REVIEW OF THE LIMITED MERITS REVIEW REGIME

STAGE ONE REPORT

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1. INTRODUCTION AND KEY FINDINGS/CONCLUSIONS

On 30 April 2012 the Panel was appointed to consider issues arising from the performance of the limited merits review (LMR) regime for electricity and gas networks submitted its Interim Report on Stage One of its work to the Standing Council on Energy and Resources (SCER). The Panel now submits its completed Stage One Report, which, for ease of future reference, incorporates the material presented earlier, with minor adjustments where appropriate to reflect the later, wider context. The major new material is in sections 4, 5 and 6 below; of which the most substantive is section 6, which sets out our assessment of the performance of the regime, evaluated relative to the original policy objectives and intentions.

Section 4 addresses the requirement in the Terms of Reference to provide quantification of the impacts of the outcomes of appeals of regulatory decisions to the Australian Competition Tribunal (ACT). We have singled out this aspect of the evaluation tasks for a short, separate treatment, because the relevant numbers can easily be misinterpreted. As explained in section 4 the estimates presented are immediate, impact effects of the decisions, considered in isolation from other factors. They are therefore not measures of the ultimate effects on the long term interests of consumers, which, given the National Electricity Objective (NEO) and National Gas Objective (NGO), are the things that it would be desirable to measure.

The Panel's findings on this material are limited to two obvious points, and to a more fundamental conclusion that foreshadows the Panel's most important conclusions on the performance of the regime: (i) in some cases, the immediate impacts have been of considerable financial significance; (ii) the immediate impacts in these cases have been higher prices for users and consumers; and (iii) it is not possible for the Panel to reach a view of the effects of the decisions on the long-term interests of consumers.

The reason for the last of these conclusions is that the changes resulting from the ACT decisions are made relative to initial decisions of the relevant regulator (principally the Australian Energy Regulator (AER), but also the Economic Regulation Authority (ERA) in Western Australia), and the longer-term impact of the ACT decisions depends upon the likely effectiveness (in achieving policy objectives) of the AER/ERA decisions that are being amended. Unfortunately, notwithstanding the high level of assessment activity that has taken place at the appeals stage, *there have been no evaluations, within the merits review process, of the effectiveness (in achieving policy objectives) of the initial, overall AER decisions*.

Section 5 is, for the most part, a 'reporting' section, which summarises review arrangements in other regulatory areas and in overseas jurisdictions. The material here will be relevant for Stage Two of the Panel's tasks, and for the moment it suffices to note that (a) for major regulatory decisions such as price or revenue control determinations, some or other form of merits/administrative review is a common feature of regulatory systems, and (b) the comparisons indicate considerable diversity in institutional arrangements. Whilst the

Australian arrangements can be said to be unique, the same can also be said about most of the other frameworks: there appears to be no 'standard model' to draw upon.

Section 6 sets out the Panel's principal findings and conclusions. Having examined the Ministerial Council on Energy's (MCE's) Decision Paper and other, related documents of the time, we are clear that, notwithstanding the desire to limit the potential for escalating delays and costs, policy makers recognised the importance of being able to review regulatory decisions at a broad enough level to secure improvements in decisions, and improvements in decision making, that would contribute to the achievement of the National Electricity and Gas Objectives. This is reflected both in discussions in relevant documents and in decisions that sought to mitigate the risk of an overly narrow approach to review, most particularly the introduction of s71O(1) of the National Electricity Law (NEL) and s258(1) of the National Gas Law (NGL). The policy position was, in turn, well grounded in important features of the relevant, regulatory decision making processes. As the Administrative Review Council (ARC) pointed out in its submission in 2005, among the decisions to be reviewed are ones that *"... involve high levels of discretion, complex economic concepts and many layers of small, inter-related judgments."*

The Panel's high level assessment of the performance of the LMR regime is that, in its implementation, the regime has failed to address the realities of regulatory decisions summarised in this ARC statement. Instead, a narrower, more formalistic and more formulaic approach to review has developed, which has been relatively detached from the promotion of the objectives set out in the NEL and NGL, and particularly from the requirement that regulatory decisions be directed toward encouraging outcomes that are in the long term interests of consumers. The reasons for this development are probably several, and, given the Terms of Reference, the Panel has not sought to address them fully in Stage One of its Review.

In relation to the specific weaknesses of the appeals arrangements, the Panel has identified the following deficiencies of the regime:

- The arrangements have not ensured that all stakeholders' interests have been adequately taken into account. Specifically, the long term interests of consumers have typically not been explicitly considered when review decisions have been made.

- Consumer bodies and network user associations (with justification) feel excluded from the appeals process, including, but not exclusively, for cost reasons.

- The regime lacks legitimacy with important stakeholder groups: trust and confidence in the AER and the ACT has not been established, and the AER itself does not appear to have any great confidence in the regime as currently constituted.

- The lack of legitimacy puts regulatory certainty at future risk, particularly if upward pricing pressure continues, driven by factors such as the increasing costs of environmental regulation.

- Doubts about the effectiveness of the regulatory arrangements have a basis in the facts that (a) some of the ACT's decisions have had major implications for network charges and end consumer prices, (b) convincing and coherent accounts of how these decisions might have positive effects on the long term interests of consumers have been lacking, and (c), more generally, an informed consumer would find it very difficult to discover a credible account, from any authoritative source, of why energy prices are changing as they are.

- The measures introduced to mitigate the risk of appeals becoming too narrowly focused, most particularly s71O(1) of the NEL and s258(1) of the NGL, have not been utilised. Why this is so is, at the moment, something of a puzzle, to which attention will need to be turned in Stage Two of the Panel's Review.

- The LMR has been costlier to operate and cases have taken longer than was anticipated at the outset.

On the basis of these points, the Panel has no hesitation in concluding that there has been considerable divergence between outcomes and the policy intentions that motivated the development of the LMR regime. Further, the magnitudes of the divergences and their potential implications for the achievement of high level public policy objectives indicate that a considerable effort is merited in seeking to strengthen the regime, in ways that will allow it to better serve its intended purposes. Such strengthening would also increase the robustness of the regime in the face of what might turn out to be challenging times in the energy sector.

In the next three months the Panel will be considering what recommendations to make to the SCER about adjustments that might be made to the regime, and will, as it has done thus far, be seeking the constructive assistance of stakeholders in the process. In order to get this next stage of deliberation and discourse off to a good start, section 7 of this Report, headed 'Next Steps', provides some guidance on current Panel thinking about how the evaluation of options might be developed, and what factors might be influential in shaping the Panel's further thinking.

2. BACKGROUND TO THE CURRENT REVIEW

On introduction of the limited merits review (LMR) regime, the Ministerial Council on Energy (MCE) decided that a review of the effectiveness of the regime should occur within seven years of its commencement. This commitment to a review was included in the relevant legislative instruments, and anticipated a public review that would '*assess how the review scheme has operated since commencement.*'

In December 2011 the Standing Council on Energy and Resources (SCER), the successor organisation to the MCE, agreed that the review of the LMR regime should be brought forward, with the intention of it concluding by 30 September 2012. A Terms of Reference document was developed for the review and, on 7 March 2012, an expert panel (the Panel) was appointed. The review formally commenced on 7 March 2012.

The Panel consists of Professor George Yarrow (Chair), Dr John Tamblyn and the Hon. Michael Egan. The Panel is supported by a Secretariat provided by the Commonwealth. The Secretariat's functions are primarily administrative in scope, and include the provision of logistical support for consultations and some assistance in summarising submissions and other research.

The review is being conducted under the auspices of the SCER. The Panel is independent from the SCER and is funded by a special account contributed to by all the SCER member jurisdictions.

This report is the Panel's Stage One Report under the Terms of Reference. It does not necessarily reflect the views of SCER or its officials.

2.1 Origin of the Limited Merits Review Regime

In 2005, the MCE's Standing Committee of Officials (SCO) released a consultation regulation impact statement (RIS) regarding options for regulatory decision making in the electricity and gas sectors. This set out the principal issues for consultation and the MCE's initial views. Following extensive consultation and discussion on the RIS, the MCE released its Decision Paper '*Review of Decision-Making in the Gas and Electricity Regulatory Frameworks*' in May 2006.[1] The Panel has relied heavily on this Decision Paper in forming its views about the underlying objectives in establishing the LMR regime; although, as suggested in some submissions, interpretation of objectives has also taken account of the

[1] Ministerial Council on Energy (2006) "Review of Decision-Making in the Gas and Electricity Regulatory Frameworks", Decision, May 2006.

wider context of the institutional and policy developments of the time, and of other documents that contain relevant material.

A central issue for the MCE concerned the objective of providing a regulatory framework that *'promotes the efficient investment in and use of energy infrastructure, such that economic regulatory decisions provide a balanced outcome between competing interests and protect the property rights of all stakeholders'*. The Panel notes that (i) this is not quite the same formulation as that of the National Electricity Objective (NEO) and National Gas Objective (NGO), but (ii) there is no necessary inconsistency between the two formulations provided that care is taken when interpreting the notion of 'balancing'. Specifically, assessing the 'long term interests of consumers' – the criterion that lies at the heart of the NEO and NGO – requires a balancing of the consequences of regulatory decisions for potentially conflicting purposes (promoting the interests of consumers today and promoting the interests of consumers tomorrow). The relevant 'balancing' between Network Service Providers (NSPs) and consumers is of a different kind, since it involves relationships between means (ways of promoting efficient investment in, operation of and use of networks) and ends or purposes (the 'long term interests of consumers').

In assessing the best ways of achieving the specified goal, the RIS canvassed a number of options for the review of regulatory decisions:

- continuing with the then status-quo;
- relying on judicial review only;
- introducing full merits (*de novo*) review; and
- introducing a limited merits review regime.

As part of the initial assessments, the SCO provided a brief analysis of these options and an initial indication of its preferred approach. These views can be summarised briefly as follows.

- ***Status Quo:*** The status quo was not favoured because of a separate objective of the MCE, which was to introduce consistent frameworks for reviews of decisions in relation to gas and electricity.

- ***Judicial Review:*** Judicial review was assessed as having some clear advantages, including promoting regulatory certainty, avoidance of multiple actions relating to a single matter, and good use of assessment resources via remittance back to the Australian Energy Regulator (AER) rather than substitution of a new decision. It was also assessed as having potential drawbacks including: potentially high costs and significant delays to the appeal process; and limitations on matters that could be appealed, particularly those relating to the merits of an administrative decision. It was considered that the cost, complexity and legal formality, of Judicial Review could make it an unattractive option for energy users and other interested third parties.

- ***Full Merits Review:*** Whilst the potential contribution of Full Merits Review to more efficient decision making was noted, the approach was not favoured, primarily because of issues around regulatory uncertainty and the challenges a review body would face in re-assessing a decision that was, in part, based on a lengthy iterative and consultative process. There was also concern that this approach would give rise to large financial costs that would have to be borne first by the applicant and regulator, then passed on to consumers and/or taxpayers.

- ***Limited Merits Review:*** LMR was perceived to have a number of benefits including: the potential to correct a range of errors, and not just errors of law; providing a higher level of accountability for decision-makers; allowing competing interests to be weighed; and the possibility of mitigating risks associated with gaming the system by imposing restrictions on the matters that would be subject to review. The primary drawback of the option identified in the initial assessments was the potential for the regime to be biased towards the regulated entities, i.e. the NSPs.

