the High Court also fulfils functions in competition law similar to those fulfilled by the Tribunal). While this likely reduced the costs of establishing and maintaining the review body in New Zealand, it has also required merits review hearing of the IMs to be fitted into the High Court's calendar, which has contributed to delays in resolving the merits review applications that have been heard in New Zealand to date.

The New Zealand system has a number of key features that relate to the proposal of the binding and reviewable Rate of Return Methodology described above:

- All merits review applications (i.e., from all parties), on all issues, have in practice been heard at once as part of a single process. This avoids duplication of appeals and the costs and uncertainties attendant to staggered/overlapping merits reviews.
- Because the IMs for all regulated businesses are developed concurrently, at the conclusion of that process all stakeholders (including consumers and businesses) have a clear understanding of how the Commission intends to make its regulatory decisions. In other words, it improves regulatory transparency. This places all parties on an equal footing to be able to evaluate the strengths and weaknesses of the methodologies and processes the Commission intends to employ in its decisions, and to decide whether merits reviews should be sought.
- The Commission's decisions (e.g., the setting of price-quality paths) becomes a relatively mechanistic application of the upfront IMs. This would tend to lower the overall cost of the decision-making process.

62 Section 52ZA(2) and (3) of the *Commerce Act 1986* (NZ).

Adaption to the Australian context

New Zealand's IM approach could be adapted to Australia in the following way:

- The AER would develop a detailed Rate of Return Methodology that specifies upfront precisely the methodologies that the AER would use to determine the allowed rate of return. In a 2011 rule change proposal, the AER proposed a similar approach, whereby it would conduct periodic "WACC reviews" that would "be undertaken outside of reviews of access arrangements". In relation to that rule change proposal, the AER proposed that "the rates of return that service providers propose in access arrangement proposals would need to be consistent with the most recent 'statement on the cost of capital' published at the end of each WACC review." (in other words, the outcomes of the WACC reviews would be binding on NSPs).[63]
- Unlike the current Guideline developed by the AER, the Rate of Return Methodology would be prescriptive and binding on the AER. In fact, the phraseology "Guidelines" is unhelpful in this context because it implies some future discretion may be available to the AER when implementing the methodology. It would not have such discretion when implementing the Rate of Return Methodology when making revenue reset decisions. It would therefore be better to replace the term "Guideline" with "Methodology", which is the language used in the Commerce Act 1986 (NZ).[64] The question of prescription versus discretion is dealt with in section 4.1.4 below.
- Any parties that wish to challenge this Rate of Return Methodology may make an application for a merits review to the relevant review body. All merits review applications would be heard through a single, streamlined review process.
- As under the existing system, the review body may uphold the AER's original decision, substitute its own decision, or remit the matter back to the AER for reconsideration with orders to remake the original decision.
- The final Rate of Return Methodology would then be applied by the AER when making its individual revenue reset decisions.
- Any parties concerned that the AER has not applied the Rate of Return Methodology correctly when making its revenue reset decisions may only seek a judicial review rather than a merits review of those decisions.
- The Rate of Return Methodology would need to be reviewed periodically, through a full consultative process, to ensure that it remains fit for purpose.

63 AER, Price and revenue regulation of gas distribution and transmission services AER's proposed changes to the rate of return provisions of the National Gas Rules, September 2011, section 2.

64 See Subpart 3 of Part 4 of the Commerce Act 1986 (NZ).

Statutory timeframes for reviews of the Rate of Return Methodology would need to be specified in the NER/NGR.

- The AER would have the ability to initiate more frequent reviews of the Rate of Return Methodology. Relatively minor reviews (e.g., to correct minor errors) may be initiated by the AER. However, the AER would only be able to initiate more fundamental reviews, within the timeframes set out in statute, if requested to do so by a relevant stakeholder, and only if the reasons for the review sought satisfy criteria for interim reviews. These criteria would need to be developed and specified in the NER/NGR. Such a restriction would be needed to ensure that the Rate of Return Methodology provides all stakeholders with certainty over how the AER will determine rate of return allowances.
- Any revisions must be consistent with the NER/NGR prevailing at the time.
- A change to the NER/NGR may be one of the criteria that would allow a major interim review of the IMs to be conducted. Any interim revisions to the Rate of Return Methodology may not be used to vary extant regulatory determinations (i.e., determinations still in force). They would only be applicable to any new determinations made.[65]

4.1.3 Potential benefits

The key advantage of an IM approach of the kind outlined above is that it would allow affected parties to seek merits reviews of those decisions but through a single process that would reduce significantly the costs associated with multiple and staggered appeals.

This approach would also help address possible concerns held by the AER that NSPs currently do not raise concerns early about the approaches it intends to apply (as signalled in its Guidelines), but rather seek to ventilate those disagreements through expensive and disruptive appeals.

4.1.4 Potential limitations of Rate of Return Methodology option

A process that involves the development of methodologies in the abstract (i.e., before they are actually applied in practice to actual data, and without consideration of the real world impacts on NSPs and consumers) may create risks. Often, regulatory methodologies are developed and refined iteratively, by trying different

65 Suppose a set of IMs were finalised in 2020 and, subsequently, a reset decision for the period 2022-2027 is finalised by the AER. However, in 2025, an interim revision to the IMs is made. This revision could not be used to vary retrospectively the decision relating to the period 2022-2027; it may only affect any subsequent reset decisions made by the AER.

approaches, evaluating the results to check if they are reasonable, and then refining further.

As a result, selecting methods in advance of actually applying them may result in inappropriate methods being adopted. Under the Rate of Return Methodology approach, that might become apparent only once it has been implemented in a decision. At that point, there would be no scope for any merits review (for consumers or NSPs) in order to remedy the error.[66] This problem may be solved by the AER reviewing the Rate of Return Methodology where it has resulted in the adoption of inappropriate methods, but this review will take time and (other than a periodic review) would be at the AER's discretion.

Another consideration is that changing market circumstances may warrant the adaptation of the methodology used to determine the rate of return allowance. This was apparent in the wake of the Global Financial Crisis, during which time financial market conditions were distorted, and the old rate of return methodology specified in the Rules at the time was considered by many, including the AEMC, to no longer be fit for purpose. Indeed, a key motivation for changes to the NER and NGR in 2012 was to move away from a prescriptive set of Rules that specified a very narrow set of estimation methods, financial models, and market data, which prevented the AER from adapting its approach in response to changing market circumstances. However, the Rate of Return Methodology would not be fixed for all time. While the Rate of Return Methodology would be sufficiently specified to provide NSPs and consumers certainty, it would be subject to periodic review by the AER (and review at the AER's discretion) so as to safeguard against it becoming inconsistent with market conditions. Again, such a review is likely to take time.

4.1.5 Alternative solution: Restrictions on the grant of leave on overlapping rate of return issues

The consultation paper notes correctly that there have been a relatively high number of applications for review since the legislative amendments in 2013. As discussed in section 2.2, a number of these applications relate to the same or very similar grounds for review, and that these serial or overlapping applications have occurred because parties have sought, reasonably, to preserve their legal positions pending the outcome of an ongoing review process. As a consequence, the number of reviews sought has been high, and the AER has had to commit resources to participating in each of those review applications.

One means of addressing the issue of serial applications (which would be low-cost and a more incremental reform than the Rate of Return Methodology option

66 If the AER has applied its Rate of Return Methodology faithfully, there would be no scope for seeking a judicial review either.

discussed above) would be to revise the way in which the Tribunal grants leave to seek review. Under these revised arrangements:

- The Tribunal must defer leave to seek review on grounds the same as or substantially similar to grounds that have been dealt with or are being dealt with in other proceedings before the Tribunal, unless the Tribunal is positively satisfied that there is a real chance that the new expert opinion or data will result in a different determination.
- Where leave has been deferred or a new application made, and the other matter determined, the Tribunal has the power, on the application of a party to the proceedings, to make the same orders in relation to the application before it as in the other matter where it is satisfied that the Tribunal has dealt with the same or substantially similar grounds (i.e., orders to affirm, vary or set aside and remit the AER's decision may be applied). The power of the Tribunal to make the subsequent orders should be discretionary so that an applicant for review does not gain the benefit arising from a successful ground claimed by another party if the applicant had not "raised and maintained" the same matter before the AER.

Such a provision may, in principle, have obviated the need for the Tribunal to hear the Victorian DNSPs merits review applications to the extent they dealt with matters already addressed by the Tribunal and the merits review application of SA Power Networks may have been deferred until the NSW and ACT merits review cases had been determined.[67]

4.1.6 Implementation

Rate of Return Methodology

The implementation of a binding Rate of Return Methodology would require amendment to both the rules, and the NEL and NGL.

The AEMC has responsibility for the rule making functions under the NEL and NGL and it would have to complete the consultation process set out in the NEL and NGL before it amended the rules. The COAG Energy Council may implement these reforms by making a rule change request to the AEMC. Alternatively, the COAG Energy Council may request the AEMC to conduct a review in relation to the effectiveness of the AER's decision-making processes for determining resets. Possible reforms to the rules to address the concerns described above would be considered in this review by the AEMC.

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67 Of course, this provision would not have prevented the uncertainty that has been created for the Victorian DNSPs and consumers as a result of the AER subsequently seeking a judicial review on these matters.

The current rules in clauses 6.5.2 and 6A.6.2 of the NER and clause 87 of the NGR provide a starting point for the consultation process to develop the Rate of Return Methodology. However amendment would be required to specify that the Rate of Return Methodology is binding on the AER and to require the AER to apply it when determining the return on equity and return on debt in the reset process. The AER would develop the Rate of Return Methodology in accordance with consultation procedures, which would include a requirement to hold a "hot-tub" (discussed further in section 4.2). The Rate of Return Methodology would also have to be reviewed using the same process periodically.

Amendments to the NEL and NGL would also be required. These amendments would provide that the determination of the Rate of Return Methodology is a "reviewable regulatory determination" under section 71A of the NEL and 244 of the NGL (this could also be done by regulation) and restrict the Tribunal from granting leave to appeal or intervene in any merits review application of a reset on a matter that is dealt with by the Rate of Return Methodology. The NEL and NGL would also have to address what happens following a successful review of the Rate of Return Methodology for those NSPs that the AER has made decisions in the interim.

The current Rate of Return Guideline developed by the AER in 2013 may form the basis for the new Rate of Return Methodology. However, given the significance of having a binding methodology, we consider that it is necessary to undertake consultation again with that known to interested parties. In any case, the current Rate of Return Guideline is due to be reviewed over the next two years. The development of these Rate of Return Methodologies would be a process that may be time-consuming. However, it is unlikely to be significantly more time-consuming than the development of the current rate of return guidelines.

We note that the proposed changes would result in the separation of merits reviews on the Rate of Return Methodology and other matters dealt with by the AER's decisions in respect of each NSP. This contradicts the holistic assessment of the AER's decisions by the Tribunal that was intended as a result of the 2013 reforms to the NEL and NGL. In addition, there are likely to be transitional issues given that the AER would be required to make reset determinations while the Rate of Return Methodology is developed.

Restrictions on the grant of leave on overlapping rate of return issues

To implement this reform, the NEL and NGL would need to be amended to include a new provision in Division 3A of Part 6 of the NEL and Part 5 of Chapter 8 of the NGL so that the Tribunal must defer subsequent merits review applications if the issue has already been raised in a matter before the Tribunal with the Tribunal given powers to grant orders and apply the decision in the subsequent merits application at its discretion as described above.

The effect of this amendment is to incentivise potential applicants and interveners to intervene in the first merits review application that raises the relevant issue because later merits review applications bringing the same issue will be deferred by the Tribunal. This formalises the approach of the NSPs in the NSW and ACT merits review cases and the merits review applications that have followed it where grounds on the return on equity have largely ceased to be pressed by the NSPs following the Tribunal's decision in the NSW and ACT merits review cases. The suggested amendments would ensure that this is the case given that the second merits review application would also fail if the first merits review application failed unless the Tribunal is satisfied that there is new expert opinion or data will result in a different determination. On the other hand, subsequent merits review applications would also have the orders made in the first application applied to them (being to affirm, vary or stay and remit the AER's decision) at the discretion of the Tribunal and provided the relevant NSP had "raised and maintained" the issue.