2.2 The MCE Decision Paper

In its Decision Paper,[2] the MCE confirmed a policy preference for the LMR option over what had developed into the next most favoured option, namely reliance on Judicial Review only. Following this decision, changes to the relevant legislative instruments were enacted and the LMR regime came into force.

As indicated, the Decision Paper has been central to Stage One of the Panel's Review, because it summarises the MCE policy position and its expectations regarding the benefits of reviews of decision making in the electricity and gas sectors. In addition, the Decision Paper outlined the decisions to be subject to review, the reviewing body (the Australian Competition Tribunal (ACT)), the participants in the review process, the grounds of review, the details of admissible evidence, and costs and administrative procedures. The Paper also contained a commitment that a review of the new regime would be undertaken within seven years of its introduction.

Of particular significance for the Panel's work are the various remarks concerning policy intent contained in the Decision Paper. For example, the MCE expressed an intention to develop a system that would achieve the best decisions possible from among those considered feasible, within a framework where the benefits of the review could be expected to outweigh the costs to stakeholders.

Various criteria that were considered relevant to the development of the review scheme were listed as follows:

- Maximising accountability;
- Maximising regulatory certainty;

[2] Ibid.

- Maximising the conditions for the decision maker to make a correct initial decision;
- Achieving the best decisions possible;
- Ensuring that all stakeholders' interests are taken into account, including those of service and network providers, and consumers;
- Minimising the risk of 'gaming'; and
- Minimising time delays and cost.

These criteria raise immediate questions concerning how they relate back to the objectives and principles set out in the National Electricity Law and National Gas Law , and whether and how they should be weighted when resolving trade-offs. The Panel has received helpful submissions on these matters in the course of its consultations, particularly in relation to background material capable of providing a wider perspective on the relevant policy context. The main issues are discussed in the opening parts of section 6 below, ahead of the Panel's assessment of the performance of the LMR regime.

3. THE PANEL'S APPROACH

3.1 Organisation of the Review of the LMR

The Terms of Reference divide the Panel's tasks into two stages:

- *Stage One.* An overview assessment of how the LMR regime has operated to date in both the electricity and gas sectors, and of the extent to which policy outcomes anticipated in the MCE Decision Paper have been achieved. Stage One was required to be completed by 30 June 2012.

- *Stage Two.* To provide advice to the SCER about whether changes to the avenues for appeal available for network businesses are required to deliver an appropriate balance between the commercial needs of the businesses and efficient outcomes for consumers, consistent with the NEO and NGO.

As noted in our Interim Report, the Panel's view is that the first of these stages is a largely stand alone exercise, centred on a backward look at what has happened, but that the second, more forward looking stage, will be partly dependent on the evidence discovered and views formed during Stage One. The two stages also involve somewhat different evaluative exercises: the first comparing actual and expected outcomes, the second comparing alternative options for improvement on the basis of criteria that reflect over-arching policy objectives.

Stage One

The practical import of the Panel's approach is that the relevant counterfactual in Stage One of the Review is based on the outcomes anticipated in the MCE decision paper. That is, it is with these initial anticipations that actual outcomes are compared. The Panel has therefore focused on two major tasks:

- Developing an understanding of the history and performance of the LMR regime to date, and

- Developing an understanding of the policy objectives underlying the MCE's Decision, and of how the MCE anticipated that the LMR regime would work in contributing to these objectives.

For the first of these tasks, we gathered evidence on, among other things:

- The chief characteristics of the cases that have come before the ACT to date,

- The structure of the LMR regime, with a view to assessing whether any inferences about incentives can be made from that structure,

- The conduct of the various parties who have been participants or potential participants in the LMR appeals process since its inception,

- The reasoning contained in the ACT's judgements,

- Some of the more important energy cases from the period before the LMR regime was introduced,

- Some of the more important appeals cases arising in other sectors, and

- Practice in comparator jurisdictions overseas.

Stage Two

Having compared actual outcomes with anticipated outcomes, Stage Two of the Panel's task will be to provide advice to the SCER on whether any changes to the regime appear desirable in the light of past performance and its contribution to over-arching policy objectives. Although the precise scope of the work in Stage Two has yet to be decided by the Panel, we provide some guidance on initial thinking in section 7, on Next Steps, below, and here make one or two more general points about our likely approach.

- As discussed below, although the Panel has formed the view that the outcomes of the LMR regime have fallen short of expectations in some important respects, it is not necessarily the case that alternative approaches will produce better results/outcomes. The point here is simply that Stage Two involves a different set of comparisons, between the assessed effects of different options, not (as in Stage One) between actual outcomes and expected outcomes.

- In assessing the relative merits of alternative options, including the merits of larger and smaller scale changes, we will draw on the findings of the Stage One investigation, as set out in this Report.

- The Terms of Reference for the Panel noted the significant interdependencies between the work of the Panel and the subject matter of the AER's initiated Rule change proposal for the Economic Regulation of Network Service Providers (NSPs), currently being reviewed by the Australian Energy Market Commission (AEMC). The Panel has already been engaging with the AEMC on this process and will engage more closely during Stage Two, since the relative merits of any options being considered might well be affected by the outcomes of the AEMC's rule change process.

3.2 Consultation

The Panel has been greatly assisted in its tasks by the consultation process, which has provided a considerable amount of information via written submissions and reports, and via the meetings that the Panel has held with interested parties. Without exception, the interchanges have been constructive, and the overall quality of the material can only be described as exceptionally high by international standards. Details of submissions to the Panel, and of Panel meetings, are set out in Annexes 5 and 6 respectively.

In order to provide an initial, organising framework for consultation, the Panel published two 'statements of issues' or consultation papers, setting out areas where we sought views. In retrospect, these are to be interpreted as starting points for thinking about the LMR regime, rather than as documents that capture all, or nearly all, of the central issues. The Panel's thinking developed, and continues to develop, iteratively, and the discussion in section 6 below has been considerably influenced by this process.

We do not seek to summarise the written and oral submissions to the Panel in this Report, but some of the main points that came out of it are referenced in the discussion in section 6. The Panel does note, however, that in addition to areas where there was almost universal agreement and areas where the views of different stakeholders diverged strongly, there were some issues on which the centre of gravity of views was closer to what might be described as puzzlement. Since these puzzling issues appear to have major implications for Stage Two of the Panel's Review, we have left them as open questions for now.

3.3 General Observations on the Operation of the LMR Regime over Time

Description of the Limited Merits Review Process

The LMR regime allows parties affected by prescribed decisions to have those decisions reviewed by the ACT where it can be established that there is a serious issue to be heard and *relevant* grounds for review. Key features of the existing review model in the NEL and NGL are:

- Allowing limited merits review, by the ACT, of certain regulatory decisions, where, in this process, the ACT has the functions and powers of the original decision maker;[3]

- The applicant must seek leave from the ACT to bring a review based on certain criteria;[4]

- The applicant must establish one or more of four grounds of review based on regulatory errors of fact or discretion[5] and demonstrate there is a serious issue to be heard[6];

[3] NEL s71P(3) and NGL s259(3).
[4] NEL s71E – 71H and NGL ss248-251.

- The AER may raise a matter not raised by the applicant or an intervener and may raise a possible outcome or effect that may occur as a consequence of the ACT varying or setting aside a determination[7],

- A regulated network service provider or a Minister of a participating jurisdiction may intervene in a review without leave of the ACT, and the ACT may grant leave to intervene to a user, consumer or a person or body who is a reviewable regulatory process participant[8],

- A party, other than the AER may not raise any matter that was not raised in submissions to the AER before the reviewable regulatory decision was made[9],

- The ACT must not consider any matter other than review related matter[10], and

- An applicant has 15 business days to bring an application for review. The ACT has a time limit, after granting leave, of three months (which may be extended) to determine the review.[11]

The following decisions are subject to merits review[12]:

- Ministerial decisions in relation to coverage of gas pipelines (including binding no-coverage determinations);

- Decisions by the AEMC on the form of regulation to apply in gas;

- AER[13] decisions to draft and approve (or revise) gas access arrangements;

- AER ring fencing decisions, including non-approval or voiding of associate contracts, in gas;

- AER pricing and revenue determinations for transmission and distribution in electricity (including application of regulatory test); and

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[5] NEL s71C and NGL s246.
[6] Even if there is a serious issue to be heard, leave to have an application heard relating to revenue amounts must be refused by the ACT unless the error demonstrates a financial impact of more than $5 million or 2%.
[7] NEL s71O(1).
[8] NEL s71J - 71L.
[9] NEL s71O(2).
[10] NEL s71P.
[11] NEL s71D, 71Q and NGL s247, s260.
[12] From NEL s71A "A reviewable regulatory decision is a network revenue or pricing determination that sets a regulatory period or any other determination or any other decision of the AER that is prescribed by the NER to be a reviewable regulatory decision".
[13] The MCE noted that, for the AER decisions specified in this paper, in the case of Western Australia, the relevant decision-maker was that State's Economic Regulation Authority (ERA).

- AER decisions not to exempt entities from ring fencing guidelines or impose additional ring fencing requirements, in electricity[14].

Number of appeals

In the period from the commencement of the LMR arrangements in January 2008 to 29 February 2012[15], information currently available to the Panel indicates that the ACT issued 40 separate decisions in relation to the energy sector, of which some 22 decisions involved matters of a substantive nature (i.e.: they were not decisions on questions of leave to appeal, or other procedural matters). The ACT has often determined a number of separate substantive matters within a single decision, reflecting multiple, separate grounds of appeal raised by the parties. Since the commencement of the limited merits regime in January 2008, the ACT has considered a total of 53 substantive matters

A high level overview of the operation of the current LMR regime in the NEL and NGL since its introduction in 2008 is provided in Tables 1.1 and 1.2 at Annex 1. These tables have been prepared by the Australian Government Solicitor (AGS).[16] Note that some different aspects of some decisions are provided in both Tables 1.1 and 1.2.

Table 1.1 provides a summary of elements, other than the weighted average cost of capital (WACC), that have been appealed and covers electricity and gas decisions of the ACT since 2008. Table 1.1 details the 25 non-WACC matters which were successfully appealed. Ten of these matters were remitted to the AER.

Table 1.2 provides a summary, in tabulated form, of the cases in which WACC parameters were in dispute and includes:

- The elements of decisions that were appealed;
- The ground/s of review under which decisions were appealed;
- The findings in relation to decisions of the regulator that were appealed;
- The findings of the ACT (as compared with the Regulator's findings);

[14] It is noted that, in the Northern Territory and Western Australia, the model applies to gas access matters. Electricity decision references relate to the National Electricity Market.

[15] The Panel has taken note of ACT decisions since 1 March, and these have been considered in discussions of the various issues. However, the later decisions have not been incorporated into the tables prepared for the Panel by the AGS, which reflect the position at the beginning of the current Review. In late June, the Energy Networks Association (ENA) submitted a Table summarising ACT cases which brings matters up to date at the time of its submission, and which will be made available on the Review's web pages. The ENA table covers the ATCO decision of early June 2012, which appears significant and which the Panel will consider more carefully at the beginning of Stage Two of its Review.