However, this amendment has the potential to prevent the holistic assessment by the Tribunal of the whole of the AER's decision and the interrelationships between the constituent components and may allow opportunistic applicants to seek to have the orders made in the first merits review application applied to them where they have not "raised and maintained" the issue. The second risk is dealt with in the discretion given to the Tribunal to make the same orders in the subsequent merits review application.

There may also be delays in the resolution of later merits review applications as they have to wait until the first merits review application has been dealt with by the Tribunal. However, in practice the delay is likely to be less extensive than is currently the case given that currently the later merits review applications have to be heard again on the issue that has already been considered whereas the amendment allows for the later merits review applications to have the benefit of the decision in the first merits review application at the Tribunal's discretion. This is also likely to result in a reduction in the costs of merits reviews, particularly on rate of return issues.

4.2 More investigative approach to revenue resets

4.2.1 The problem

The current approach to regulatory resets could be enhanced by the AER taking a more investigative approach. At present:

- NSPs submit proposals to the AER;
- the AER conducts its own analysis, or engages its own experts to conduct analysis (usually at arm's length to the NSPs) as a way of testing the proposals;

- the AER presents its views in a draft decision as a way eliciting responses and further evidence from stakeholders; and
- once such evidence is considered, the AER publishes its final decisions.

On issues that are the subject of expert opinion (being the return on equity, the return on debt, the estimation of the cost of corporate income tax and the benchmarking techniques) the process before the AER generally involves experts retained by the AER, NSPs and consumer groups contending competing methodologies and/or matters of expert opinion. This process before the AER, and subsequently before the Tribunal that reviews the materials before the AER, leads to a phenomenon of competing expert opinions that often does not assist in elucidating the matters generally in dispute and therefore does not assist either decision maker in reaching a decision consistent with the rules and the long term interests of consumers.

The fundamental character of current processes that limit the Tribunal to reviewing the materials before the AER means that there is a risk of sub-optimal decision making by both the AER and the Tribunal unless this issue is addressed.

4.2.2 The solution

Hot-tubbing of experts

Whilst an adversarial approach can be useful in eliciting the strongest arguments from all parties, a more investigative revenue reset process could be useful in clarifying the areas of agreement and disagreement. The way to address this issue is to require the AER to convene hearings at which experts engage directly with each other to clarify matters on which they agree and do not agree, and the reasons for any lack of agreement ("hot tubs").

During a "hot-tubbing" forum, the AER Board Members and Staff could:

- Put questions directly to experts from all sides, including the AER's experts, to gain a more profound understanding of the issues, and to clarify the areas of agreement and disagreement; and
- Test the opinions of different experts directly, and by allowing experts to respond to one another's arguments.

Forums such as these have been used successfully in other jurisdictions. By way of example, the New Zealand Commerce Commission held such a session on 7 September 2016 to test the views of various parties (including consumers and users) and their experts on a number of rate of return issues. This session was part of the Commission's ongoing IMs review.

The AER could be given the option of asking experts involved in the hot-tubbing forum to prepare a joint report that sets out clearly:

- The areas of common ground;

- The areas of disagreement;
- Each expert's opinion on a particular issue; and
- The evidence in support of each expert's opinion.

If this process is required by both the AER, and is permitted for the Tribunal (as discussed at 4.4 below), we expect that the "wall of paperwork" that the AER presently has to contend with would be reduced and the ability of both decision makers to make the best possible decision that is consistent with the rules and the long term interests of consumers would be enhanced.

Workshops

The AER could also convene workshops that allow the AER Board Members and Staff to question and hear directly from NSPs, including internal technical experts such as engineers and treasury teams. Whilst the AER has used such workshops in the past they have been limited to workshops in relation to the development of guidelines and frameworks of approach rather than as an investigative tool in relation to a NSP proposal. Workshops could be used more routinely, particularly as a tool to build more constructive relationships between the AER and stakeholders, and for the AER to gain more practical insights into the day-to-day operations of the NSPs.

Issues papers

Clauses 6.9.3(b) and 6A.11.3(b) of the NER provide that the AER must publish an issues paper not more than 40 business days after the submission of a revenue proposal by an electricity NSP, as well as invitations for written submissions on the issues paper and to attend a public forum on the issues paper. There is no analogous requirement in the NGR.

Although the AER has published issues papers in accordance with these clauses, these issues papers have, to date, been fairly high level in the sense that they:

- Set out the AER's initial observations on NSPs' proposals (typically summarising the key elements of the proposal); and
- Signal the way in which the AER intends to assess the proposal.

The issues papers are currently aimed at helping consumers particularly to understand the main aspects of the proposals so as to make it easier for consumers to engage in the consultation process.

Whilst this is useful in assisting with consumer participation, the issues papers could go further by:

- setting out the AER's reflections on the robustness/comprehensiveness of NSPs' proposals;

- identifying and gaps in the NSPs' analysis and areas in which the AER is seeking more detailed analysis and evidence; and
- identifying any areas of the NSP's proposal that raises particular concerns for the AER.

The issues papers currently published by the AER do not do this to any great extent.

The idea would be to signal clearly and early to NSPs (and other stakeholders) any matters on which the AER is likely to require assistance in its deliberations so that NSPs and other stakeholders can focus their efforts in compiling the analysis and evidence that would be of most use to the AER. This avoids material and contentious new issues being raised late in the process (i.e., following the AER's publication of its Draft Decision), at which point there may be too little time or opportunity to provide relevant material that would usefully inform the AER's decision. This, in turn, would lower the likelihood of review being sought because more matters may be resolved between AER and parties before the conclusion of the reset stage.

The requirement for the AER to publish issues papers in relation to gas NSPs could also be introduced in the NGR.

Enhanced consumer participation in the reset process

The consultation paper expresses two chief concerns about the extent to which consumers are represented through the review process:

- Firstly, the COAG Energy Council is concerned that consumers may have limited ability to access the review process without costly legal representation, despite one of the key objectives of the 2013 legislative changes being to increase consumer participation in the LMR process. For instance, the consultation paper notes the following:[68]

  > Other areas for consideration include that the LMR regime is not delivering timely and predictable revenue determinations and continues to present barriers to the participation of key stakeholders, such as consumer groups.

- Secondly, whilst the materially preferable test was introduced as part of the 2013 legislative changes in order to ensure that the LMR changes promote the long-term interests of consumers, there seems to be an overarching concern that it is unclear that recent decisions by the Tribunal have achieved this. This issue was discussed in section 2.3.2.

In our view, the most effective way of ensuring that consumers are represented properly in the LMR process is to ensure strong participation by consumer groups

68 Consultation paper, p.4.

at the revenue reset stage. The NEL and NGL provide that the Tribunal must not grant leave to any party, either as an intervener or applicant, if that party has not raised and maintained the matter before the AER. This requires meaningful participation throughout the reset process. If consumers are absent from the reset process, they will be unable to act as contradictors to NSPs, or applicants in their own right, through any subsequent LMR process. Therefore, in order to address the COAG Energy Council's concerns around consumer access to the review process, it is essential that proper consideration be given to consumers' participation in the revenue reset process.

Further, to the extent that both the AER (and the Tribunal) must make decisions that best promote the long-term interest of consumers, it is desirable that consumers contribute through the reset process to help the AER interpret properly what the NEO and the NGO mean — including, how considerations about price should be traded off against quality, safety, reliability and security of supply. And, as we noted in section 2.2, it is important that consumer groups frame their contributions to the reset process in a meaningful way that assists the AER when it makes its revenue reset decisions.

Following changes introduced by the AER in 2013, consumers are now more active in the AER's revenue process than ever before. For instance, the AER has published best practice guidelines to help regulated networks engage more effectively with their consumers, particularly when developing their regulatory proposals.[69] The AER has also recently established a Consumer Challenge Panel comprised of experts in economics, law, regulation, energy networks and consumer advocacy to provide feedback to the AER on:

- whether NSPs' regulatory proposals are in the long term interests of consumers; and
- the effectiveness of the NSPs' engagement with their customers and how that engagement has been reflected in their proposals to the AER.

The AER has taken account of this feedback in its decisions since 2013.

The improved involvement of consumer groups through the regulatory process means that they are better informed and positioned to participate in the LMR process than they have been in the past. Indeed, we have already seen evidence of this first with PIAC successfully obtaining leave from the Tribunal to appeal (when similar groups have in the past failed to do so),[70] and then mounting competent challenges through the review process. It seems likely that with the growing

69 The process that resulted in the development of these guidelines, known as the AER's Better Regulation reforms, was guided by input from a consumer reference panel convened by the AER.

70 See, for example, Biggar, D. (2011), Public utility regulation in Australia: Where have we got to? Where should we be going? ACCC/AER Working Paper No.4, July, pp 16-18.

engagement of consumers through the AER's revenue reset processes, they will be increasingly well-equipped to contribute to the review process.

Further, as discussed in section 2.2, the establishment of ECA as a peak consumer body in 2015, with an explicit mandate to "promote the long term interests of consumers of energy with respect to the price, quality, safety, reliability and security of supply of energy services…" is likely to provide an effective vehicle for enhanced consumer participation at the revenue reset stage.

The preceding discussion suggests that there have been some very encouraging developments since 2013 concerning the role of consumers during both the revenue reset stage and also at the LMR stage. If the COAG Energy Council considers that even greater participation of consumers at the review stage is desirable, it would be necessary to ensure that ECA has sufficient resourcing to participate effectively in the regulatory and review processes.

4.2.3 Potential benefits

It is worth noting that the AER has, on occasion, employed some of the approaches discussed above. For instance, when the AER conducted 2008 'Electricity transmission and distribution WACC parameters review', the AER arranged an experts' roundtable session to explore technical rate of return issues in greater depth and draw out areas of consensus between different experts. We understand that in 2013 the AER sought input from NSPs on the terms of reference for a study that was commissioned by the AER on beta (an input into the rate of return allowance).

These are examples of very positive and helpful initiatives by the AER to build consensus, participation by stakeholders, and to clarify areas of disagreement. However, initiatives such as these, and those described above, could be used more frequently as part of the revenue reset process.

In a recent presentation at the 2016 ACCC Regulatory Conference, Professor (adjunct) Scott Hempling observed the following:[71]

> Most regulatory hearings are a cross between boxing and ping pong. Questions and answers fly between lawyer and witness, each trying to out hit, out fake, out spin and occasionally out smart the other. Based on parties' positions rather than the public's needs, the verbal friction produces more heat than light, the ratio of useful information to hours consumed always low. Through most of this counterpunching, the commissioners are spectators. This approach induces a host of suboptimal behaviors...

[71] Hempling, S. (2016), Effective Regulatory Procedures: Purposes, Practices and Paths, ACCC Regulatory Conference: Brisbane, August.

Whilst Professor Hempling's statements referred specifically to regulatory hearings, the same can be said for adversarial regulatory processes in general.

Professor Hempling then went on to argue that a more collaborative and investigative process is likely to deliver much better regulatory outcomes for consumers. The approach recommended by Professor Hempling is consistent with the approach that we outline above, which is intended to invert the outcomes described in Professor Hempling's quote by producing "more light than heat".

The main advantages of this more investigative approach to revenue resets are:

- Greater clarity of issues for the AER, which means that it can focus its efforts on those areas of greatest contention, rather than all matters that may be raised by experts on any side. This would generally streamline the revenue reset process.
- Sharper focus on areas of disagreement between experts, and testing of experts' arguments directly, to aid the relevant review body through any subsequent merits review process.
- A more collaborative and collegial approach to the regulatory process that would help neutralise the highly adversarial sentiment that currently prevails.

Note that the option outlined above would not be a substitute for a LMR system; rather it would complement the LMR arrangements and help streamline reviews by narrowing the grounds for potential dispute between stakeholders and the AER.

4.2.4 Potential limitations

The main perceived disadvantage of such an approach might be difficulty in scheduling within an already crowded regulatory timetable opportunities for such forums and interaction between experts. However, as discussed above, such approaches may in fact streamline the reset process and create more room for the AER within the limited time available to focus on the issues that matter most.

4.2.5 Implementation

The implementation of each of these options as mandatory requirements in the AER's decision-making process would require the amendment of the rules. The issues discussed in section 4.1.6 apply.

In order to implement these reforms, the rules would need to be amended to require:

- The AER to publish a sufficiently detailed issues paper, following the submission of a proposal by a NSP, that identifies early in the process any key areas of contention or concern in the NSP's proposal, and the analysis and evidence that the AER would find useful to resolve those matters to its satisfaction. This would allow NSPs and interested parties to respond in a

useful, fulsome and targeted way to any areas of concern identified by the AER, early on, during the reset process; and

- The AER to hold "hot-tubs" of experts and workshops with the NSPs on the issues identified in the issues paper following its publication.

While the AER has the discretion to identify issues for NSPs, hold joint hearings of experts and workshops and has done so in the past, the purpose of this reform is to require the AER to implement these steps in its decision-making process for the reset of each NSP.

The amendments would result in the issues relevant to the AER's deliberations being crystallised earlier so that the NSP and other interested parties can appropriately direct their submissions to the matters in issue, and so that the AER, NSP and other interested parties have an opportunity to explore the expert opinions with the experts and the factual background of the NSP. Consequential amendments to the rules are likely to be required to require the AER to justify any new issues raised later in the process so as to ensure that the issues papers it publishes are a clear, early signal to the NSP and interested parties of any material concerns that the AER may have about the proposal. In addition, procedural requirements for the "hot tubs" and workshops would need to be set out.

We do not consider that an extension in the timeframe for the AER's decision-making would be required if these steps were incorporated into the decision-making process.

4.3 Amendment to materiality thresholds

4.3.1 The problem

Underpinning the broader concern about too large a number of applications for LMR (compared to what was envisaged by the original policy intent), may be a concern that too many applications have concerned trivial matters.

4.3.2 The solution

If that is the case, one solution might be to amend the existing financial thresholds that must be satisfied before the Tribunal may grant leave to seek review. At present, s 71F(2) of the NEL provides that:

> …the Tribunal must not grant leave to apply under section 71B(1) even if there is a serious issue to be heard and determined as to whether a ground for review set out in section 71C(1) exists unless the amount that is specified in or derived from the decision exceeds the lesser of $5 000 000 or 2% of the average annual regulated revenue of the regulated network service provider.

An analogous provision exists in s 249(2) of the NGL.

The amendment to the thresholds for leave may be in two parts.

- Firstly, the financial thresholds relating to materiality could be raised in absolute terms.
- Secondly, the thresholds could be specified such that *each* ground of review must satisfy the threshold, rather than apply cumulatively to all grounds of review.

Amending the financial thresholds in this way would prevent parties from seeking review on individual grounds that are not material in their own right.

4.3.3 Implementation

Amendments to section 71F of the NEL and section 249 of the NGL would be required to increase the financial threshold and/or to clarify that the threshold applies to each ground individually.

4.4 More investigative Tribunal

4.4.1 The problem

The COAG Energy Council's consultation paper raises a number of concerns about the quasi-judicial and legalistic character of the existing review body, the Tribunal, and questions whether a review body that is more "investigatory" in nature would be more effective than the Tribunal in its current form.

The main concerns raised by the COAG Energy Council's consultation paper are the following:[72]

- Regulatory determinations of the type issued by the AER are very complex and technical. The tight timeframes for reviews of energy decisions (i.e., three months, with the scope for extensions if required) and the access to a limited pool of suitably qualified experts without conflicts of interest may hinder a quasi-judicial body such as the Tribunal to evaluate the merits of the AER's decisions properly.
- The inherently legalistic nature of the Tribunal's process:
  - Leans towards a highly adversarial approach that tends to result in binary decisions;
  - Could create a barrier to consumer participation as the scope for meaningful consumer participation is limited without costly legal representation.

Implicit to the point about the Tribunal's decisions leading to binary outcomes is an assumption that the current LMR arrangements provide NSPs with a 'one-way

72 Consultation paper, pp.13-14.

bet'—i.e., there is no downside to seeking review, only upside, because the Tribunal cannot make a determination that puts the NSPs in a worse position than they would be in under the AER's original decision. This assumption is incorrect. As discussed in section 2.2, the ability for consumers and users to participate as interveners and/or applicants can and has in recent cases offered a contraposition to arguments put forward by NSPs.[73] In addition, the ability for the AER to draw the Tribunal's attention to interrelated parts of its decision, and the introduction of requirements on the Tribunal, in 2013, to consider such interrelationships, also raises the possibility that the Tribunal could make a determination that results in the NSPs receiving a worse financial outcome than would arise in the AER's original decision.

As to the point about the accessibility of the LMR process to consumers, we note that there have been significant improvements in the participation of consumers in the review process, and also to the accessibility of the review process, even to consumers without legal representation:

- In relation to the NSW and ACT merits review applications, and subsequent applications, the Tribunal undertook direct consultation with consumers.
- In relation to the NSW and ACT merits review cases, PIAC participated both as an applicant and an intervener, and another consumer group, SACOSS, sought review of the AER's decision in relation to SA Power Networks.[74] In its decision in the NSW and ACT merits review cases, the Tribunal referred extensively to PIAC's submissions, and noted that it had been assisted greatly through PIAC's participation.

For the reasons described in section 2.2.2, the establishment of ECA (as a national consumer advocacy body with a mandate to promote the long-term interests of consumers of energy) in 2015 provides another means by which consumers could be represented through the merits review process.

In respect of the general concern about the legalistic nature of the Tribunal's process, it is worth noting that it is not feasible to remove from the current regulatory framework all legal involvement. This is because Australia's constitutional common law system confers on consumers, NSPs and other parties affected by the decisions of the AER the right to seek judicial review. This is an inalienable right, and applies to the decisions made by any administrative body in Australia.

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73 For example, as discussed in section 2.3.2, PIAC's recent involvement as an applicant in the NSW and ACT review, in which PIAC argued that the equity beta estimate applied by the AER in its revenue determinations should have been lower than it was. As a result of PIAC's participation as an applicant, the NSW and ACT NSPs that sought review could have faced a reduction in allowed revenues.

74 It is worth noting that both PIAC and SACOSS represent very broad constituencies of consumers, as opposed to, say, groups representing narrow interests (such as large industrial consumers of energy).

It is worth noting, in this regard, that the quasi-judicial nature of the existing LMR system actual offers important benefits.

- First, the strict procedural nature of the quasi-judicial system (by contrast to the less prescribed framework that an administrative review body would operate under) reduces significantly the likelihood of judicial review challenges on procedural fairness grounds.
- Second, aligning the decision-making criteria of the merits review body (the Tribunal) and the original decision-maker (the AER), as the current LMR arrangements do, prevents the merits review and judicial review proceedings in relation to the same decision by the AER being run in parallel to one another. Such a system would be considerably more costly and time-consuming than the current one.

4.4.2 The solution

Having identified a number of concerns associated with the legalistic, quasi-judicial nature of the Tribunal, the COAG Energy Council's consultation paper suggests that one option to address these concerns would be to establish "a new investigatory body" (i.e., Option 3).

Different merits review models

Merits review bodies can be described by a continuum:

- At one extreme of the continuum are review bodies that conduct tightly-defined limited merits reviews, whereby the review body may only consider the material that was before the original decision-maker (i.e., the 'review-related material'), and may only consider matters that were "raised and maintained" by the applicants. These review bodies tend to be either fully judicial (such as the Oberlandesgericht Düsseldorf in Germany), or quasi-judicial (such as the Tribunal).
- At the other extreme of the continuum are review bodies that may conduct a full re-examination of the original determination, even if the applicants sought review only on very narrow grounds. Such reviews are referred to as full *de novo* reviews. Full *de novo* reviews tend to be carried out by administrative review bodies (such as the UK's old Competition Commission), which have the freedom to investigate and explore entirely new issues.

Located between these two extremes are a range of possibilities for different kinds of review body, which will be more or less investigative in nature. For instance, the UK's current review body, the CMA, is an administrative body that is not permitted to conduct full *de novo* reviews (i.e., it is not allowed to re-open and re-determine the entirety of the original decision), but may conduct its own original investigations on the narrow grounds of review brought by appellants. This may be described as a 'limited *de novo*' process.

The preceding discussion makes clear that the choice offered by Option 3 of the COAG Energy Council's consultation paper is not simply a binary choice between the existing Tribunal and a new investigative review body. Rather, the choice is between the existing Tribunal and a range of possible variants, ranging from a body that is somewhat more investigative to one that is fully investigative (i.e., that conducts full *de novo* reviews).

In order to consider meaningfully this choice, it is important to:

- be clear about the characteristics of any alternative model under consideration; and
- recognise the benefits and limitations of those alternative models.

What should be the characteristics of a more "investigatory" review body?

It is important to be clear about the problem that the COAG Energy Council seeks to resolve from the introduction of a "new investigatory body". If the issue is that the Tribunal is inherently legalistic then the way to solve this problem may be to amend the existing model under which the Tribunal makes decisions to give greater clarity of the issues to be determined.

The removal of "legalism" in the merits review process may be inherently desirable. This could be achieved by permitting the Tribunal to hear from experts directly in "hot-tubs" so that all of the experts relied on by the AER, the NSP and consumer groups are called together to elucidate the areas of agreement and disagreement between the experts for the benefit of the Tribunal. In such a process, the experts would take centre stage in the presentation of the arguments and issues between them, and this would provide a better way to communicate these arguments to the Tribunal. The effect of this is to remove some of the legal formalism that is characteristic of the Tribunal's current process. This is discussed further in the section below.

However, the removal of legalism in the Tribunal is not what Option 3 of the consultation paper proposes. Instead, it proposes the introduction of a "new investigatory review body", which suggests that there is an unidentified problem with the Tribunal that needs to be resolved, as the consultation paper uses the term "investigatory review body" at the level of generality. There is likely to be a spectrum of roles and powers that could be given to an investigatory body, which range from a limited merits review on the papers before the AER to a full *de novo* review with the opportunity for the body to develop its own independent analysis and views. There are different issues associated with and consequences of different models of investigatory bodies along this spectrum.

Any new investigatory review body will always operate within a legal framework, which includes the availability of judicial review of both the AER and the review body itself. This is because the AER exercises powers under the NEL/NGL and

the NER/NGR which determine the rights of NSPs to earn revenue and the amount that consumers must pay for the relevant services. As noted above, neither the COAG Energy Council nor the Commonwealth can legislate to remove the power of the Federal Court and High Court to judicially review decisions of the AER (and any other review body that reviews the AER's decisions).

The question then becomes how the investigatory review body ought to be designed to mitigate the risk of judicial review, as opposed to being an investigatory review body that is a step along the way to judicial review.

Depending on how the review body is designed, and the functions given to it, one scenario that may arise is that parties who are dissatisfied with the AER's decisions may pursue judicial review in the Federal Court and merits review in the review body in parallel. For example, if the investigatory review body was directed to address the question whether the AER's decision was "unreasonable in the context of materially compromising the delivery of the long term interests of consumers as set out in the NEO/NGO", then parties may seek judicial review of the AER in parallel, where the issue in dispute went to the question of whether the AER had properly interpreted and applied the NER/NGR and NEL/NGL.

If it is intended that the investigatory body should reduce rather than encourage judicial review, then the body and its processes must have certain "legal" characteristics. There must be procedural fairness, its processes must be open and transparent, it must make its decisions in accordance with the same legal framework as applied by the AER and it must publish its reasons explaining the probative matters that it has had regard to. The existing Tribunal satisfies all of these criteria. Further, the Tribunal as currently constituted presents a further advantage to the overall framework of review and the ultimate role of the courts. The President of the Tribunal is a Federal Court judge. There are two consequences to this aspect of design:

- Firstly when judicial review applications are filed by NSPs in the Federal Court in addition to merits review applications in the Tribunal, the Federal Court adjourns those judicial reviews pending the resolution of the merits review. This is because the merits review in the Tribunal in part addresses the question to be determined in the judicial review, that is, whether there has been an error in the interpretation of the NER/NGR and NEL/NGL.
- Secondly, because the Tribunal is presided over by a Federal Court judge if a party subsequently seeks judicial review of the Tribunal (as the AER has recently done in relation to the NSW and ACT merits review cases) the hearing is before the Full Court of the Federal Court (three judges). In the event that the investigatory review body did not share these characteristics of the Tribunal any review of the review body's decision would be first to a single judge of the Federal Court and then to the Full Court.

This is a strength of the current merits review regime because it means that the merits are determined by a quasi-judicial body that minimises the risk of parallel and sequential legal reviews. There has largely been an absence of judicial review cases being heard by the Federal Court and only two cases of review of the Tribunal being brought since the regime was first implemented.