- Any decision by the ACT to exercise its discretion under e.g. Pt 6 Div 3A of the NEL and Ch 6 Pt 5 Divs 2-4 of the NGL. These include decisions granting leave to intervene in a review, allowing new information or material to be submitted and extending the period within which a determination must be made (evidently, the cases tabled are those in which leave to apply for review was granted); and

- Whether the ACT remitted decisions to the regulator or made substitute decisions.

As suggested by the AGS, some points to note from the information provided in Table 1.2 are:

- In all of the cases considered, the ACT decided the applicant had successfully made out a relevant ground for review;

- Service providers have successfully appealed regulators' determinations of the debt risk premium, the risk free rate, and the assumed utilisation of imputation credits (gamma). However, challenges to decisions on the equity beta parameter have been unsuccessful;

- Where the ACT's reasons are clear as to the grounds of review[17], applicants have, most often, been successful on the ground that the regulator's decision was unreasonable. For example, in four of the five cases dealing with the debt risk premium, applicants were successful on the 'unreasonableness' ground;

- The other ground of review on which applicants have tended to succeed is the 'incorrect exercise of discretion' ground. The ACT has been careful to note that 'incorrect exercise of discretion' is a separate ground for review from the ground of unreasonableness;

- The ACT extended the period for making its determination under s71Q of the NEL in two matters.

- Leave to intervene was granted to two parties in Application by EnergyAustralia [2009] ACompT 8. South Sydney Organisation of Councils was granted leave to intervene in EnergyAustralia's application and Nyrstar Australia Pty Ltd was granted leave to intervene in Transend's application. In Application by GasNet Australia (Operations) Pty Ltd [2003] ACompT 6, a case under the Gas Pipelines Access (Vic) Law, Energy Action Group which represents the interests of domestic utility consumers was granted leave to intervene; and

[17] The grounds on which an applicant has successfully challenged the regulator's decision are not always apparent from the terms of the Tribunal's decision. Language such as 'the AER fell into error' are, in this respect, opaque.

- Of the cases examined, only one involved remittal to the regulator. In Application by EnergyAustralia and Others [2009] ACompT 8 (12 November 2009) the ACT remitted the relevant matter back to the AER.

4. THE DIFFICULTIES IN ESTIMATING EFFECTS ON REVENUES AND PRICES

4.1 Effects of the outcomes of appeals on revenues and prices

As part of the contextual information specified in the Terms of Reference for the Review, the Panel was asked to assess the impact of appeal outcomes on Network Service Providers (NSP) revenues and on prices to end users. The Panel has chosen to address this aspect of the information separately from the rest, for two reasons:

- The relevant 'information' is of a qualitatively different kind to the other contextual matters specified, being evaluative rather than factual; and

- Simple presentation of the numbers without explanation is likely to be misleading.

It is not a particularly difficult exercise to calculate an immediate impact effect of an ACT decision, particularly in cases where (a) the ACT finds against the appellant and the original AER decision is unaffected, or (b) there is an adjustment to a cost of capital component. In the first case, the direct impact on revenues/prices will be zero (although there will be the costs of the appeal itself to be borne); in the second case it is a matter of calculating the revised, allowed cost of capital and applying it to the regulatory asset base.

Crucially, such calculations assume all other things are equal, or are unaffected by the ACT decisions; but that is not an assumption that can safely be made. Consider, for example, an outcome in which the cost of capital is adjusted upwards on appeal, but in two different contexts, each involving a privately owned NSP:

1. The original regulatory decision had set the allowed cost of capital at a level significantly below market rates, and

2. The original regulatory decision had set the allowed cost of capital at a level significantly above market rates.

In case 1, if the appeal outcome had been no adjustment, regulated prices would have been set on a below cost basis, which, over time, is a sure way to destroy supply side incentives generally, and to discourage investment in particular. Although (by assumption) the appeal leads to higher prices in the short-run, the hike would be based on unduly low, pre-appeal prices. Consumers might be worse off in the short term as a direct result of the decision, but in general we would expect the long-term interests of consumers to be better promoted by avoiding what would, in effect, be a partial expropriation of capital. Although the chain of consequences might be difficult to anticipate with any precision, experience indicates that, in

the longer-term, prices to consumers for supplies of given quality (e.g. given reliability) would tend to be lower, not higher, as a result of the price hike consequent on the appeal.[18]

The position looks very different in case 2, however. Here, by hypothesis, the capital of the relevant NSP is already being more than adequately remunerated, and the general expectation is that the upward adjustment to prices caused by the appeal has the effect of transferring resources from consumers to companies, via price hikes, with little or no compensating benefit. In fact, it is possible for the outcome to be even worse for the long term interests of consumers than a simple calculation of immediate financial impacts might suggest. Perceptions that decisions that are already over-generous to NSPs are being rendered more generous by appeals outcomes can serve to (i) cause those adversely affected to question the effectiveness and integrity of the regulatory regime, (ii) reduce trust in decision makers exercising delegated powers, and (iii) reduce the legitimacy of regulatory institutions and of the system of delegated regulation in its entirety. These are serious matters, and perceptions that outcomes are unfair can, by promoting politicisation of the regulatory process, have highly adverse consequences for regulatory certainty in the longer term. The words 'fair' and 'reasonable' are, therefore, prominent in the lexicon of regulatory best practice.

Assessing the revenue and price implications of appeal outcomes in a way that is relevant to the NEO and NGO requires substantive, longer-term impact assessment, to examine the effects of a decision, or a series of decisions, in their entirety, without leaving anything relevant out. If an outcome boosts confidence in the regulatory system, for example because it contributes to the NEO or the NGO, that is an effect to be taken into account, and so are the effects consequent on such a boost in confidence. A similar point holds in relation to the implications of appeal decisions for investment incentives.

The Panel is not in a position to assess these matters, however, largely because it has insufficient material before it on which safe assessments can be made. As we understand it, at least in relation to the cost of capital cases, the AER's position is that its original price control decisions were, irrespective of errors of fact and calculation that might subsequently have been found, substantively sound, and that they allowed NSPs good prospects of revenues at least sufficient to recover efficiently incurred costs, including a reasonable rate of return on capital invested. It might have been expected that, at some point during the course of merits review, that (AER) position would have been tested, to at least some extent, and that the ACT's assessments of the AER's, broad views would themselves be available for evaluation by stakeholders, as part of a normal regulatory discourse.

That is not, however, how the merits review regime has worked to date: the merits of the most substantive outcomes of the AER's work – i.e. the revenues determined – have not themselves been assessed, either directly or indirectly, in terms of their implications for the long term interests of consumers (which depend upon prices stretching well out into the future, as well as upon prices in the immediate period). We note in passing the apparently

[18] In practice, the usual outcome in this type of situation (i.e. below cost pricing) is lower reliability, but other things being equal, this is equivalent to an increase in the 'quality adjusted' price.

paradoxical result that the merits of the AER's determinations of revenue allowances have not, in fact, actually been reviewed in the course of merits review, but the more pressing point is that the Panel is not in a position to fill that gap. What the Panel is in a position to conclude, however, and which it does conclude, is that the existence of this 'assessment gap' is not something that was intended by the MCE, and that it is a major defect of the way in which the LMR regime has been implemented and operated in practice.

We say 'major' defect because of the nature of the outcomes in the sequence of cost-of-capital cases that have come before the ACT. It is these that have attracted the hostility of non-NSP stakeholders, and which have raised questions about the integrity and effectiveness of the regime; effects that are obviously related to the size of the direct and immediate impacts of ACT decisions on the determined revenues (and hence on network charges and end-user prices). Major transfers of resources have taken place in consequence of those decisions, without any substantive evaluation of whether those transfers were merited in terms of the NEO and NGO.

Given these points, and re-emphasising the dangers of misinterpretation, we report below estimates of the sizes of the revenue transfers for the major cost-of-capital appeals outcomes. These estimates have been provided by submitters to the Panel in the course of Stage One of the current review. We note that there are some differences in approaches, and there is some controversy surrounding the estimates. The Panel has, however, not sought to adjudicate on these matters: the submissions all conclude that, in dollar terms, large transfers of resources have occurred in consequence of the ACT decisions, and the estimates of the size of the transfers are not radically dissimilar. That conclusion, which appears to be uncontested, is sufficient for the Panel's current (Stage One) purposes.

4.2 Estimates of the implications of ACT cost-of-capital decisions for the revenue determinations under review

In his report commissioned by the Energy Networks Association (ENA), Professor Allan Fels included the following table setting out estimates of the revenue impacts, over the relevant pricing period, of Tribunal determinations.

These estimates do not include revenue impacts for the Victorian electricity distribution review and the Queensland (QLD)/South Australia (SA) gas review, which were not publicly available at the time the report was completed.

Revenue impacts of Tribunal determinations (Table 3 of Fels report)

Proceedings	Estimated revenue impact
SA electricity transmission	$21 million
NSW electricity distribution and transmission/ Tasmania transmission	$1,919 million
SA/QLD electricity distribution	$815 million
Australian Capital Territory gas	$5 million
NSW gas	$148 million

In Table 3 of a report for the APA Group, Ernst and Young produced the following estimates for direct revenue impacts on an annual basis.

Annual revenue impact of corrections in AER allowed Weighted Average Cost of Capital (WACC) (Table 3 of Ernst & Young report)

Error corrected	Corrected WACC	Impact per annum ($m) Total network Regulated Asset Base (RAB)	Impact per annum ($m) Gas networks RAB	Impact per annum ($m) Gas transmission only RAB
Understatement in Debt Risk Premium (DRP)	Base WACC +0.32%	$227m	$27.7m	$3.5m
Overstatement of value of gamma	Base WACC +0.71%	$498m	$60.9m	$7.7m
Total error	Base WACC + 1.04%	$725m	$88.6m	$10.6m

Translating these numbers into impacts over a full five-year pricing period yields an estimated total impact of around $3.6 billion.

Finally, although highly critical of the Ernst and Young methodology, Carbon Market Economics (CME), in a report for the Energy Users of Australia Association (EUAA), made the following estimates for 5-year revenue effects.

Calculation of the difference in allowed revenues attributable to WACC-related appeals (Table 1 from CME report)

Entity	Year Review Sought	Gamma	Debt Risk Premium	Risk Free Rate	Difference between AER and ACT ($million)	Allowed revenue in AER decision ($million)	Difference as a percentage of AER allowed revenues
Integral Energy	2009			X	$388	$4,402	9%
Energy Australia	2009			X	$945	$8,619	11%
Country Energy	2009			X	$467	$5,586	8%
Transend	2009			X	$80	$962	8%
Transgrid	2009			X	$374	$3,619	10%
Energex	2010	X			$288	$7,295	4%
Ergon	2010	X			$200	$6,790	3%
ETSA	2010	X			$246	$3,820	6%
Jemena Gas Networks	2010	X	X		$159	$2,237	7%
ActewAGL distribution (gas)	2010		X		$5	$306	2%
SP Ausnet	2011	X	X		$31	$2,446	1%
Citipower	2011	X	X		$31	$1,190	3%
Powercor	2011	X	X		$58	$2,512	2%
United Energy Distribution	2011	X	X		$41	$1,675	2%
Jemena	2011	X	X		$31	$994	3%
					$3,344	**$52,452**	**8%**
					Total	**Total**	**Weighted average**

The Panel notes that the final column of the CME table gives an indication of the implied effect of the revisions of the AER's initial determinations on network charges. These estimated percentage increases in charges translate into somewhat smaller percentage increases in end consumer prices, since transmission and distribution costs contribute only part of the total costs of retail supplies (a fraction that will vary with type and location of customer).