In summary there are two key risks associated with moving the model of the review body away from the quasi-judicial nature of the Tribunal towards a purely administrative body (including one which applies different criteria to that of the primary decision maker – the AER):

- First, if procedural fairness obligations and transparency are stripped away from the investigatory body, then the investigatory review body's own decisions are more likely to be subject to judicial review. Such reviews would be heard before the Federal Court by a single judge rather than the Full Federal Court as is the case for judicial reviews of the Tribunal, introducing an additional level of judicial oversight.
- Second, there is a risk of parallel reviews: a judicial review in the Federal Court before a single judge of the AER's decision and a merits review undertaken by the investigatory review body (which is itself subject to judicial review). The Federal Court is unlikely to adjourn the consideration of the judicial review of the AER's decision where the question being considered by the investigatory body is different from the question to be determined in the judicial review.

The creation of a new investigatory body that is administrative in nature may therefore risk multiple judicial reviews that would increase rather than reduce the legalism in the merits review process. Litigation will not be avoided. In addition, it is likely to result in judicial review cases involving complex and specialist subject matters being heard by a single Federal Court judge. This risk is dependent on the type of investigatory review body established, the questions it is asked to answer and the procedures it is required to follow.

However, it would be possible, with relatively minor legislative changes, to make the existing Tribunal more investigative in nature (with enhanced access to expertise—as discussed below), and to reduce the legalism involved in the review process. Such changes would largely address the concerns expressed by the COAG Energy Council, and also avoid the risks of a proliferation of judicial reviews.

Involvement of experts at Tribunal hearings

The existing Tribunal could, with relatively minor amendments to its functions, be made more investigatory such that it could:

- Direct questions to experts. Such an approach is likely to illuminate more clearly the complex economic and financial issues that arise during the course of reviewing the technical aspects of the AER's original decision.

- Use a "hot-tubbing" format to allow experts to test one another's arguments directly, provide responses to challenges from other experts, and to help expose the grounds on which there is agreement or disagreement, and the reasons for their particular views.

The objective of such an approach would be to allow the Tribunal direct access to all the relevant subject matter experts, and to allow those experts to be tested and probed as a key part of reaching its decision.

It is clear that the Tribunal could be reoriented in this way because the Tribunal uses hot-tubbing and cross-examination of experts when hearing competition matters. In addition, as described in section 2.2, the legislative amendments in 2013 allowed the Tribunal to conduct consultation with consumers as part of a merits review process using a format that was not legalistic in nature, and allowed consumers direct access to the Tribunal without legal representation.

The key advantages of this approach described above are the following:

- Of the available options, it would involve the least change from the current Tribunal process, and therefore would be the least costly option (in terms of one-off establishment costs, as well as ongoing operating costs).
- It would remove the primary role legal advocates have under the current model and allow the Tribunal to engage directly with the experts relied upon by the AER, NSPs and interveners.
- The clear procedural nature of the Tribunal would continue to offer the clear guidance on procedure, limiting significantly the risk of costly judicial review applications on procedural grounds (vis-à-vis a review body that would be more administrative in nature).
- It would also remove the risk of parallel merits and judicial reviews because the question that the Tribunal is asked to consider on review is aligned with the question asked of the primary decision-maker, the AER.

4.4.3 Implementation

The introduction of expert "hot-tubs" to the Tribunal process may be implemented by including a new provision in the NEL and NGL that permits the Tribunal to hear evidence from experts that gave views considered by the AER in the reset process in the manner contemplated by rule 23.15 of the Federal Court Rules 2011.

This amendment is likely to lead to the Tribunal's hearings being less legalistic as the expert evidence to be considered will be explained by the experts themselves rather than by a party's lawyers. This may also shorten the time required by the Tribunal to resolve merits review applications as the issues between the experts become clearer through the "hot-tub" process.

Appendix – Merits review regimes overseas

New Zealand

Key points

- The current merits review regime was introduced in 2008 explicitly to: increase the accountability of the regulator; improve the quality of regulatory decisions; and enhance investors' and consumers' confidence in the regulatory system.
- A system that involved judicial reviews alone was considered insufficient to achieve these goals.
- Merits reviews may be sought only on the methodologies, rules, processes, requirements and evaluation criteria that the regulator will use when making its decisions—so-called 'Input Methodologies' (IMs). These are determined upfront. Subsequent regulatory decisions that apply the IMs are may only be subject to judicial review.
- Merits reviews are conducted through a full judicial process by the High Court. The presiding judge is assisted by two lay members with specialist expertise in relevant areas such as economics and regulation.
- The New Zealand system shares some important features with the Australian system. Merits reviews may be conducted only on the materials that were before the original decision-maker, and only on the grounds on which the parties have appealed (i.e., they are LMRs like in Australia). The High Court must also apply a 'materially better' test (which is similar in construction to the 'materially preferable' test that the Tribunal must apply).
- To date, only one merits review has occurred. The process took 34 months to complete and involved at least 58 challenges to the regulator's original decisions. Of these, only two were upheld by the Court.
- A recent evaluation of the effectiveness of the merits review regime was conducted recently by the Ministry that oversees the legislation under which the merits review regime is constructed. The evaluation found that the merits review regime had largely achieved the original policy intent (outlined above).
- However, the evaluation also found some areas for possible investigation and potential improvement, including:
  - improvement of consumer engagement in the regulatory process;
  - amendment of review processes and rules to, for instance, allow the Court to hear directly from experts (e.g., through hot-tubbing) and relaxation of the closed record requirement; and

- consideration of whether the 'materially better' test should be amended or substituted.

Introduction

In New Zealand the economic regulatory of network industries is the New Zealand Commerce Commission (the Commission).[75] The Commission is responsible for making price-quality decisions in respect of is responsible, under Part 4 of the Commerce Act 1986, for making price-quality determinations for:

- 17 electricity distribution businesses;
- 1 transmission business;
- 4 gas distribution pipelines; and
- 1 gas transmission business.

These decisions are made using an incentive-based, building-block-style system of regulation akin to those found in Australia, the United Kingdom and a number of European countries.

Under the same piece of legislation, the Commission is responsible for monitoring the performance of all of the businesses above, as well as:

- 12 further 'consumer-owned' electricity distribution businesses that are exempt from price-quality regulation; and
- 3 major New Zealand airports.

The Commission's Part 4 regulatory obligations were introduced as a broader package of reforms in 2008. When these regulatory arrangements were introduced, a merits review regime was introduced concurrently. The principal objectives of the merits review regime were to make the Commission more accountable, to strengthen incentives for it to make well-considered and high-quality decisions, and to increase stakeholder confidence in the regulatory framework.[76] In particular, there was a concern amongst policymakers that the Commission was not sufficiently accountable for its regulatory decisions, and that there were inadequate checks and balances in place to ensure regulatory accountability:[77]

> The Commission's regulatory decisions are subject to judicial review only. There is a general perception that the accountability regime for the Commission is weak, as judicial review applies to questions of law and process only and not the substance of a decision. Thus the regime is less capable of correcting regulatory error or improving

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75 The Commission is also responsible for enforcing competition and consumer protection laws.

76 Ministry of Business, Innovation and Employment (MBIE), Part 4 of the Commerce Act 1986: Merits Review Regime Evaluation Summary Findings from Interviews with Stakeholders, April 2016.

77 Ministry of Economic Development (MED), Regulatory impact statement: Review of Parts 4 and 4A of the Commerce Act, p.39.

the regulator's decision making over time. This can impact on business/investor confidence in the regime.

Given the relatively large number of businesses regulated by a relatively small agency such as the Commission, policymakers were acutely aware of the scope for:

- A proliferation of expensive merits reviews that would tie up inefficiently the Commission's valuable resources; and
- The use of merits reviews as a gaming tool (e.g., to slow down the regulatory process).

It was an explicit objective of policymakers to ensure that the new regulatory system was as streamlined and low-cost as possible.

Input Methodologies

A key part of the solution developed by policymakers was the explicit separation between two parts of the decision-making process that all regulators follow and almost universally combine:

- The development of "regulatory methodologies, rules, processes, requirements and evaluation criteria" — so-called 'Input Methodologies) (IMs); and
- The implementation of those IMs to make regulatory decisions.

Under this framework, most of the Commission's work is front-loaded into developing the IMs. These IMs are intended to be extremely detailed and prescriptive, setting out how it will make each constituent part of its overall price-quality decision, as well as the processes it will follow in making those decisions. The IMs are binding on the Commission.

The binding and prescriptive nature of the IMs are important points of difference from the AER's Better Regulation Guidelines, which are neither. Another important point of difference from the Australian system is that there are no rules equivalent to the NEL/NGL in New Zealand, and no decision-making body equivalent to the AEMC.

The IMs must, by law, be reviewed by the Commission at least every seven years to ensure that they continue to be fit for purpose. The Commission can initiate more frequent reviews, and has done so. However, it was not envisaged that fundamental revisions would occur less frequently than the seven-year cycle. In practice, however, the Commission has made fundamental revisions to the IMs (albeit through an open and consultative process) more frequently than the seven-year cycle envisaged originally by policymakers.[78]

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78 The first merits review decision of the original IMs was completed in December 2013. The review body (the High Court) remarked in its judgment that some aspects of the Commission's reasoning in the original IMs were not well supported and noted that these aspects should be re-examined at the

A key objective of setting up-front rules in this way was to provide consumers, regulated businesses and other stakeholders a high level of certainty about the regulatory process (including being able to predict with a high degree of confidence the way in which the Commission would make decisions).

Two critical aspects of the New Zealand system are the following:

- The IMs that apply to all businesses regulated under Part 4 are developed simultaneously, through a single process; and
- Only the IMs (and not the subsequent regulatory decisions that apply those IMs) may be subject to merits review. The regulatory decisions that relate to individual businesses may be subjected to a judicial review process if the relevant stakeholders consider that the Commission has failed to apply the IMs correctly. In such a process, only matters of law may be examined.

The IMs system has a number of features:

- Because the IMs for all regulated businesses are developed concurrently, at the conclusion of that process all stakeholders (including consumers and businesses) have a very clear understanding of how the Commission intends to make its regulatory decisions.
- All merits review applications (i.e., from all parties) in relation to the IMs, on all issues, are heard at once as part of a single process. This avoids duplication of appeals and the costs and uncertainties attendant to staggered/overlapping merits reviews. The downside of this is that the review body has had to contend with a very large number of matters as part of a single review.
- The Commission's decisions (e.g., the setting of price-quality paths) becomes a relatively mechanistic application of the upfront IMs. This would tend to lower the overall cost of the decision-making process.

Multi-track regulatory system and associated review mechanisms

Policymakers in New Zealand foresaw that the upfront setting of IMs intended to apply by default to all the regulated businesses could result in regulatory outcomes unsuitable for some businesses. Therefore, a multi-track system was devised:

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next IM review. All of these aspects related to the determination of the Weighted Average Cost of Capital allowance. The High Court's comments were *obiter dicta* rather than directions to remake those aspects of the IMs immediately. Following the publication of the High Court's judgment, two major user groups requested that the Commission re-examine these matters as soon as possible. The Commission commenced consulting on these matters in February 2014, and made a final determination on those matters (including revisions to the IMs) in June 2015.

- The IMs apply automatically to all non-exempt electricity distribution and gas businesses under the so-called default price-quality path (DPP) system.
- Any such business that considered that the resulting DPP regulation would be unlikely to suit its particular circumstances (either because it is intrinsically different to other DPP-regulated businesses, or because its circumstances had changed materially), may apply to the Commission to be regulated under a customised price-quality path (CPP). The CPP route is a more costly and onerous one for the company, generally involving much more detailed analysis and scrutiny of the business's circumstances by the Commission, and longer timeframes, than would be the case under the DPP option. The higher cost (and risk) involved under the CPP route means that, in practice, only one business has, to date, sought a CPP process.[79]
- The single electricity transmission operator, Transpower New Zealand, was deemed to face such materially different circumstances to the Part 4 electricity distribution businesses that it is regulated separately under an individual price-quality path (IPP).

Merits reviews may be sought on the DPP and IPP IMs, as well as on CPP regulatory decisions.

Who may seek review?

Section 52Z of the Act provides that any person who gave views on an IM determination to the Commission (as part of the Commission's regulatory process), and who, in the opinion of the Court, has a significant interest in the matter, may appeal to the High Court against the determination. This includes regulated businesses, consumers and other market participants (e.g., electricity retailers).

The review body and review process

Review body

The relevant review body in New Zealand is the High Court. This means that the review process is a full judicial process.

Given the complex economics and regulatory matters arising in such reviews, the High Court judge is assisted by two lay members (usually economists and regulatory experts with relevant competencies).[80]

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79 This business was Orion Networks following the very disruptive circumstances it faced following the 2010 and 2011 Canterbury earthquakes.

80 The two lay members that assisted the High Court in the first merits review process were in fact current members of the Tribunal, Mr Robin Davey and Mr Rodney Shogren.

Appendix – Merits review regimes overseas

Section 52Z of the Commerce Act 1986 provides that:

> (3) In determining an appeal against an input methodology determination, the court may do any of the following:
>
> (a) decline the appeal and confirm the input methodology set out in the determination:
>
> (b) allow the appeal by—
>
> (i) amending the input methodology; or
>
> (ii) revoking the input methodology and substituting a new one; or
>
> (iii) referring the input methodology determination back to the Commission with directions as to the particular matters that require amendment.

There is no threshold specified in the Act for the granting of leave to appeal (i.e., no *de minimis* threshold).

Decision-making test

As with the 'materially preferable test' that the Tribunal must follow when making a decision, s 52Z of the Act prescribes a decision-making test that the Court must apply when conducting its review of the Commission's decision on an IM:

> (4) The court may only exercise its powers under subsection (3)(b) if it is satisfied that the amended or substituted input methodology is (or will be, in the case of subsection (3)(b)(iii)) materially better in meeting the purpose of this Part, the purpose in section 52R, or both.

Unlike in Australia, where the materially preferable test applies to both the Tribunal and the AER, in New Zealand, the materially preferable test does not apply to the Commission.

The Ministry of Business, Innovation and Employment (MBIE), which has stewardship of the Act, recently conducted an evaluation of the merits review process and found that there was general dissatisfaction amongst stakeholders about the 'materially better' test. Some stakeholders argued that:[81]

- The materially better test is note defined clearly in the Act and therefore is difficult to interpret; and
- It represents too high a hurdle for appealing the Commission's decisions on the IM successfully.

However, other stakeholders have argued that in the absence of the materially better test, parties would be able to cherry-pick the issues on which review is sought.

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81 Ministry of Business, Innovation and Employment (MBIE), Part 4 of the Commerce Act 1986: Merits Review Regime Evaluation Summary Findings from Interviews with Stakeholders, April 2016, pp.10-11.

Review process

The Act provides that any merits review conducted by the Court must be by way of rehearing and must be conducted solely on the basis of the documentary information and views that were before the Commission when it made its determination. No party to the review may introduce any new material during the appeal.[82] These requirements are very similar to the requirements that the Tribunal in Australia must follow.

The judicial nature of the review system means that the merits review process is conducted using legal procedures, and in an adversarial fashion, whereby only legal counsel for each party may address the Court.

The Court does not question or cross-examine experts or other witnesses (e.g., senior management for the regulated businesses) or use a hot-tubbing format to hear the exchange of views between experts. In its recent evaluation of the review process, MBIE found that a number of stakeholders considered that, given the complex nature of the issues that the Court must grapple with, it would have benefited from direct examination of experts and hot-tubbing.[83] MBIE noted that one possible objection to this approach is that this could result in the introduction of material that the Commission did not have before it at the time it made its decisions. MBIE noted that a counterview is that the Court is well-placed to manage the process such that the closed record requirement under the Act is not violated.

Unlike the Tribunal, the Court does not consult directly with consumers as part of the review process. Consumer involvement in the review process only occurs with consumer groups participating as appellants or interested parties.

Merits review experience

The parties

The Commission made its first ever IM determinations in December 2010. In February 2011, several parties applied to the High Court for a merits review of the Commission's determinations. In total, nine parties were granted status as

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82 It is worth noting that this 'closed record' requirement has recently been criticised in New Zealand for promoting the submission of a large volume of material to the Commission, when it was making its initial decision on the IMs. As a result, the Court had to contend with what was considered to be a large volume of material (reportedly 40,000 pages). See Ministry of Business, Innovation and Employment (MBIE), Part 4 of the Commerce Act 1986: Merits Review Regime Evaluation Summary Findings from Interviews with Stakeholders, April 2016.

83 Ministry of Business, Innovation and Employment (MBIE), Part 4 of the Commerce Act 1986: Merits Review Regime Evaluation Summary Findings from Interviews with Stakeholders, April 2016, p.14.

Appendix – Merits review regimes overseas

appellants, and two were given status as interested parties (i.e., akin to interveners).[84] The appellants included:

- Four electricity networks;
- The Major Electricity Users' Group (MEUG);
- Three airports; and
- One airline user of airports.

MEUG and one gas pipeline also appeared as interested parties.

The grounds of review and outcome

The Court heard appeals on six distinct matters:

- Asset valuation;
- Cost of capital;
- Corporate tax allowance;
- Cost allocation;
- Regulatory process and rules (the IMs are intended to cover the processes and rules that the Commission must follow when making its determinations); and
- Capital expenditure.

Of these, the most substantive matters were the first two: asset valuation and cost of capital. This is not surprising because these two matters determine the largest building block component of networks' revenues (i.e., the return on capital).

There were at least 58 individual grounds of review related to the six matters above and the Court upheld the Commission's IM decisions on all but two relatively minor matters. The two grounds on which the appellants succeeded were in relation to one electricity network's (Vector's) appeal as to when controlled prices may be reviewed and the other, the three airports' appeal as to the date at which their land is to be valued for the first time under information disclosure regulation.[85]

As noted above, although the Court upheld the Commission's IM determination on all grounds, it did identify in its judgment a number of issues related to the cost of capital IM that the Commission should reconsider when it next reviews that IMs.

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84 Originally, 12 parties sought review but three subsequently withdrew their applications.

85 Wellington International Airport Ltd and others v Commerce Commission [2013] NZHC 3289 (11 December 2013), [1950].

All of the matters raised by all parties were heard as part of a single process.[86]

Timeframes

The merits review process took a total of 34 months to complete (with the applications for review being submitted in February 2011 and the final judgment being handed down in December 2013). Hearings were held over 39 days in late 2012 and early 2013.

The main reasons cited for the lengthy review process include the following:

- Two of the parties to the review, Vector and Transpower, had also pursued judicial review applications on procedural matters related to how the Commission had pursued its decision-making process. These matters needed to be dealt with before the merits review process could be completed.[87]
- The large number of matters that were subject to review (which was contributed to by the large number of parties involved).
- The scheduling of hearings amongst other matters underway with the High Court.

Recent evaluation of the merits review process

As noted above, in April 2016 MBIE completed an evaluation of the merits review regime. This review involved considering the outcomes of the first merits review under Part 4 of the Act, and whether those outcomes had been effective in achieving the purpose set out in the Act. MBIE conducted extensive interviews of all the major stakeholders involved in the first merits review, including network businesses, consumer groups, the Commission, legal counsel, the presiding High Court judge and two lay members.

MBIE concluded that the first merits review had largely met the policy objective:[88]

> …the fundamental policy goals for instituting the merits review regime appear to have mainly been realised; in particular, to make the Commission more accountable for its IM determinations and to improve regulatory certainty. We would expect the breadth of issues considered by future merits appeals to reduce, resulting in significant reductions in the costs of future appeals and the time for cases to be heard and decided.

However, the evaluation identified a number of areas for possible improvement. MBIE has suggested that further work may be required in three areas:

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86 The Court did assess each ground of review individually in its judgment.

87 Ministry of Business, Innovation and Employment (MBIE), Part 4 of the Commerce Act 1986: Merits Review Regime Evaluation Summary Findings from Interviews with Stakeholders, April 2016, p.6.

88 Ministry of Business, Innovation and Employment (MBIE), Part 4 of the Commerce Act 1986: Merits Review Regime Evaluation Summary Findings from Interviews with Stakeholders, April 2016, p.4.

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- Ways of improving the level of consumer engagement in the regulatory process generally. MBIE did not suggest that the merits review process needs to be revised to encourage greater consumer participation at the review stage.
- Ways of improving the efficiency of the processes and rules employed in merits reviews, including (for example) allowing the High Court to employ hot-tubbing, and potentially also relaxation of the requirement that the review must only be conducted on the material that was before the Commission at the time it made the original decision.
- Whether the 'materially better' test should be amended or substituted.

United Kingdom

Key points

- The appeals regime for energy networks has recently undergone a material reform. The previous de novo regime has been replaced by a focused appeals regime. However this change was triggered by a European Directive, not by any dissatisfaction with the prior regime.
- The new appeals regime requires the appellant to demonstrate that elements of the regulators decision are wrong on one of five specific grounds. These grounds go beyond those applicable to Judicial Review, and allow for an appeal on the merits of decisions.
- Appeals may be brought by the affected network, by other holders of licences under the relevant legislation and by customer representative groups. Any interested third party may make submissions on live appeals.
- Appeals are heard by the Competition Markets Authority (CMA), a non-ministerial department of government that employees 700 staff. Appeals are overseen by CMA Panel members, each of which is an expert in a relevant field. Appeals are guided by legal input, but have a more administrative rather than judicial nature.
- Two appeals have been brought under the new arrangements and the CMA's findings in respect of these appeals are informative as to the margin of appreciation that will be afforded to regulators. Our view is that the CMA has found an appropriate balance between correcting obviously poor aspects of Ofgem's decision while not second guessing Ofgem's judgement where that judgement has been made broadly reasonably.
- In our view, there is a high level of confidence in the capacity of the CMA to make sound decisions and to provide guidance to the sector regulators for which it is the "super regulator".

Introduction

The UK model of regulation for energy networks (RIIO, Revenue = Incentives + Innovation + Output) is now reasonably well known[89]. It is a RAB based system with strong financial incentives to manage costs efficiently, and to deliver a wide set of well specified outputs. The model was designed and is administered by Ofgem. Energy network licensees have certain rights of appeals against Ofgem's decisions and in response to certain requirements set out in the EU's Third Energy Package[90], these appeal rights have relatively recently undergone material reform.

In the remainder of this annex we set out:

- A review of the recent changes to appeal arrangements.
- A description of the present appeal arrangements.
- An overview of recent experience in the exercise of these arrangements.

Recent changes to UK appeal arrangements

Prior to November 2011 licensees had the right to reject a price determination made by the Ofgem. Ofgem would then refer the regulatory determination to the appeal body, the Competition and Markets Authority (CMA)[91], for redetermination against a public interest test (i.e. whether the decision of the regulator operates, or may be expected to operate, against the public interest). Since November 2011[92], Ofgem now has the right to impose its decision on licensees (i.e. there is no longer a right to a de novo review), subject to the right of appeal by licensees to the CMA on specified grounds, a set of arrangements that might be described in summary as focused and merits based.

The change from full redetermination to focused appeals did not arise out of any expressed dissatisfaction on the part of stakeholders or policymakers with the previous system. The trigger for the change was solely the need for the appointed National Regulatory Authority, as specified under the European Commission's

89 Strictly, this is the model of regulation that applies to energy networks in Great Britain. Northern Ireland has its own independent regulator, the Utility Regulator, which makes regulatory determinations cognisant of the local needs and requirements of Northern Ireland. The Utility Regulator does not use the RIIO model, although since it relies on the usual "building blocks" model there are a number of similarities.

90 An overview of the Third Package can be found here: https://ec.europa.eu/energy/en/topics/markets-and-consumers/market-legislation

91 Prior to October 2013, the Competition Commission.

92 Northern Ireland's devolved authority has now adopted essentially identical appeal provisions, as of February 2015 (The Gas and Electricity Licence Modification and Appeals Regulations (Northern Ireland) 2015).

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Third Package for energy, to be able to take "autonomous decisions" [93] and to be "functionally independent from any other public or private body."[94, 95]

The Department for Energy and Climate Change, which was responsible for implementing the Third Package, took the view, after receiving appropriate legal advice, that the previous arrangements did not comply with these requirements, as the ability of individual entities/the industry to force Ofgem to reconsider its decision or to have to revert to another party before proceeding did not provide sufficient autonomy and/or independence. In contrast, the revised appeal arrangements allowed Ofgem to take the decision it considered appropriate unfettered, with the interests of licensees protected by the ability to appeal subsequently.