To illustrate, for a residential consumer of electricity in NSW on a standing offer, recent Australian Energy Market Commission (AEMC) figures[19] suggest that transmission and distribution charges made up approximately 8.1 per cent and 37.6 per cent respectively of the retail price in 2009-10. If, therefore, ACT decisions led to increases in transmission charges of 10 per cent and to average increases in distribution charges of 9 per cent in NSW over the 5 year regulatory period (numbers that are in line with the figures in the CME table), the effect on the end retail price would be around 4.2 per cent over the regulatory period.

As indicated above, the only inference that the Panel is minded to draw from these figures at this stage is that the effects of ACT revisions to AER determinations can be matters of some consequence for network users, end consumers and NSPs. Thus, quite apart from the more fundamental, long term implications of the effectiveness of the LMR regime (e.g. linked with trust, legitimacy, regulatory certainty, etc.), these more readily quantifiable, short-term impacts are sufficient to indicate the significance of the regime for achievement of the NEO and the NGO.

[19] See AEMC, *Future Possible Retail Electricity Price Movements: 1 July 2010 to 30 June 2013*, November 2010.

5. MERITS REVIEW IN OTHER SECTORS AND JURISDICTIONS

The Terms of Reference require that, as part of Stage One of the Review, the Panel provides a high level overview of appeal arrangements overseas and of appeal arrangements operating in Australia in other contexts. This section sets out a general overview, and discusses some of the principal attributes and characteristics of the 'models' adopted in other Australian contexts and in other jurisdictions such as the United States (U.S.), the United Kingdom (UK), one or two other member states of the European Union (EU) and New Zealand. In anticipation of future issues in Stage Two of the Review, we highlight some of the similarities and differences relative to the LMR regime established for Australian electricity and gas networks.

5.1 Appeal mechanisms in other regulated sectors in Australia

The possibility of merits review of administrative decisions is an important and distinctive feature of the Australian legal and administrative landscape. More than 400 Commonwealth acts provide for the merits review of administrative decisions (made under those acts) by the Administrative Appeals Tribunal (AAT). In exercising its jurisdiction, the AAT has the ability to affirm, vary or set aside the decision of the original decision-maker. Other Commonwealth legislation gives responsibility for merits review of administrative decisions to more specialised tribunals – such as the Australian Competition Tribunal (ACT).

Within a general framework, the availability of such review, the competent reviewing body, as well as the process of review itself, can vary in important respects between different agencies, and also as between different decisions within an agency. Such variation can be seen in relation to the availability, and nature, of review of decisions of Commonwealth agencies involved in regulation of the utility industries. For example, it can be seen in the availability of, and approach to, the review of Australian Competition and Consumer Commission (ACCC) decisions made in relation to the third-party access regime (Part IIIA of the *Competition Consumer Act 2010* (CCA 2010)), and in relation to the telecommunications specific access regime (Part XIC of the CCA 2010). We discuss the approaches adopted in these areas briefly below.

The ACT is empowered to review the arbitration decisions of the ACCC associated with the economy-wide third party access regime, such as decisions in the railway and airports sectors. The ACT's role in reviewing these decisions is to re-arbitrate the access dispute, and, for the purpose of the review, the ACT has the same powers as the ACCC. The ACT can either affirm or vary the ACCC's determination. Participation in this review process is limited to those who were involved in the ACCC's determination, and other parties permitted to intervene by the ACT.

Up until January 2011, parties in such proceedings were permitted to submit material to the

ACT that was not before the ACCC when it made its decision. However, following recent changes, the ACT may now only review information submitted to the original decision-maker, with the qualification that the ACT can request certain specified additional information from the ACCC for the purposes of making its decision. The ACT is ordinarily expected to make a decision within six months of receiving the application for review (unless extended). Finally, the determination of the ACT can be appealed to the Federal Court by a party to the arbitration (on questions of law only).

The arrangements for review of decisions under the telecommunications specific access regime are set out in Part XIC of the CCA 2010. Prior to January 2011, the arrangements were based on a 'negotiate-arbitrate' model, whereby once a service is declared, and in the event that the parties are unable to agree to the terms and conditions of access, the ACCC would act as an arbitrator of the dispute. Unlike the arrangements under the economy-wide access regime, merits review was not available in respect of ACCC arbitration determinations under the telecommunications specific access regime. However, access providers in telecommunications could voluntarily submit an access undertaking which specified the terms and conditions of access for a specified service, which the ACCC will either accept or reject. Up until January 2011, the ACT was empowered to review ACCC decisions in respect of such undertakings. When reviewing the ACCC's decision, the ACT was required to assess the undertaking in its entirety having regard to the same statutory criteria by which the ACCC was bound. It could reject or affirm the undertaking.

However since January 2011, the possibility of merits review of undertaking determinations by the ACCC is no longer available. This follows from more general changes to the access regime, and in particular the replacement of the negotiate-arbitrate approach to one where the ACCC now has the power to set up-front access prices and terms for declared telecommunications services for a period of between three and five years. In effect, the ACT no longer has a role in hearing reviews in relation to access in the telecommunications sector.[20] The explanatory memorandum to the Bill that introduced these changes noted that: "*To promote regulatory certainty and timely decision-making, merits review of decisions under Part XIC is no longer available. Judicial review is still available, however, for parties wishing to appeal a point of law.*"

It is notable that, under the former appeals process in the telecommunications sector, all of the ACCC decisions that were challenged were affirmed by the ACT on appeal. That is, with the exception of one decision (relating to the ACCC's decision to exempt certain of Telstra's Exchange Service Areas from standard access obligations),[21] the appellants had been unsuccessful in their appeals on telecommunication matters before the ACT.

[20] The ACT continues to have a role in relation to the anti-competitive conduct regime in telecommunications (Part XIB of the CCA).
[21] Application by Chime Communications Pty Ltd [2008] ACompT 4 (22 December 2008).

5.2 International approaches to review and appeals in the energy sector.

The discussion below presents a very general overview of the appeals processes in the energy sector, particularly in the U.S. and the UK, which are two countries that have developed liberalised energy markets over the past two to three decades. In considering international approaches, the Panel considers that it is important to bear in mind that the appeals mechanisms that have developed reflect specific regulatory arrangements, legal and institutional frameworks, and a range of historical factors associated with each jurisdiction. Such contextual factors may differ in important respects from those which prevail in Australia.

Nevertheless, the comparisons can potentially yield useful high-level insights into the principles at work in the development of appeals processes. As discussed below, in the U.S. there is a considerable emphasis in the arrangements on trying to achieve settlement between parties, with contested matters that are not settled heard in trial-like proceedings before an internal (to the agency), but impartial, administrative law judge (ALJ). The ALJ makes a recommendation, or issues an initial decision that goes for consideration, to the Commissioners of the regulator for a final decision. Once the regulator makes its final decision and makes an Order, the grounds for any further appeal are circumscribed, and the Courts do not undertake a full review of the regulator's decision. In contrast, in the UK, appeals of price control decisions in the energy sector are considered by an independent, external public administrative body (the Competition Commission), which conducts its own *de novo* investigation and can potentially substitute its own decision for that of the regulator.

The United States – internal review: the administrative litigation model

The U.S. has a long and well-established tradition of review of administrative decision-making. However, as many commentators have noted this model was not purposively designed, but rather evolved over the past 120 years of regulation of the natural monopoly industries and administrative decision-making.

Although the U.S. is similar to Australia in that many activities of the energy sector have been liberalised and open to competition over recent decades, the form of regulation that is typically applied in the energy sector differs in significant respects from the Australian (and the UK) approach. The general approach in the U.S. is principally based on adaptations of rate of return, or cost of service, regulation, and generally relies less on forecasting of future expenditures.

For current purposes, two important distinguishing features of the U.S. appeal/review arrangements, both at the Federal and State level, are particularly worth noting:

- A focus in the regulatory process on negotiated settlements between the parties; and

- The use of so-called administrative hearings/administrative litigation to resolve matters that are contested.[22]

In brief, the latter feature involves the use of officials, the ALJs, who are situated within the regulatory authority, but act impartially, and are responsible for investigating contested matters and for producing a factual 'record' of the investigation, and for making or recommending an initial decision concerning the resolution of the dispute.

Administrative hearings at the Federal level are conducted by the Office of Administrative Law (OALJ), which is an office within the FERC (the energy regulator). However, the ALJs that preside in that office are governed by legislation (the *Federal Administrative Procedures Act 1946*) that is designed to give them decisional independence. While such judges are employees of the FERC, their appointment is absolute. They are not subject to most of the managerial controls which can be applied to other employees of a federal agency (e.g. they are not subject to performance appraisals), their compensation is established independent of agency recommendations, and the circumstances in which disciplinary action can be taken against a judge are narrowly prescribed. Other rules, such as those regarding communications between the agency and the Office during hearings, seek to ensure that ALJs, although part of the executive, not of the formal judiciary, are as independent as possible from FERC.

An ALJ may attempt a negotiated settlement before conducting a formal hearing. If settlement fails, the ALJ will conduct a hearing. The administrative hearing is trial–like, with testimony and evidence presented by FERC staff, parties to the proceeding and interveners, and possibilities for cross-examination. Testimony can be presented by outside experts, as well as by both company representatives and staff of the agency. During this time any of the parties may make data requests to the other parties.

In general, ALJs have two primary duties in the administrative adjudication process. The first duty is to preside over the taking of evidence and act as the finder of facts in the proceedings. In support of this duty, ALJs are authorized to regulate the course of the hearing, issue subpoenas, rule on offers of proof and receive relevant evidence, take depositions or have depositions taken, hold settlement conferences, rule on procedural requests, question witnesses, and make findings of fact and conclusions of law. An ALJ's other main duty is to act as a decision maker by making or recommending an initial decision about the resolution of the dispute. This decision must be written and accompanied by formal findings of fact and conclusions of the law. In all of these regards, ALJs, who are executive branch employees, function much like trial judges in the judicial branch of government.

[22] 'Contested matters' at the Federal level include: an appeal from a Commission order; a complaint; a rate matter, where FERC considers the proposed rates, terms and conditions are either unjust, unreasonable, unduly discriminatory or unlawful.

After conducting the hearing, the ALJ takes an Initial Decision, which will then be remitted back to the Commissioners of FERC. This initial decision will be subject to review by the full Commission, implying a 'second pair of eyes' look at the issues. Such review can involve the filing of briefs that object or take exception to parts of the Initial Decision, or sometimes can occur through oral presentation. In reviewing the decision the Commissioners have all the powers which the agency formally has in making the original decision, and can choose to undertake a *de novo* review.[23] The FERC then issues its decision and Order.[24]

When all administrative remedies are exhausted, a party dissatisfied with a FERC decision may petition for Judicial Review. The Federal Courts of Appeal hears appeals from FERC decisions. The reviewing court will set aside a decision found to be:

- arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law;
- contrary to constitutional right, power, privilege, or immunity;
- in excess of statutory jurisdiction, authority, or limitations, or short of statutory right;
- without observance of procedure required by law;
- unsupported by substantial evidence in a those cases that are subject to trial-like proceedings or otherwise reviewed on the record of an agency hearing provided by statute; or
- unwarranted by the facts to the extent that the facts are subject to trial *de novo* by the reviewing court.