Relatively few appeals were made against Ofgem decisions under the previous de novo arrangements[96], and there have been no appeals at all since 1997[97]. In our view this signals that there was a general level of satisfaction on the part of the regulated companies with Ofgem's regulatory decisions. When coupled with the observation that wider stakeholders and policy makers had expressed no dissatisfaction with the de novo arrangements, this does suggest that the de novo regime was generally considered to be performing well at the point it was changed[98].

Finally, in 2013 the Department for Business Innovation & Skills published a consultation paper setting out potential options for reforming regulatory and competition appeals[99]. A number of concerns were provided as the motivation for this consultation[100], which were:

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93 See Electricity Directive 2009/72/EC, article 35(5)(a), Gas Directive 2009/73/EC, article 37(5)(a).

94 See Electricity Directive 2009/72/EC, article 35(4)(a), Gas Directive 2009/73/EC, article 37(4)(a).

95 For discussion of the rationale for change, see for example "Implementation of the EU Third Package, Consultation on licence modification appeals", Department for Energy and Climate Change September 2010. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/43240/586-eu-third-package-condoc2.pdf

96 There have been several more recent appeals made in Northern Ireland against decisions taken by the Utility Regulator. For example Northern Ireland Electricity in 1997 and 2014 and Phoenix Natural Gas Limited in 2012.

97 British Gas, in 1993 and 1997 and Scottish Hydro-Electric in 1995.

98 De novo appeal arrangements persist in the water sector.

99 "Streamlining Regulatory and Competition Appeals", Department for Business Skills and Innovation, June 2013. https://www.gov.uk/government/consultations/regulatory-and-competition-appeals-options-for-reform

100 Ibid, page 4.

- 'Concerns have been expressed that there are a significant number of appeals in some sectors, with relatively little downside risk to a firm from lodging an appeal.'
- 'Even where there are few appeals, those that are brought are often lengthy and in turn, costly.'
- 'There is a significant degree of diversity in the way these issues are handled across sectors in terms of which appeal bodies hear which types of appeal and the standards by which those appeals are decided.'

These concerns were unlikely to have arisen in respect of the energy sector, where, as noted above, few appeals had been brought under the previous arrangements and where the new focused appeal arrangements had not yet been tested. The consultation paper discuses a number of issues, related to the diversity of appeal rights across different sectors and disciplines, and explores whether an appropriate balance is being struck between frequency/depth of appeal, the correction of injustices and cost/efficiency. It is worth stressing that the removal of appeal rights is not contemplated. The consultation paper stated that:

> The right of firms to appeal regulatory and competition decisions is central to ensuring robust decision-making and holding regulators to account in the interests of justice. Where firms are materially affected by regulatory decisions, they should have an effective right of challenge if they consider that the regulator has made a mistake or has not acted reasonably.

We also note that the government is yet to act on this consultation, and include the consultation in this annex solely in the interest of completeness.

Key features of the UK energy network appeals regime

The nature of the review

Under the previous arrangements the CMA would determine afresh the entire price control as it considered appropriate, in order to reach a decision that it considered most apt to operate in the public interest. Under the revised arrangements, the CMA will now receive focused appeals and must determine whether the elements of decisions brought to its attention are 'wrong'. The key provision establishing the standard of review is set out in the Electricity Act 1989, Section 11E(4). These relevant grounds are that:

- Ofgem failed properly to have regard to its statutory duties;
- Ofgem failed to give the appropriate weight to its statutory duties;
- The decision was based, wholly or partly, on an error of fact;
- The modifications fail to achieve, in whole or in part, the effect specified by Ofgem; and
- The decision is wrong in law.

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These grounds clearly differ from those in place for Judicial Review proceedings (i.e. illegality, irrationality or procedural impropriety), signalling the intention for the appeal body to consider the merits of arguments.

The relevant question then is the extent to which the appeal body will allow Ofgem (or the Utility Regulator) a margin of appreciation before deciding that a decision is wrong on one or more of the grounds above. There is no clear prescription of the magnitude of this margin, leaving this matter largely in the hands of the CMA to interpret (we return to this topic below).

Parties able to appeal

In addition to modifying the appeal rights of the licence holders, the changes to legislation also granted rights of appeal to parties other than the directly affected licensee. The revised legislation permits the following entities to appeal Ofgem's decisions[101]:

- The licensee whose licence is to be modified.
- Any other licence holder under the Electricity Act 1989 (e.g.. another network company, a supplier, a generator) whose interests are materially affected by the decision.
- Bodies representing the above (e.g. the Energy Networks Association).
- Citizens Advice and/or Citizens Advice Scotland as customer representatives.

The appeal body

The CMA is a non-ministerial department of the UK Government, employing approximately 700 people. In addition to conducting regulatory licence appeals in the energy sector, it also has much wider powers and responsibilities, including investigating mergers that may restrict competition, potential breaches/abuses of UK or EU competition law, undertaking market investigations and enforcing consumer protection legislation. The CMA is overseen by the CMA board, and its inquiries/investigations are led by expert panel members, appointed for a term of up to 8 years.

Panel members are appointed through open competition based on their experience in relevant disciplines, including competition, economics, law, finance and business. There are 8 inquiry chairs currently in place, each of which is an eminent expert in their field, and each of which has enormous experience of relevant matters from their previous career. There are presently 24 other panel members, each of which again has impressive credentials and experience from their previous experience.

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101 See Section 11C(2) of the Electricity Act 1989.

The combination of leading expert figures from the panel, together with the ability to call on deep expertise from within the CMA staff (supported as necessary with additional external advice), allows the CMA to undertake very wide ranging, broad and deep reviews, from a position of great authority. As is evidenced by the review of recent consultation papers outlined above, in our view there is a rather high level of confidence in the great majority of decisions taken by the CMA across its various areas of responsibility. In respect of utility regulation, the CMA has been seen to be the "super regulator" for infrastructure more widely in the UK, handing down critical guidance on certain key areas to the sector regulators.

Appeals process

A person wishing to make an appeal must first make an application for leave to appeal to the CMA. This Notice of Appeal must be submitted within twenty working days, beginning from the first working day after the day in which the Authority's decision is published. The Notice of Appeal must include a statement of truth. The CMA will then determine whether it considers there are any reasons to refuse permission to appeal and, if it so decides, will notify the parties of its decision and reasons.

If leave to appeal is granted then a 6 month[102] process is initiated, beginning with the Authority providing a representation to the CMA in respect of the reasons for its original decision and the grounds of appeal raised by the appellant. The appellant will then be permitted to respond in writing to the submission of the Authority, and so on and so forth. Non confidential versions of all submission will be made publicly available on the CMA's website. Any interested third party (including for example individual consumers or consumer representatives) may make submissions to the CMA during the course of this process and the CMA will specify a timetable for receipt of any such submission. In most cases, written evidence appended to the Notice of Appeal provided to the CMA by main parties should be in the form of a witness statement verified by a statement of truth.

The CMA has some discretion as to how it organises oral hearings as part of the appeal process. However, based on experience from the first appeals to be heard under the focused arrangements now in force (see below), the CMA will conduct oral hearings as follows:

- Each party to the appeal (the appellant and the Authority) will be granted a separate hearing at which they can present their case and answer questions from the CMA panel.
- Attendance at the hearing is left up to the company, but typically the "front bench" will be comprised of the CEO, the relevant directors, legal counsel

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102 The CMA must publish its Final Determination within 6 months from the date at which it grants leave to appeal, with a maximum 1 month extension should circumstances require it.

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(both internal and external, but external counsel does not tend to dominate except on legal matters), engineering and economic experts/advisors, both internal and external.

- Questions are prepared and given by the inquiry panel members, supported by analysis prepared by CMA staff, with the inquiry chair managing the process.
- Any party may speak to deal with a question, and our experience is that these question and answer formats work well at allowing a forthright exchange of views on technical matters, with freedom to express arguments as is seen fit, for supplementary questions and supplementary answers. This assists the exploration of the issues (although of course the exchange of paper through formal submissions remains the main element of the appeal).
- Oral hearings are attended by representatives of the opposing party (so the Authority would attend the appellant's hearing and vice versa), although the typical protocol is that they are not permitted to join the discussion. They may of course follow up in writing on any issues that they consider were not adequately addressed at the hearing.

Overall there is a desire that such processes should be the words of the appealing company, and that the appellant should not "hide behind" advisors. The inquiry panel seem very keen to engage with the subject experts to understand fully arguments and to test and probe them, as a key part of reaching their decision. While all parties to an appeal tend to rely on significant legal advice, the oral hearing in particular has a very administrative, rather than judicial, look and feel.

Finally, should the CMA receive substantially similar appeals from two parties that it considers to be closely related, it may direct that these appeals will be heard together.

The decisions open to the CMA

In its Final Determination the CMA must make one of the following decisions in respect of each appeal item.

- Quash the Authority's decision;
- Remit the matter back to the Authority for reconsideration in accordance with the CMA's directions;
- Substitute its own decision; or
- Uphold the decision (i.e. reject the appeal).

We note that the decision of the CMA is applied only to the appellant, not to all related licence holders. Hence, should one network operator successfully appeal against an element of a price control that has been applied to all in the industry, the decision is not automatically read across into the licences of the other networks.

Experience from recent regulatory determinations

Since focused appeal rights were introduced, there have been two appeals brought, both in respect of the electricity distribution decision (RIIO-ED1) taken by Ofgem in late 2014). One appeal was brought by Northern Powergrid, the owner and operator of two licences (Northern and Yorkshire). A second appeal was brought by British Gas Trading (BGT), owner of Centrica one of the largest vertically integrated generation/retail business in the UK, on the basis that its interest were materially affected by the distribution network regulatory determinations (hence BGT's appeal was against each and all of the decisions Ofgem took in respect of the electricity distribution licensees). Northern Powergrid was successful in respect of one of its three grounds of appeal. British Gas Trading was partially successful in respect of one of its five grounds of appeal. Both appeals were concluded comfortably within the statutory timetable of six months.

To provide even a summary description of the eight grounds of appeal and the CMA's findings in respect of each would add considerably to the length of this annex, and in the interests of brevity we have not done so. However, we do consider that the CMA's findings in these two appeal cases are informative in respect of how it has interpreted its responsibilities and duties, and in determining the limits it may in future place on Ofgem's (and others) discretion.

The one area where the CMA found unambiguously in favour of the appellant was in respect of Northern Powergrid's appeal against Ofgem's so-called Smart Grids Benefits adjustment. In respect of this ground the CMA found, inter alia, that:

- The adjustment made by Ofgem in respect of Smart Grid Benefits in its Final Determination was markedly different from what had been signalled at earlier stages of the review and that such a change required careful justification.
- That neither Ofgem's own analysis nor the external evidence it cited, when properly considered, provided material support for the view that there was a shortfall in Smart Grid Benefits offered by the companies in their business plans.
- That the approach adopted by Ofgem in respect of Smart Grid Benefits had the potential to distort future incentives.
- That the consultation process in respect of the methodology for Smart Grid Benefits adopted at the Final Determination stage was inadequate.
- That Ofgem's analysis of the required quantum relied heavily on an obvious outlier.
- That Ofgem's model contained calculation errors.

In the light of these findings, the CMA decided to quash Ofgem's decision.

The CMA's decision in this regard is illuminating. It had clearly reached the view that Ofgem's decision in this regard was poorly justified, designed and

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implemented. Consequently the decision could not stand and there could be no public policy rationale for exposing the appellant to the decision, in particular as it would signal that a similar quality of work would be acceptable in future. To allow a regulatory decision with such weak foundation to stand would clearly not be in the long term interests of the public, even though upholding Ofgem's decision would have lowered prices in the short run.

The CMA also changed one other aspect of Ofgem's RIIO-ED1 decision, in respect of certain changes to the calibration of Ofgem's information revelation incentive mechanism ("the IQI mechanism"). Interestingly the CMA did not agree with BGT's case – that no change should have been made to the calibration during the course of the review process. Rather they found while a change was justified, the change actually made by Ofgem did not have the effect that Ofgem had, at an earlier stage of the review, signalled it had intended. The CMA therefore decided that, having completed its review of this topic in response to BGT's appeal, it would substitute its own judgement for that of Ofgem as there were clear grounds to do so.