Based on these provisions of the Administrative Procedures Act, it has been argued that a different standard of review applies depending on whether the decision of an agency was subject to a 'trial-like procedure'. If an agency decision was UUnot subject to a trial-like procedure, it may only be set aside if *"arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law"*. For formal adjudications (in respect of which evidence has been collected and reviewed in trial-like procedures, such as occurs where a matter is dealt with through an ALJ process within FERC), agency decisions must be supported by *"substantial evidence"* after the court reads the "*whole record*".[25] The argument turns on the view that the *'arbitrary and capricious'* standard of review is more deferential to the agency than the *'substantial evidence'* standard of review.

A considerable proportion of regulation of the energy sector in the U.S. is undertaken by State Public Utility Commissions. As in the federal sphere, Administrative Law Judges are involved in the resolution of contested matters in many states. Such ALJs may be within the agency itself (e.g. California, New York), or may preside in a centralized State Office of

[23] This is based on the relevant sections of the Administrative Procedures Act.
[24] In some cases petitions may be filed for reconsideration and rehearing.
[25] Case law has elaborated the substantial evidence standard, and there are a complicated set of principles surrounding what will comprise substantial evidence, (e.g. more than a scintilla, less than a preponderance etc.…) and the degree to which the court will defer to agency's interpretation of statute, it's judgment etc.

Administrative Hearings, to which agencies can refer contested cases (e.g. Texas, New Jersey).

Formal institutional safeguards of decisional independence are generally weaker for state than federal ALJs. For example, state ALJs within agencies (or in centralized panels) have appointments for fixed rather than absolute terms.[26] In general, state laws prescribe ALJs' required code of conduct, circumstances for removal etc. Codes of Conduct for ALJs often require fair, impartial decision-making etc. ALJs at the state level are not always lawyers. The status of the decision of ALJs at the state level can vary by state. In some states an ALJ decision is only recommendatory (e.g. New York) however, in other cases, especially in states where the decision is made by a centralized panel of ALJs, any decision of an agency to modify or reject that decision must be given in writing and reasoned (e.g. Texas).

To summarise, the U.S. administrative and review arrangements in general terms differ from Australia in some significant respects. First, there is an emphasis at the administrative level on negotiated settlements, and all parties, including interveners, are encouraged to engage in settlement negotiations at an early stage. However, in circumstances where settlement cannot be reached, matters are referred for 'administrative litigation' which is conducted by an impartial ALJ, usually located within the regulatory agency. After conducting a trial, and collecting evidence, the ALJ will issue an Initial Decision. The Initial Decision, which is typically only recommendatory, is then reviewed by the Commissioners, who, after hearing any further evidence, will then issue the agency's final decision and order. This final decision can be appealed to the relevant Courts, but the grounds for appeal are circumscribed (i.e.: it is not a full merits or *de novo* review at this later stage).

United Kingdom – external investigation by the Competition Commission

The current regulatory arrangements in the UK, – which comprises two jurisdictions: Great Britain (GB) and Northern Ireland – including their appeals aspects, are much more a creature of deliberate policy design than those in the U.S., being a product of the privatization programmes of the 1980s and early 1990s. In comparison with Australia, wider discretion is delegated in both the conduct of price control matters, and in the review of the decisions of the primary decision maker, in GB the Gas and Electricity Markets Authority (GEMA), supported by the Office of Gas and Electricity Markets (Ofgem).

The Panel notes that the structure of the system reflects conditions at the time of its birth. There were no very clear precedents to work with when gas was privatized in 1986 and, as old regulators are fond of saying, 'we made it up as we went along.' The idea of crafting more than minimal sets of rules was, given the lack of experience, not one that was given much thought.

[26] That is, they are not permanent appointments like at Federal level, but this is true of 'judicial' judges at the State level as well.

The arrangements arguably also reflect a traditional cultural predilection for self regulation/self control over rules/laws handed down from above. It would, for example, be potentially wrong to jump too quickly from an observation of lack of written down rules to a conclusion of potential for unbounded capriciousness. The British Constitution is, famously, unwritten, but local politics is nevertheless relatively (though only relatively) orderly, restrained and predictable.

In very general terms, the GB system is one where Ofgem undertakes a periodic price control review, and then GEMA makes a price control decision. To effect this price control decision, the regulator will seek a modification to the licence issued to the relevant company. Until November 2011, if a company was not content with the price control decision, it could reject the proposed modification of its licence. In the event of rejection, GEMA had the option of adjusting the decision and trying again, or could refer the matter the Competition Commission (CC), an administrative agency of government, for review. Since the proposed price control is contained in a licence condition, referral of a dispute about that licence condition means that the CC takes into account any factor considered relevant to the determination of the price control.

It can be noted that this arrangement does not involve an appeal in the normal sense. Licensees can simply veto regulatory decisions, and, if they do, it is at the discretion of the regulator whether or not to take matters to the CC. The significance of this feature is often under-appreciated in assessments of the arrangements.

Since November 2011 the appeals arrangements have changed, in response to the third EU energy package, not from any UK initiated process (in summary the veto rights of licensees were seen as incompatible with the new European rules). The new arrangements are currently untested, and we note only some of the main features of the arrangements (greater detail is to be found on the Competition Commission website, and in the relevant regulation):

- The veto power of companies over changes to their own licences has been abolished, and GEMA can now directly enforce its own decisions.

- All licensees (whether network companies, generators or retailers) and consumer representative bodies can appeal decisions.

- The CC decides whether or not to consider an appeal on defined criteria.[27] This gate-keeping aspect of the role is not totally dissimilar to that played by the ACT under the LMR regime

[27] The CC may allow the appeal only to the extent that it is satisfied that Ofgem failed to have proper regard to, or give appropriate weight to, its duties; that the decision was based, wholly or partly, on an error of fact or was wrong in law, or a modification of the licence failed to achieve the effect intended. To the extent that the CC does not allow the appeal, it must confirm the decision appealed against.

- If it allows an appeal, the CC is effectively at large to consider whatever it thinks relevant in assessing the licence modification being challenged. The CC can quash the decision or relevant portion of the decision and either remit it back to Ofgem for reconsideration and determination, in accordance with any directions given by the CC, or substitute its own decision and give any directions to Ofgem or any other party to the appeal.

- The CC is expected to complete its process within a period of 6 months.

For reasons that many commentators in the UK believe lack substantive logic, arrangements will change again if legislation to combine the Office of Fair Trading and the Competition Commission commands support in Parliament and eventually receives Royal Assent. The details of this are still being made up, but the best guess is probably that something looking like the current arrangements would continue, but with appeals to the new Competition and Markets Authority.

As noted, the primary review body for price control decisions in the energy sector in the UK is the CC.[28] The CC is an independent public body which conducts in-depth investigations into matters relating to competition issues (such as mergers and market investigations) as well as having certain functions in relation to the utility industries. The CC does not initiate its own investigations but matters are referred to it by other authorities and agencies, including the sectoral regulators in energy, water and sewerage, railways, and airports. CC inquiries are conducted by a specially formed panel, typically comprising three to five members, including a Chair. The panel is drawn from the pool of members of the CC which currently sits at just above 35 members. Each Member is appointed for a period of eight years and has a particular specialisation in competition economics, law, finance or industry. The panel members are supported by a staff of around 130 (full-time equivalents).

An interesting fact relating to the UK is the small number of price control appeals that have been made in the quarter century or so since the privatization of British Gas – there were, for example, no appeals in the thirteen-year period between 1998-2011[29] – although it remains to be seen whether this will change as a result of the new arrangements. The causes of this lack of activity are a matter of some, albeit minor, controversy in the UK, and the Panel simply notes that, if nothing else, the example illustrates the obvious point that it is not necessary for the scope of appeal to be narrow for the level of appeal activity to be low.

It is also a potentially interesting aspect of UK arrangements that the process for appeals of decisions in the Communications sector is different to that of the other regulated sectors,

[28] Decisions of GEMA/Ofgem are also subject to judicial review under administrative law. Under certain provisions of the Electricity Act 1989 and Gas Act 1986, Ofgem is required to consult with the Secretary of State on certain licence changes and the Secretary of State has the power to 'veto' the proposed licence modifications.

[29] There is a currently an open case concerning gas pipeline issues in Northern Ireland, which has its own regulator and is not, therefore, within Ofgem's jurisdiction.

including energy. Specifically, appeals from the decisions of the communications regulator (Ofcom) on price control matters are, in the first instance, heard by the Competition Appeal Tribunal (CAT), which is then required under the relevant legislation to remit any price control issues within the appeal to the CC. The original telecoms regulator (Oftel) had been originally subject to the same arrangements, but, on the creation of Ofcom, with its wider range of powers and duties, appeals standardisation settled on the CAT as the preferred institution.

The CAT is a specialist judicial body with cross-disciplinary expertise whose function is to hear and decide cases involving competition or economic regulatory issues. All cases presented before the CAT are heard by a panel comprising three members, of which the Chairman is either a judge of the Chancery Division of the High Court or a senior lawyer. It is therefore not unlike the ACT in structure but, consistent with the status of Tribunals in the UK, it is classified as a judicial body.

According to published guidance, the CAT must refer any price control matter to the CC for determination, and then apply the CC's determination when deciding the other aspects of the appeal. Unlike the approach adopted in the other regulated sectors, when the CC conducts its review, it is required to follow any specific directions given by the CAT. Specifically, the price control matters, which are referred by the CAT to the CC, are done in the form of reference questions, which are based on alleged errors identified in companies' Notice of Appeal. The CC responds to these reference questions on the basis of evidence and arguments presented to it in its review. Unlike in energy, participation in the CC proceedings is limited to the parties to the case, the appellant, the regulator and any interveners who are admitted by the CAT (i.e. the proceedings do not permit open participation by third parties or members of the public in the way that CC procedures usually allow).

Finally, the Panel notes that the option of 'Judicial Review only' is not possible in the UK, since merits review is required by relevant EU Directives. The telecoms arrangements come nearest to the option in the UK, in that the primary review body (the CAT) is judicial in nature. However, the legislation continues to provide for an important role to be played by the CC, which is able to deploy rather greater assessment resources to price control issues than would be feasible for the CAT acting alone. It may be relevant for the Panel's Stage Two deliberations that the level of appeal activity in telecoms has been very high by UK regulatory standards.

Appeals processes in the energy sector in New Zealand

Under the new arrangements in New Zealand, the Commerce Commission (the Commission) must periodically determine the 'input methodologies' that it will use to regulate different services within the energy sector. These input methodologies include matters such as cost of capital, asset valuation, allocations of common costs and pricing methodology.