However, the CMA did not find in favour of either of the two appellants in respect of any other ground. These appeal items covered:

- For Northern Powergrid:
  - The method through which Ofgem had determined regional labour adjustments in its benchmarking.
  - The way in which it had forecast future real price escalation.
- For BGT:
  - Alleged double recovery of certain excluded service revenues.
  - The method through which Ofgem determined targets for its interruptions incentive.
  - The transitional arrangements Ofgem put in place following its decision to change assumed asset lifetimes.
  - Changes Ofgem made to calibration of its rolling cost of debt mechanism.

In respect of each of these, the CMA provided a detailed rationale for rejecting the appeal case. However the common theme behind these decisions is that:

- Ofgem had prepared broadly sound analysis and had consulted upon it reasonably;
- the effect on companies, in absolute and relative terms, seemed reasonable and proportionate.
- while there might be alternative approaches that could be adopted in a number of these areas, none was superior in every dimension or in respect of every relevant criteria; and

- that Ofgem had a clear set of objectives in mind and its decision largely met those objectives.

In these areas then, there was relatively weak evidence to draw the conclusion that Ofgem had erred. Even if Ofgem's decisions were not perfect in every regard, its approach lied sufficiently within a reasonable margin of appreciation and should be allowed to stand.

In our view, the CMA's judgements in these recent appeal cases are telling in respect of how the CMA has interpreted its role under the revised legislation. It is not for the CMA to second guess every judgement that Ofgem, or any other regulator, may make. But where Ofgem has not conducted itself reasonably, it is willing to step in and make corrections that improve decision making. Going into the second round of RIIO price controls, companies will have a clear idea of what it is that could give rise to a successful appeal. Similarly, Ofgem will have a clear understanding of the standard to which it will be held by its super regulator. We anticipate that policy makers will be satisfied with how the CMA has acted, and this approach seems to us to be unlikely to trigger a wave of frivolous or vexatious appeals.

Germany

Key points

- Regulatory decisions made in Germany are guided by rather prescriptive legislation, which in many important areas limits the discretion of the regulator.
- The German system provides for court appeals that embody a limited review of merits. New evidence can be brought forward to inform proceedings. Judicial Review of court decisions may be sought subsequently.
- There has been a relatively large volume of appeals, which to a degree is predictable given the number of companies. This has also been driven by the desire to test the new arrangements following their introduction.
- The appeals contesting regulatory parameters with a substantial impact on costs, in particular on cost of equity, were decided in favour of Bundesnetzagentur. The Court came to this conclusion since it took the view that the Bundesnetzagentur had taken decisions on the basis of sound economic grounds, i.e. the regulatory decisions taken had merit.
- However a number of appeals were decided in favour of the companies. Where this has been the case, the judgements of the courts has been instructive to legislators (and regulators) as to the deficiencies of the original decision and how they could be improved. This has led to subsequent additions/ amendments to the original legislation.

- In principle customers may appeal against regulatory decisions, but the judicial nature of review proceedings substantially restricts this possibility.

Introduction

The German model of regulation for energy networks is based on a revenue-cap, with network operator free to set individual tariffs (subject to the overall revenue constraint). Allowed revenue is fixed at each regulatory reset, and changes within period arise only due to changes for inflation and for efficiency over/under performance against allowances. This provides an incentive to outperform within each period, with a new revenue cap set equal to costs at each review.

The model is mainly prescribed in law and administered by the national regulator, Bundesnetzagentur.[103] In addition, for network operators only acting in one federal state in Germany, state-regulators administer the law. However, it is possible to pass this competence to the national regulator.

One key feature of German regulation is the large number of network companies.

Table 3: Energy networks in Germany in 2015

	Electricity	Gas
TSO	4	17
DSO (more than 100,000 customers)	73	25
DSO (less than 100,000 customers)	803	689
TSO	4	17

Source: Bundesnetzagentur

In the remainder of this annex we set out:

- A description of the law/ordinances describing the regulation for energy networks.
- A description of the present appeal arrangements.
- An overview of experience in the exercise of these arrangements.

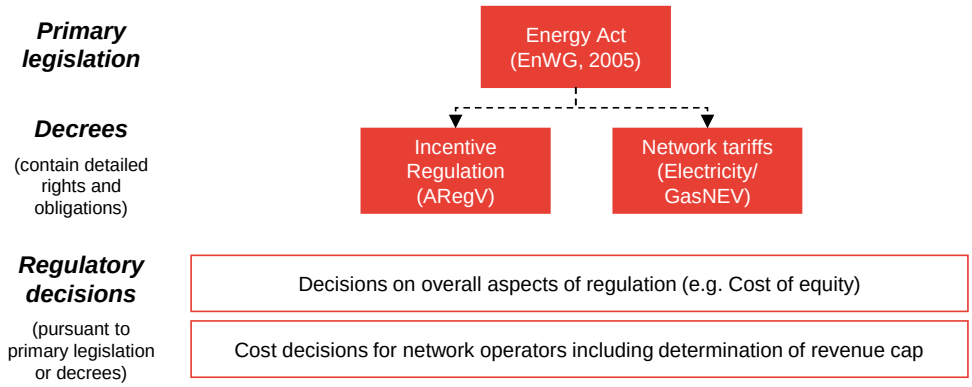
Legal framework for incentive regulation in Germany

The national legal framework for incentive regulation in Germany is determined by a combination of Primary Legislation and Decrees (see Figure 6). This

103 In addition, for network operators only acting in one state in Germany state-regulators administer the law. However, it is possible to pass this competence to the national regulator.

legislation is enacted to achieve the objective of the German Government, guided by the requirements of the relevant binding EC Directives. The legislation is then implemented by Bundesnetzagentur through its regulatory decisions, with these decisions turned into specific decisions for each company.

Figure 6. Levels of national legislation in Germany for incentive regulation for energy networks



Source: Frontier Economics

- **Primary legislation** – the Energy Act (EnWG)[104] defines the first level of national legislation. It sets the general framework for incentive regulation (§21a EnWG), e.g. the overall regulatory approach should be a revenue cap, range for regulatory period (2 to 5 years), classification for non-controllable and controllable costs, definition of efficiency targets etc. §21a EnWG states that further details on regulation shall be determined by decrees of the government.

  The Energy Act also defines the competences of the national regulator (Bundesnetzagentur) and the regulators at state level. Finally, the Energy Act defines the appeal arrangements (§75 ff EnWG) against decisions taken by the regulatory authorities.

- **Decrees: "Incentive regulation decree"** – the regulatory framework for incentive regulation is set out in the Incentive regulation decree ("Anreizregulierungsverordnung 2016", ARegV[105]). The ARegV sets the framework for gas/electricity TSOs/DSOs in a relatively prescriptive way limiting the degree of freedom by the regulator. The ARegV *inter alia* sets out:

104 Energiewirtschaftsgesetz (Gesetz über die Elektrizitäts- und Gasversorgung), https://dejure.org/gesetze/EnWG

105 Anreizregulierungsverordnung, Amendment 2016, http://www.bmwi.de/BMWi/Redaktion/PDF/A/anreizregulierungsverordnung,property=pdf,bereich=bmwi2012,sprache=de,rwb=true.pdf

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- The overall regulatory approach for the revenue cap, where the regulator is not allowed to deviate from the prescribed revenue cap in the ARegV.
- The basis on which cost allowances should be determined.
  - In principle (as opposed to the UK and also Australian regime) the German regulation does not use companies' planned costs for setting the revenue cap but uses the outturn costs from a so-called "photo-year". On these cost all relevant regulatory parameters apply. The ARegV defines the "photo-years" as the t-3 year from the start of the next regulatory period (e.g. for the regulatory period starting 2013 the cost from 2010 were relevant). There is little or no emphasis placed on company business plans for practical reasons. Owing to the large number of regulated companies, a process focused on business plan scrutiny would be prohibitively resource intensive.
- A detailed list stating how costs should be considered to be either non-controllable, volatile or controllable, and then how each should be treated.
- A detailed description of the benchmarking model which shall be used for calculating individual efficiency targets for companies including:
  - the benchmarking methodology (DEA, SFA);
  - which costs to assess;
  - the obligatory outputs (at least for the 1st and 2nd regulatory period); and
  - outlier analysis.

  However, the regulator had freedom to determine further output parameters in the 1st/2nd regulatory period and can freely choose output parameters from the 3rd regulatory period (for gas (electricity) networks starting 2018 (2019).
- A detailed description of the catch-up period for inefficient costs, which is 5 years from the 2nd regulatory period onwards, and how to translate inefficient costs into cost targets.
- A prescription for how to determine a general productivity factor, which for the 1st/2nd regulatory period should be 1.5% and 1.25%). From the 3rd regulatory period onwards the regulator has the freedom to determine the general productivity factor by its own. The ARegV only states that the regulator shall use state-of-the-art methods and historic data from the energy networks. The ARegV states that the regulator can set separate values for gas and electricity networks, but does not allow setting separate values for TSOs and DSOs.

- A detailed description which index to use for inflating costs and how to calculate it.

- **Decrees: "Network tariffs decree" for gas/electricity** – these decrees ("Stromnetzentgeltsverordnung"[106], "Gasnetzentgeltsverordnung"[107]) define how costs are determined for the "photo-year" of incentive regulation for TSO and DSO companies. The decrees are similar for the electricity and gas network companies. The decree *inter alia* sets out:
  - Details on the calculation of depreciation. This includes standardised depreciation periods and the differentiation for equity- and debt-financed depreciation.
  - Details on costs where values from accounts are to be used, including the cost of debt.
  - Details on the calculation of the cost of equity, which shall consist of the risk-free rate plus a reasonable risk premium. The decree defines how the risk-free rate shall be calculated. When setting the "reasonable risk premium" the regulator has more freedom.
  - Details on the calculation of the equity portion of RAB, based on indexed historic costs. In 2013 a new article was included in the decree (§6a GasNEV/StromNEV) which clarified the applicable indices. This removed the scope for appeals by the companies in respect of the "right" index to be used by the regulator.
  - In 2013 a new article was included in the decree (§7(7) GasNEV/StromNEV), which clarified the calculation of cost for "excess equity". This fixed legal appeals by companies on the "right" costs which shall be used by the regulator.
- **Decisions by regulator** – this includes decisions on topics applicable to all companies, e.g. cost of equity, and individual cost decisions (including the determination of incentive regulation) for each energy network companies.

106 Verordnung über die Entgelte für den Zugang zu Elektrizitätsversorgungsnetzen (Stromnetzentgeltverordnung - StromNEV), https://www.gesetze-im-internet.de/bundesrecht/stromnev/gesamt.pdf.

107 Verordnung über die Entgelte für den Zugang zu Gasversorgungsnetzen (Gasnetzentgeltverordnung - GasNEV), https://www.gesetze-im-internet.de/bundesrecht/gasnev/gesamt.pdf.

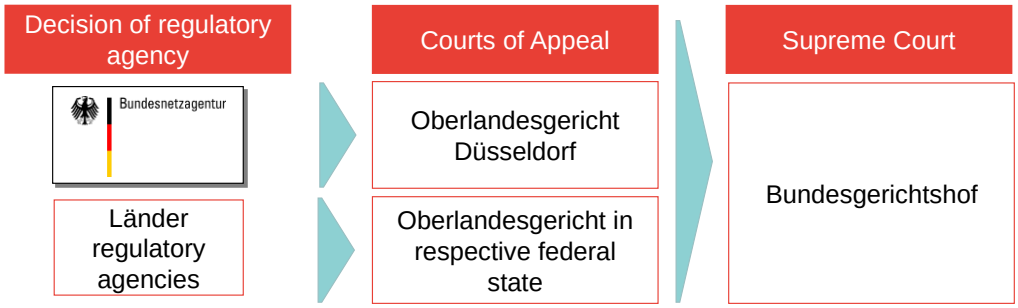
Appendix – Merits review regimes overseas

Key features of the German energy network merits review regime

The nature of the review

Under the German arrangements the appeal bodies for decisions of regulators are courts:

Figure 7. Appeal process in Germany



Source: Frontier Economics

In Germany there is a two stage appeals procedure.