A merits appeal is available to the High Court against an input methodology determination. The appeal can be made by anyone who 'gave views' to the Commission under the determination process and has a 'significant interest' in the matter. The reviewing Court is comprised of one judge and two lay members with relevant economic, accountancy or related experience (or only one lay member if the court determines only one is required). The appeal is conducted by way of rehearing, with the Court limited to considering the material before the Commission when it made the determination. To succeed on appeal, the appellant has an onus of establishing to the court that its own proposed methodology will be 'materially better' in meeting the purposes of the relevant legislation. The Court may confirm, amend or revoke the methodology determination, or refer it back to the Commission with specific directions for amendment. An appeal against the decision of the High Court can be made to the Court of Appeal only on points of law.

Although input methodology determinations can be subject to merits review, the decisions of the Commission which incorporate these methodologies – such as the price-quality paths that are set for certain energy businesses – can be appealed only on questions of law. Appeals for judicial review of Commission decisions can be made to the High Court in New Zealand. Appeals against High Court decisions go to the New Zealand Court of Appeal, followed by the Supreme Court of New Zealand.

Appeals processes in the energy sector in continental Europe

Further variety/diversity in approaches to appeals of regulatory decisions in the energy sector can be found in other international jurisdictions. Two European illustrations are set out below.

In Germany, decisions of the federal regulator in the energy sector (the Bundesnetzagentur) are subject to review in the first instance by a panel within the special cartel division of the Higher Regional Court of Düsseldorf. The panel that hears the cases comprises three judges, and examines both the facts and legality of a decision under a special procedure which is similar to an administrative court proceeding. In particular, the Court may make *ex officio* inquiries regarding the facts, can assign participants to comment on points or evidence, and can engage expert witnesses in relation to technical and economic matters. It has been estimated that since 2005 more than 900 review proceedings have been initiated (although the Panel notes that this figure should be interpreted in the context of a highly fragmented industry structure, with large numbers of 'local' providers). However, many proceedings are withdrawn and no final judgment is issued. Appeals from the decisions of the Higher Regional Court are on the basis of judicial review only to the Federal Court of Justice.

In the Netherlands, the appeals process of decisions of the Dutch Office of Energy Regulation (which, similar to the AER, operates as a Chamber within the National Competition Authority) is split into phases. In the first phase, contested decisions can be re-considered within the regulatory agency, by a separate team, often as a first step before the appeal is then made to an external review body. If the matter is still contested, an appeal can be made to a

specialist section of the relevant Court, which is an administrative court with judges who specialise in matters relating to the regulated industries and competition law.

Appeals in the energy and airports sectors in the Republic of Ireland

In Ireland, certain regulatory decisions in the energy[30] and aviation sectors can be subject to review by an appeals panel, which, rather unusually, is specifically constituted to hear a specific appeal as and when it arises. Although to date no appeals panel has been established in the energy sector (unlike aviation, where a succession of three panels has considered and reported on airport price determinations in 2006 and 2010, and on an interim determination in 2008) the legislation provides that the panel shall be independent and have all the powers and duties of the regulator that are necessary to carry out its functions.

There are potentially informative differences between the Irish approaches in energy and aviation. In aviation, the price controls relate only to three, publicly owned airports, Dublin, Cork and Shannon, of which Dublin is much the most significant for regulatory policy. The Aviation Appeals Panel (AAP) is a 'remittal only' body, without power to substitute its own decisions, and is expected to reach decisions ('on the merits') within a period of three months (extended from the two months allowed when the first panel was established). The more powerful (though yet to eventuate) appeal panel in energy, which can 'stand in the shoes' of the primary regulator, is expected to reach decisions in six months. Thus, the time constraints are proportioned to the powers of the appeals body

5.3 Summary

The central aspects of the appeal mechanism arrangements in other regulated sectors in Australia, and in other jurisdictions are presented in Annex 2 in Tables 2.1 and 2.2. These tables are necessarily at a general level, as each approach has particular characteristics and features that don't necessarily lend themselves to high-level comparisons: much of the importance lies in the detail. Nevertheless, on the basis of the tabulated information, the Panel makes the following, broad observations:

- First, there is currently considerable diversity in the appeal arrangements for the other regulated sectors at the Commonwealth level in Australia. In particular, following recent changes, a more limited form of merits review of ACCC arbitration determinations exists under the general third-party access provisions of the CCA. In telecoms, the possibility of merits review of ACCC determinations in relation to undertakings has been removed entirely, and decisions can be challenged on points of law only through judicial review.

[30] In energy, the relevant decisions relate to generation. Transmission and distribution continue to be monopolised by the state-owned Electricity Supply Board (ESB), and, to date, judicial review has been considered sufficient to address any matters of dispute between the ESB and the regulator.

- Second, as might be expected, the approaches to appeals in the energy sector adopted in the U.S., UK and elsewhere show considerable diversity in terms of process and scope. In relation to U.S./UK comparisons, we note that, in the U.S., review of contested matters is typically undertaken through a process that is internal to the regulatory agency, but with functional separation within the organisation. In the UK, in contrast, a body external to the regulator undertakes review of the contested matter. Despite these obvious differences, there are two important similarities between the general approaches. First, in both cases there is a perceived need for the initial review to consider the 'merits' of the matter (i.e.: review is not restricted to judicial review in the first instance). Secondly, in both cases the body undertaking the review is specialised and (in principle) has access to adequate resources to undertake such a review.

6. EVALUATION OF OUTCOMES RELATIVE TO GOALS/INTENTIONS

6.1 The effectiveness of the current merits review in achieving the original policy intent

In accordance with the Terms of Reference, Stage One of the Panel's Review has focused on assessing the extent to which the outcomes of the limited merits review (LMR) regime are consistent with the policy outcomes anticipated in the Ministerial Council on Energy's (MCE) 2006 Decision Paper, and in documents of the time that cast further light on what the LMR regime was expected to achieve. To date, therefore, the Panel has not given much attention to questions surrounding the reasons for or causes of any divergences that have been found, although we note that a number of submissions have provided us with views on these further matters, which will become much more central to the Panel's deliberations in Stage Two of the Review.

The original policy intent

Assessment of policy intent naturally starts with the National Electricity Objective (NEO) and National Gas Objective (NGO), which set out policy for the relevant economic sectors at its highest level. The NEO, as set out in s7 of the National Electricity Law (NEL), is specified as follows:

The objective of this Law is to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to –

1. *price, quality, safety, reliability, and security of supply of electricity; and*
2. *the reliability, safety and security of the national electricity system.*

The NGO, set out in s23 of the National Gas Law (NGL), is expressed almost identically, with 'electricity' replaced with 'natural gas' and the final reference to a 'national ... system' deleted. In what follows we will, for brevity, refer only to the electricity sector whenever the related points in respect of the gas sector are similar.

The NEL, at s16(1) states that:

> *The AER must, in performing or exercising an AER economic regulatory function or*
>
> *power -*
>
> > *(a) perform or exercise that function or power in a manner that will or is likely to contribute to the achievement of the national electricity objective; ...*

More generally, at Clause 7 of Schedule 2 of the NEL we find:

> *7—Interpretation best achieving Law's purpose*
>
> *(1) In the interpretation of a provision of this Law, the interpretation that will best achieve the purpose or object of this Law is to be preferred to any other interpretation.*

The Panel notes that whenever the Australian Competition Tribunal (ACT) is 'standing in the shoes' of the Australian Energy Regulator (AER), as for example when its substitutes its own decision for a decision of the AER, it must be subject to the same requirements.

Immediately following the statement of the NEO, the NEL sets out a series of revenue and pricing principles. These effectively codify aspects of the regulatory arrangements that are considered central to the achievement of the NEO. In brief, they specify that:

- A regulated network service provider should be provided with a reasonable opportunity to recover at least its efficient costs.

- A regulated network service provider should be provided with effective incentives in order to promote economic efficiency.

- In determining a regulatory asset base, regard should be had to any, relevant previous determinations.

- A price or charge for the provision of a direct control network service should allow for a return commensurate with the regulatory and commercial risks involved in providing the direct control network service to which that price or charge relates.

- Regard should be had to the economic costs and risks of the potential for under and over-investment in a distribution system or transmission.

- Regard should be had to the economic costs and risks of the potential for under and over utilisation of a distribution system or transmission system.

The AER (and, by implication, the ACT when standing in the shoes of the AER) must also take these principles into account when making revenue and pricing determinations for network providers, including in relation to access determinations (NEL s16(2)).

MCE aims and intentions in relation to the limited merits review regime

As already noted, in the specific context of considering the arrangements for the review of regulatory decisions, the MCE set out a list of narrower goals as follows:

- Maximising accountability;
- Maximising regulatory certainty;
- Maximising the conditions for the decision-maker to make a correct initial decision;
- Achieving the best decisions possible;
- Ensuring that all stakeholders' interests are taken into account, including those of service and network providers, and consumers;
- Minimising the risk of "gaming"; and
- Minimising time delays and cost.

As pointed out in some submissions, these goals can come into conflict with one another, and therefore require some interpretation and weighting if they are to be used as evaluation criteria. The NEO/NGO and the revenue and pricing principles of the NEL provide a basis for this task, and the MCE Decision Paper, and other material produced as part of the process leading up to the introduction of the new regime, can provide more detailed guidance.

One of the key issues that has emerged, on which there is substantial disagreement among stakeholders, is the extent to which, in introducing the LMR regime, the MCE intended that the scope of matters considered by the ACT on appeal would be limited (an intention that might reflect the allocation of a high weight to the goal of 'minimising time delays and cost'). In the Panel's view, the intentions of the MCE appear to be clear from the following passage in the Decision Paper

> ***"Role of original decision-maker***
>
> *Once proceedings are commenced, the original decision-maker will become a party to proceedings. The original decision-maker will be able to raise new grounds of review, that is, review will not be limited to only those grounds advanced by the applicant. This measure allows an application for review to operate as a broad "re-opener" if the original decision-maker so elects, notwithstanding limited grounds of review put forward by the applicant."*

The reference to the capacity to re-open issues on a broad basis is, in the view of the Panel, particularly informative, and the intention that there be opportunities for holistic review of AER determinations is confirmed by other documents from the time. For example[31], in the legal advice of Johnson Winter and Slattery, attached to the Swier Report, it is said that:

> *This intention was repeated in a Standing Committee of Officials of the Ministerial Council on Energy (**MCE SCO**) paper dated 1 March 2007 (released with Energy Market Reform Bulletin No. 82) responding to submissions on an exposure draft of*

[31] See also the paragraph from the MCE Decision Paper cited in the discussion of 'gaming' below.

the NGL. In response to a comment that the AER should not be able to raise new grounds in a merits review the paper stated: "Not Accepted. MCE's intention was to allow related matters to be raised in a merits review to allow the original decision to be considered holistically."

Initial discussion of policy objectives and intentions

In the Panel's view, the policy objectives set out above are both clear in form and consistent with best regulatory practice in overseas jurisdictions. The Panel notes the following aspects of the objectives, which have potential relevance for the evaluations that follow:

- The duties of the AER are reasonably clearly specified in that they derive directly from the NEO and NGO, which make the long term interests of consumers the touchstone for performance. The AER is intended to be neither an adjudicator among the interests of different stakeholder groups (although see below on the important distinction between short-term and long-term consumer interests) nor a consumer watchdog/champion/advocate. If there are any doubts about the role that the AER should play, they do not seem to the Panel to originate in the legislation.

- The reference to 'for the long term interests of consumers' necessarily conditions the meaning/interpretation of the concept of efficiency, as it applies to network investment, operation and use. In standard economics, unqualified references to economic efficiency[32] are blind to distributional considerations, so that it is in principle possible for economic efficiency to be increased by measures that would be adverse to the long term interests of the relevant consumers. The NEL/NGL is not blind in this way.

- It is the long-term interests of consumers that are relevant. This cannot reasonably be interpreted as meaning that the interests of consumers today are irrelevant, and that the only thing that matters is the welfare of energy consumers at some distant point in time.[33] It does, however, mean that it is not just the interests of consumers who will vote in the next election that count: there are future generations also to be taken into account. To the extent that the AER is required to engage in 'balancing' judgments, the chief balancing required is between the interests of consumers at different points in time. This, of course, is usually done by some or other form of discounting, although (whether explicit or implicit) choice of the relevant discount rate is not the simplest of decisions.

[32] The term efficiency has many potential meanings, usually distinguished from one another by qualifying terms: productive efficiency, cost efficiency, allocative efficiency, etc.

[33] As Keynes famously said, in response to economic reasoning that sought to ignore current realities and focus only upon an indeterminately far-off, end state, "In the long run we are all dead."

- The fact that long-term consumer interests are afforded evaluative primacy in the NEO/NGO (they are the basis for choosing preferred courses of action) does not imply that Network Service Providers (NSPs) should be precluded from making supernormal economic profits (i.e. revenues in excess of costs, including capital costs). Very rigid cost of service pricing would generally be contrary to the long terms interests of consumers because it tends to be associated with inefficiently high cost levels and lack of innovation; and below cost pricing would be worse. The policy position here is made clear in the revenue and pricing principles, which make reference to:

    - Reasonable prospects for a NSP of recovery of at least efficient costs.

    - The provision of incentives for efficiency improvements.

    - The reference to consideration of the risks (to the long term interests of consumers) that might eventuate from over- and under-investment, and over- and under-use of distribution and transmission systems (there tends to be a general view in energy regulation that risks are asymmetric, and that the adverse consequences of under-investment and over-use of assets (which may lead to security of supply problems) are greater than those of over-investment and under-use).

The last point can perhaps be usefully encapsulated by saying that the legislation perceives NSPs to be agents for the promotion of the long-term interests of consumers, and should be appropriately rewarded for their tasks.[34] Such rewards include remuneration of the costs, including the capital costs, prudently and reasonably incurred in providing the relevant services (which is sometimes conceptualised as a basic regulatory contract or compact), but ideally should also include rewards for 'beyond contract' innovations that promote long-term consumer interests.

The underlying metaphor here is that of an effectively competitive market. Regulation cannot replicate the outcomes of such a market, if for no other reason than that the outcomes of competition are unpredictable, but it can use features of effectively competitive markets to inform and improve its own performance. In the current context, the outstanding feature of competitive markets is that suppliers are very heavily focused on understanding their customers, since it is performance in serving the interests of actual and potential customers that will determine a supplier's own success or failure.

Moving on to the goals set down by the MCE at the time of the introduction of the current LMR regime, the Panel is of the view that, when interpreted in the light of the NEO, and of the revenue and pricing principles set out in the NEL, it is appropriate to impute differential significance to at least some of the elements. Thus, for example, the desire to

[34] On this perspective, the role of the AER, linked to the NEO/NGO, might be said to create the conditions in which NSP activities are conducted in ways that best serve consumers.

achieve better decisions – which may be broken down into aspects relating to (a) seeking to ensure that *final* decisions in relation to a particular determination are good decisions, and (b) improving incentives for good initial decisions to be taken by the AER (and hence a longer term effect) – appears to be of particular significance because of its closeness to the NEO, better or good decisions being simply those decisions that contribute most, through their effects on supply-side performance, to the betterment of consumer welfare in the longer term. Similarly, the goal of promoting regulatory certainty is closely related to aspects of the revenue and pricing principles of the NEL, which appear immediately after the statement of the NEO in the legislation, and should, in the view of the Panel, attract additional weight by virtue of this linkage.

Although issues such as accountability and ensuring that all stakeholders' interests are taken into account stand at a greater distance from the high level objectives set out in the NEL, the Panel is nevertheless of the view that, in addition to their immediate implications for incentives within the regulatory system as a whole, they can have major significance for the legitimacy of that system. The legitimacy of delegated, independent regulation is not a thing that can be taken for granted, as its unravelling in some overseas jurisdictions indicates, and it might reasonably be expected to come under increasing pressures in contexts where energy costs and prices are rising in the face of increasing environmental constraints. Legitimacy is, in turn, closely linked to regulatory certainty: without the confidence and trust of end consumers, a system of delegated, independent regulation is difficult to sustain in the longer term, and regulatory certainty will likely never effectively be established.

In contrast, the goals of 'minimising gaming' and 'minimising time delays and costs' of appeal seem to the Panel to be of a lesser order of significance. Indeed, their inclusion in the MCE's list of goals is likely the result of an appreciation of some of the potential risks of the new regime that was being contemplated (i.e. the development of a non-level playing field for stakeholders in appeals processes, uncontrolled cost escalation resulting from new opportunities to contest administrative decisions), in which case they might be construed as serving to direct attention to requirements for specific risk mitigation measures.

These points link back to our discussion in section 4 on the financial impacts of ACT decisions. In relation to 'gaming', it can be noted that in each of case 1 and case 2, the final outcome might have been induced by what could be viewed as selective use of the scope for review. However, the key question in these cases is not whether 'gaming' led to the outcomes, but whether the outcomes have economic effects that can be expected to lead to long term improvements in consumer welfare.

In relation to costs and delay, the substantial financial implications of some decisions (much higher than the costs of appeals[35]) indicates that it would not be consistent with the

[35] Whilst this will be more of a matter for Stage Two deliberations, it can be noted that a wide disparity between the costs of making an appeal and the potential gain from doing so will tend to encourage a high level of appeal

NEO/NGO to give high priority to minimising costs and delays if the effect of quick, cheap review would be to significantly increase the frequency of poor outcomes.

Evaluation of the policy objectives and intentions

The Terms of Reference did not ask the Panel to assess the appropriateness of general policy objectives, as expressed in the legislation, but, since, for reasons to be explained below, we have concluded that actual outcomes have, in certain respects, fallen short of what was intended, it is necessary for us to say a few words on objectives, if only for the reason that any such divergence could, at least in theory, be a consequence of poorly specified policy aims.

The Panel does not consider that this is the case, at least in relation to the high level objectives set out in the NEL and the NGL. The primacy of the long term interests of customers as an evaluation criterion, set out in the NEO and the NGO, gives the conduct of regulation the same focus as that of the supply-side of an effectively competitive market (how can we improve the consumer offering?). This is admirably clear, and avoids the confusions of multiple, conflicting objectives that have had adverse effects in jurisdictions such as Great Britain. The revenue and pricing principles in the NEL set out what might be considered best practice in relation to supply side arrangements designed to meet the consumer objective, including consideration of regulatory certainty, incentives, asymmetric risks associated with price/revenue judgments, and so on.

A corollary of the Panel's views on the appropriateness of the specification of policy objectives is that the causes of unsatisfactory outcomes lie largely elsewhere (i.e. they do not spring from the high level principles set out in the legislation). There is, however, one aspect of the legislation that, although not directly arising from the objectives themselves, does raise issues about the consistency of the objectives with other aspects of the legislation. We will consider it briefly before discussing more detailed matters; because we think it illuminates some of these more detailed matters, and in particular because it illuminates a common factor that may be at work, and which may be serving to undermine the effectiveness of the merits review regime as currently constituted.

activity (the 'break-even probability of success' will be low). If a high weight were given to the costs/delay goal, the preferred system might well be one in which the costs of each individual appeal were set very high, to discourage activity. The drawback of such an approach is, of course, that it could discourage appeals that would lead to modest improvements in decisions.

Objectives, laws and rules: the example of links between regulatory certainty and the cost of capital

In a context in which the National Electricity Rules (NER) and National Gas Rules (NGR) are subject to narrow interpretations[36], the problem with which we are concerned can be summarised in the tensions between the following points:

- A price or charge for the provision of a direct control network service should allow for a return commensurate with the regulatory and commercial risks involved in providing the direct control network service to which that price or charge relates s7A(5).

- In exercising its powers, the AER does so in a way that contributes to the NEO. The NER require that returns on capital be addressed via the capital asset pricing model (CAPM)[37], and the NEL states that these rules *"... have the force of law in this jurisdiction"* (s9).

- Irrespective of its other merits and weaknesses, the capital asset pricing model does not, at least in the standard form on which the NER are based, address issues to do with regulatory risk, which, considered as a type of risk, tends to have a number of specific characteristics when viewed from the perspective of investors.

- In consequence, the AER is bound to follow procedures that, almost definitionally, can be expected to be out of alignment with the high level objectives of public policy (as reflected in the NEO and in the revenue and pricing principles).

Put bluntly, at the moment the AER is required to proceed, as a matter of law, on the basis of a model that is known to abstract from a factor considered (in the Panel's view, rightly) to be a matter of such significance (i.e. regulatory risk or uncertainty) that it is afforded special mention in the revenue and pricing principles section of the NEL.

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[36] The difficulties about to be described subside if, as the Panel believes is appropriate, the rules are interpreted more broadly, as a set of requirements that work together for the purpose of promoting the NEO and the NGO. In that case, the concern that a particular sub-set of rules (say in relation to the determination of the cost of capital) leads to an over-tight assessment of one building block can be compensated for, within the constraints of the discretion allowed, by a consciously less aggressive assessment of one or more of the other building blocks. To work, in the sense of producing good overall decisions, a rules-based system then needs to be only approximately right, not exactly right, in each of its details.

[37] There is a difference between electricity and gas in this respect, since the NGR require only that a well accepted model be used. The NGR do, however, make specific reference to the CAPM, and only to the CAPM, and the AER has chosen to adopt the CAPM in gas NSP determinations. Similarly the ERA has also adopted the CAPM in its regulatory decisions in gas, an approach that received the approval of the ACT in its recent decision in Application by WA Gas Networks Pty Ltd (No 3) [2012] ACompT 12 (8 June 2012). Indeed, in this recent decision, the ACT seeks to minimize the differences between the NER and NGR, suggesting that they might have arisen simply from accidents of history. The Panel notes, however, that both the physics and the economics of electricity and gas networks differ, and that long-distance, high-pressure gas transmission in particular has distinguishing economic characteristics that might be expected to be reflected in an effective 'rule-book'. 'One-size fits all' approaches can have advantages in terms of administrative tidiness, but, if they lack economic logic, they can have adverse implications for economic outcomes.

That this is more than a theoretical point is indicated by the fact that the Financial Investors Group told us that they had been concerned about the narrow, CAPM focus of the regulatory approach to date, and had urged the AER to pay more attention to conditions in capital markets themselves (in contrast to models of those markets). Whilst the Panel believes that the AER has rather more discretion than the AER itself appears to believe it has, it does appear to be the case that there is an inconsistency in the current combination of laws and rules that is impeding a more realistic, market-focused approach to the determination of returns on capital.