- Regulatory decisions may be appealed to the Courts of Appeal. These courts are the Oberlandesgericht Düsseldorf for decisions taken by the federal regulator, Bundesnetzagentur, and the Oberlandesgericht in the respective federal states for decisions taken by federal states regulatory.
- Decisions by the Court of Appeal can be appealed to the Supreme Court (Bundesgerichtshof).

The grounds for appeal differ between the Courts of appeal and the Supreme Court:

- **Limited merits review at Courts of appeal** ("Beschwerde") – the grounds for appeals against decisions from the regulator can relate to process or substance of the decisions. According to §75 (1) EnWG the appeal can be based on new facts and evidence.
- **Judical Review at Supreme Court** ("Rechtsbeschwerde") – the grounds for appeals against decisions from court of appeals is restricted (§86 (1) EnWG). The appeal is only possible if
  - a legal question of fundamental importance has to be decided; or
  - the uniform application of law by courts requires a decision from the Supreme Court.

It is worth noting that the Court of appeal in its decision has to state if a "Rechtsbeschwerde" is allowed or not. In the latter case the Court of Appeal has to justify this. Nevertheless, §86 (4) EnWG lists some shortcomings of the court process, which preclude the disallowance of the "Rechtsbeschwerde".

Parties able to appeal

The EnWG grants rights of appeal at the Courts of Appeal to:

- the party directly affected by the decision, i.e. energy network company; and
- parties indirectly affected by the decision. According to § 79 (1) EnWG these are persons, which interests are substantially affected by the decision of the regulator. So in principle this grants consumers the right to appeal against regulator's cost decisions which determine the allowed revenues and resulting network tariffs. However, this right is restricted in practice because these persons only have a right to appeal if they were already a party in the process at the regulator. In order to become a party in this process the person has to apply for this at the regulator. It is legal practice (and there is also a long history of court decisions on this matter) in Germany that these applications are rejected. One of the reasons why these applications are rejected is that consumers in theory have the possibility to take civil legal actions against the tariffs network operators are charging. In the civil court the network operator cannot claim that the tariffs are reasonable, because they rely on a decision from the regulator. The reason is that a decision based on public law (decision by the regulator) is irrelevant for the civil court. Hence, the civil court by itself has to assess if tariffs (and the underlying costs) are reasonable.

The EnWG grants rights of appeal at the Supreme Court to:

- the party directly affected by the decision, i.e. energy network company;
- the regulator; and
- parties indirectly affected by the decision under the conditions described above.

The appeal bodies

The decision body of the Court of appeal ("Oberlandesgericht") consists of 3 judges (§98 (2) EnWG). The judges are assigned to the panel of judges responsible for competition law cases ("Kartellsenat") (§106 EnWG).

The decision body of the Supreme Court ("Bundesgerichtshof") also consists of judges assigned to the panel of judges responsible for competition law cases (§107 EnWG).

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Appeals process

We note that the regulatory periods for the gas and electricity network operators are sequential with a delay of one year, e.g. the 2nd regulatory period for the gas networks last from 2013-2017 while for the electricity networks it is from 2014-2018. As a result Bundesnetzagentur and the federal state regulators can spread their work load. This also has an impact on the potential volume of appeals from the companies.

A party wishing to make an appeal must first make an application for appeal to the regulator. The appeal must be submitted within 1 month, beginning from the working day after the day in which the regulator's decision has been submitted to the party.

The appeal has to be justified. The justification has to be submitted within 1 month, beginning from the working day the appeal was submitted to the regulator. The time allowed can be extended either by application of the party or by the Court of Appeal itself. The justification has to include:

- to what extent the decision is contested and the requested amendment of the decisions; and
- all supporting evidence.

The appeal and the justification have to be signed by a lawyer.

Bringing an appeal does not suspend the effect of the contested decision. In other words: the decision will be executed as if no appeal were brought.

The Court of Appeal is obliged to set up an oral hearing, however, the affected parties can agree to do without an oral hearing. The Court of Appeal can only base its decision on evidence where all parties had the possibility to comment on.

The Court of Appeal has the possibility to commission an expert opinion of its own to assess the evidence provided by the parties, i.e. the energy network company and/or the regulator. This is normally done on very specific topics. For example, in the appeal against the cost of equity decision by Bundesnetzagentur the Oberlandesgericht Düsseldorf commissioned such an expert opinion.

The appeal at the Supreme Court follows similar principles.

The decisions open to the Court of Appeal and Supreme Court

In its decision the Court of Appeal must make one of the following decisions in respect of each appeal item.

- Remit the matter back to the regulator for reconsideration in accordance with the Court of Appeal's directions; or
- Uphold the decision (i.e. reject the appeal).

We note that no appellant can be put in a worse position for filing an appeal (i.e. no *reformatio in peius*). The judgement of a higher court (after a judicial review) cannot amend the decision of the lower court in harm of the defendant or plaintiff who turns to the higher court for a new decision. In addition, we note that the decision of the Court of Appeal is applied only to the appellant, not to all other energy networks. Hence, should one network operator successfully appeal against an element of a cost decision that has been applied to all in the industry, the decision is not automatically read across into the decisions of the other networks.

The decisions from the Supreme Court follow similar principles.

Experience from regulatory determinations and recent appeals

Although the regulatory framework for incentive regulation and the definition of costs is set out in relatively fine detail in the respective decrees, there has been a substantial volume of appeals (hundreds) against the decisions of Bundesnetzagentur and the federal state regulators. However in many instances these appeals have been bundled by the Court of appeals and/or the Supreme Court. A good example was the bundling of appeals on the cost of equity. By bundling decisions the courts avoid any inconsistencies in their decisions and can reduce their workload.

In the following we summarise the main regulatory parameters which were appealed by the energy network companies and the outcome of these appeals:

- **Cost of equity** – as described above the cost of equity in Germany consists of the risk free rate (which is defined in law) and a "risk premium" which is determined by Bundesnetzagentur. In reaching its determination in respect of the "risk premium", Bundesnetzagentur commissioned an expert report, which calculated ranges for the market risk premium and the asset beta. Bundesnetzagentur then decided on the "reasonable risk premium" using the information from the expert report. Bundesnetzagentur also consulted on the draft of the decision on the "risk premium", and the resulting cost of equity, with the industry. The decision on the cost of equity was appealed by a large number of energy networks in the 1st regulatory period. The companies claimed that Bundesnetzagentur had erred in a number of areas, including on the level of market risk premium, the approach for weighting the geometric and arithmetic mean of the market risk premium, and the peer group for the beta calculation. The appeal was against a decision taken in 2008. The Court of appeal ("Oberlandesgericht Düsseldorf")[108] decided in 2013 in favour of Bundesnetzagentur and stated – based on its own expert opinion – that the

[108] OLG Düsseldorf, Beschluss vom 24. April 2013 · Az. VI-3 Kart 61/08, https://openjur.de/u/636510.html.

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decisions by Bundesnetzagentur were all based on sound economic reasoning. Since it decided that there was no unambiguous "right" or "wrong" answer arising from the relevant academic debate, Bundesnetzagentur made transparent the reasons why it decided to go into a certain direction. For example, Bundesnetzagentur applied a 50%/50% weighting of the geometric and arithmetic mean of the market risk premium to determine the final market risk premium. Companies claimed that more emphasis should be placed on the arithmetic mean, which would have resulted in a higher market risk premium. The expert reports from companies referred to certain academic literature. Bundesnetzagentur answered on this claim – supported by an expert report, as well – that in the academic literature there are some authors in favour of the geometric, some in favour of the arithmetic means and some prefer an average of both. Hence, the decision by Bundesnetzagentur to use the average, as well, could not be classified as "wrong", but is a matter of judgment backed based on the academic discussion on this topic. The decision by the Court of Appeal was again appealed by companies at the Supreme Court. The Supreme Court[109] also decided in 2015 in favour of the Bundesnetzagentur and rejected the appeal.

- **Benchmarking model specification** – as described above the "incentive regulation decree" leaves some freedom to Bundesnetzagentur when defining the output parameters for the benchmarking analysis. Some companies appealed their cost decisions for the 1st regulatory period for gas and/or electricity networks claiming that Bundesnetzagentur had erred when defining the final output parameter for the benchmarking analysis. The companies claimed that Bundesnetzagentur did not take into account in an appropriate way the so-called "City effect" (i.e. the effect of connection density on efficient costs). The companies claimed that Bundesnetzagentur should have also included the number of metering points and/or the relation of metering points to connection points as an output parameter. The Court of Appeal found that Bundesnetzagentur gave enough evidence as to how it had determined the final output parameters and that the inclusion of the "City effect" would not substantially improve the quality of the analysis. The Court of appeal therefore rejected this claim. The Supreme Court[110] also followed this line of argument when the matter was subsequently appealed again. Again this appeal process lasted from around 2009 to 2014.
- **General productivity factor** – companies claimed that the definition of the general productivity factor in the incentive regulation decree was not backed

109 Bundesgerichtshof: Beschluss vom 27. Januar 2015 ·Az. EnVR 39/13 https://openjur.de/u/763810.html.

110 Bundesgerichtshof: Beschluss vom 21. Januar 2014 ·Az. EnVR 12/12 https://openjur.de/u/681405.html.

by the respective article in the then Energy Act (EnWG). Hence, companies appealed against the application of the general productivity factor for the 1st regulatory period. The Supreme Court[111] agreed with the line of arguments of the companies and decided that no general productivity factor should be applied. The government reacted on this Supreme Court decision by amending the Energy Act (EnWG) retrospectively, so that no changes of the cost decisions for the 1st regulatory period were necessary.

- **Cost for "excess equity" and index for defining replacement values** – Companies appealed decisions with regard to the cost of "excess equity", i.e. the equity exceeding the notional share of 40%, and the index used to calculate the replacement values for equity financed assets pre 2006. In both cases the Court of Appeal and/or the Supreme Court[112] decided in favour of the companies. This resulted in an amendment of the network tariffs decrees in 2013 including an additional article defining the calculation for the cost of "excess equity" and the indices used to define replacement values.

Further appeals have been made against regulatory decisions in respect of:

- working capital[113];
- the value of beginning of period RAB[114]; and
- specifics on other regulatory parameters, e.g. calculation of expansion factor, particular investment measures[115].

The following picture emerges from the German regime, which is characterised by relatively prescriptive laws that limit the discretion of the regulator in some, but not all, dimensions.

- Many appeals have been heard during the regulatory periods following the implementation of the present regime. These appeals tested important aspects of the framework.

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111 Bundesgerichtshof: Beschluss vom 28. Juni 2011 ·Az. EnVR 48/10, http://juris.bundesgerichtshof.de/cgi-bin/rechtsprechung/document.py?Gericht=bgh&Art=en&nr=56878&pos=0&anz=1.

112 Bundesgerichtshof: Beschluss vom 18. Februar 2014 Az. EnVR 71/12, https://openjur.de/u/684178.html; Bundesgerichtshof: Beschluss vom 12. November 2013 Az. EnVR 33/12, https://openjur.de/u/675081.html.

113 Bundesgerichtshof: Beschluss vom 5. Oktober 2010 ·Az. EnVR 49/09, https://openjur.de/u/554729.html.

114 OLG Düsseldorf: Beschluss vom 11. September 2013 Az. VI-3 Kart 198/12 (V), https://openjur.de/u/647559.html; Bundesgerichtshof: Beschluss vom 10. November 2015 Az. EnVR 42/14, https://openjur.de/u/868539.html.

115 Bundesgerichtshof: Beschluss vom 28. Juni 2011 ·Az. EnVR 48/10, http://juris.bundesgerichtshof.de/cgi-bin/rechtsprechung/document.py?Gericht=bgh&Art=en&nr=56878&pos=0&anz=1.

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- The courts have explored these issues thoroughly, permitting new evidence to be adduced in proceedings, and commissioning their own expert advice to assist to exploring complex issues thoroughly.
- The appeal processes have been lengthy, with some lasting more than 5 years.
- In certain areas, including most of the substantive areas of regulation, the courts have found in favour of the regulator and against the companies. It did so when it considered that the approach of the regulator was as required by law and where the regulator had relied on sufficiently sound economic principles.
- However, in certain areas the courts have found in favour of the companies, and in these circumstances they have provided clear guidance on why.
- This guidance has allowed legislators to revisit certain aspects of the legislation to expand/amend the original wording, in order to better meet policy objectives and to better enshrine sound economic principles in the legislation.

Appendix – Merits review regimes overseas

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