The practical relevance of the problem has also been illustrated by the ACT's recent ATCO decision, the detail of which the Panel has not yet had time to fully absorb. In the name of regulatory certainty, the decision appears to elevate the standing of the CAPM in the NGR to something akin to its standing in the NER. The Panel is concerned that binding regulatory decisions hand and foot to a financial model with known defects does not immediately commend itself as an approach that will advance the NEO and NGO.

Although, as the evidence on outcomes tends to confirm (see below), the tensions are particularly strong in relation to cost of capital issues, the problem itself is a more general one. Again in a context in which rules are interpreted narrowly, the hard wiring of the NER and NGR into law places a very heavy burden on maintaining a set of rules that is consistent, across all aspects of regulatory determinations, with the ability to be able to make decisions that do, in reality, promote the long term interests of consumers. It also tends to reinforce a formalistic view of the world, in which there is a heavy focus on compliance with the NER, rather than on the policy objectives themselves. Thus, if the AER fails to follow a rule, an appeal might be made, and the ACT might correct the 'error'. However, if, by failing to follow the rule in a particular context, the AER was in fact helping to promote the NEO, then the error correction will necessarily detract from the achievement of policy objectives.

6.2 Outcomes relative to intentions

As indicated above, at the time decisions were being made, the MCE identified a number of risks associated with a LMR regime, and consequently introduced a number of specific features into the regime in order to mitigate those risks. Thus, for example, consumer organisations and others were afforded access to the appeal process in the name of ensuring stakeholder involvement, constraints were placed on grounds for appeal in order to discourage excessive appeals activity that would increase delays and costs, the AER was given powers to introduce new considerations when the ACT was hearing an appeal in order to provide incentives against cherry picking of issues by appellants, and so on.

It is the general conclusion of the Panel that, notwithstanding the foresight of the MCE in 2006 and the measures put in place at the time, outcomes of the LMR regime have deviated in material and important ways from the relevant policy objectives and intentions.

In what follows, we identify some of the principal ways in which we believe this has occurred.

The Panel notes that the MCE, in deciding the terms of reference for the current review, identified a number of questions related to the original, identified risks:

- *whether merits review has favoured any particular parties and there is evidence of 'gaming' by any parties;*
- *the costs implications for governments and parties;*
- *whether information disclosure and evidence restrictions have been effective;*
- *to what extent energy users and consumers have been able to participate;*
- *whether the ACT has appropriately acknowledged the expert knowledge developed by the primary decision-makers by remitting appropriate matters back to them.*

The Panel has not restricted its considerations solely to these matters, but has examined them alongside other issues that have emerged, in particular from the consultation process. We start with issues surrounding consumer and user engagement, since the underlying, fundamental policy objective is to promote efficient investment in, and efficient operation and use of, electricity/gas network services for the long term interests of consumers.

Lack of consumer and user engagement in the relevant regulatory discourse

One of the goals set out by the MCE was that of ensuring that all stakeholders' interests were taken into account, and the LMR regime was designed to provide for participation of consumers and users in the appeals process. We were, however, told by consumer and user associations, unanimously and in no uncertain terms, that they felt that the appeals process was a risky, costly and hostile environment for the expression of their views. Evidence was presented of the attempts that they had made to get their voices heard, and of their experiences in making those attempts. The Panel finds this consumer and user association evidence compelling.

Governmental stakeholders also expressed some frustration about their ability to participate in the ACT process and, although this outcome is less central, it adds to a general concern, which appears to be associated with a number of problems surrounding appeals, about the formalistic/legalistic nature of the appeals process. Whilst different participants had slightly different perceptions of things, it was notable that, in a submission to the Review, Ray Finkelstein QC (former presiding member of the ACT) said:

> *Regrettably, the ACT conducts itself with as much formality as a court. Indeed the procedures are largely a mirror of a court process. Hearings are conducted in a courtroom. Parties are represented by solicitors and counsel. The lawyers address*

the ACT as they would a court. Under this system, lay persons are not given any encouragement to take part, and when they do they are at a disadvantage.

He adds:

The adoption of court processes also adds considerably to the cost of proceedings and, in some instances, prevents them from being dealt with expeditiously as they ought to be.

Although not articulated very forcibly in submissions, the Panel is aware of arguments in favour of what might be called the 'judicial model'[38], and the merits of alternative ways of going about things will be considered in Stage Two of the Review. For the moment, it is sufficient to say that the position described by Mr Finkelstein, by user and consumer representatives, and by others is not, we think, what the MCE had in mind when establishing the current regime.

It is, of course, understandable that, for reasons of costs and timeliness, it may be desirable to have a less expansive participatory process at the appeals stage than during the AER's assessments. It remains the case, however, that, under current arrangements, when the ACT substitutes its own decision for a determination of the AER, it is 'standing in the shoes of the AER'. It is therefore important, as a matter of good regulatory practice, that due attention is paid to stakeholder views in the course of appeals, particularly in circumstances where the ACT is developing reasoning of its own upon which there has been no prior opportunity to comment.

The Panel recognises that, once more in the name of costs and timeliness, stakeholder voices are, for the most part, taken into account on the basis of the prior documentary record; and we did not find that consumer and user associations were seeking a much larger role for themselves during appeals. However, in the nature of the appeals, emphasis comes to be placed on sub-sets of issues, and arguments may be developed in ways that are different from their earlier versions. More importantly, the ACT has powers to develop reasoning in new directions, not necessarily covered in earlier exchanges. To achieve the objectives set out by the MCE, consumers and users need to feel that, if not exactly 'at home' in the process, they are more than simply inconvenient guests.

To avoid any potential confusion, the Panel does not believe that the problems here are caused by any lack of civility or correctness in the way consumer and user associations are treated when appearing before the ACT, and nor does it think that the adoption of the formalism of a quasi-judicial body[39] is the most important of the problems associated with the LMR regime. Rather, on the basis of the record of the decisions made, the Panel is of

[38] Sir Anthony Mason, "Administrative Review: The Experience of the First Twelve Years", *18 Fed L Review 122*, 1989; Hon Justice Downes, "Government Agencies as respondents in the Australian Appeals Tribunal", 3 February 2005.

[39] The ACT is not a judicial body, although it does conduct its business in the manner of a judicial body, and has been criticised, in several written and oral submissions to the Panel, for excessive formalism.

the preliminary view that, when matters come before the ACT, the discourse has at times become remote from the purposes of the NEL and NGL, and more specifically from the NEO and NGO. The possible *consequences* of final decisions for the long term interests of consumers are not matters that appear to be prominent in the appeals process. The Panel thinks that these consequences should be prominent when regulatory decisions are being reviewed 'on their merits', consistent with the purposes of the NEL and the intentions of the MCE, and therein lies a central issue.

The weaknesses of the regime in relation to consumer and user participation were recognised by NSPs themselves, and a number of NSPs have expressed support for a proposal made by Professor Allan Fels, and others, that public financial support be provided to establish a peak consumer body with greater resources for challenge at the end stages of regulatory determinations. The Panel will consider this proposal, alongside others, in Stage Two of its Review; but notes that consumer associations were not of the view that this would, by and of itself, be an adequate response to their difficulties.

More encouraging to the Panel was a recognition among NSPs that much more can and should be done to engage with consumers well before matters might come to the ACT, or, for that matter, long before they come to the AER; and in some cases new initiatives in this direction appear to be already under way or about to be commenced. As noted above, effective competition compels suppliers to have the (current and future) interests, preferences and requirements of their (current and future) customers continually in mind, and to devote material levels of resource to the discovery of how best to improve consumer welfare: they do not survive and prosper otherwise. Monopolies do not face such intense incentives, and require encouragement to do so, particularly in a context where the old notion that consumer preferences are simple[40] – i.e. that they want cheap and reliable energy – is increasingly challenged by the emergence of more complex trade-offs, and likely of greater heterogeneity in preferences, associated with environmental matters.

The Panel is of the view that the development of an enhanced focus on customer/consumer requirements by NSPs cannot happen soon enough, and that the AER should, consistent with those aspects of the NEL and the NER that allow for the establishment of supply-side incentive arrangements, support the transformation that is required, for example by making it clear that it will support such a re-orientation in NSP thinking by working to establish an appropriate system of rewards/incentives. Competitive markets reward success in discovering and meeting customer preferences with supernormal profits (returns above the cost of capital) and, whilst (as already emphasised) the structure of competitive incentives can never feasibly be replicated by regulatory systems, rather more could be done in this direction than is currently being done.

[40] The simplicity may always have been deceptive. Assessing consumer valuations of reliability/security of supply, and finding ways of responding to differing valuations (e.g. through load management options), are challenging tasks.

The relevance of this to the Panel's deliberations is that, if consumer and user interests are better taken into account in the earlier stages of regulatory determinations, less of a burden in this regard would be placed on the end stage review processes. We note that this would be highly consistent with the goal of seeking to ensure that the quantum of resources, including time taken, absorbed by these later processes, does not escalate.

Regulatory certainty in the shorter- and longer-run

Prima facie, the current LMR regime appears to have worked well in terms of providing regulatory certainty for NSPs, although we heard from representatives of energy suppliers that it has some features that have led to uncertainties for them, particularly in relation to the timing of final decisions. Network charges are a major cost component for energy retailers, and uncertainties about the timing and level of changes in charges is a complicating factor in retail pricing; albeit the difficulties are not ones that occur every year.

The major regulatory risk for regulated NSPs, which tends to increase in periods when there are strong upward pressures on costs, is that price controls will be tightened to a degree that does not adequately reflect the tangible and intangible investments that they have made. The tendency usually reflects an increase in the influence of shorter-term political considerations in regulatory decision making which, of course, the structure of independent regulation exists to prevent, limit or mitigate.

Manifestly, on the basis of the review outcomes to date, this is not a risk that has eventuated in Australia, and the LMR regime could arguably be credited with playing a role in this. On the other hand, the existence of the current Review of the LMR regime, which has been brought forward in time compared with intentions set out when the current regime was established, is arguably indicative of the increasing pressures that a period of rising energy costs tends to bring.

In the longer term, there seems to be a strong likelihood of a period of sustained upward pressure on energy costs, possibly of an unprecedented nature, arising from a combination of increased demand for energy associated with global economic development and the pressures that such development places on the environment. Systems of independent regulation everywhere may, in consequence, be subject to great stress. Thus, whilst the current regime has worked well in terms of promoting regulatory certainty to date, the Panel is concerned that its other weaknesses have the implication that it may contribute to increased regulatory *uncertainty* in the longer term, by virtue of lack of sufficient robustness to withstand future stresses.

The underlying point here is that regulatory certainty is not a feature of a regime that is independent of the regime's other characteristics: there are various interactions among the features of the regime that need to be taken into account. In particular, the regulatory certainty associated with the institutions of independent regulation depends upon the

legitimacy of the regime, reflected in the extent to which the consumers are willing to go along with arrangements that expose a matter of some interest to them (the cost and reliability of their energy supplies) to the outcomes of the deliberations of groups of non-elected 'experts'. Closely associated with the notion of legitimacy, is the degree of trust that is enjoyed by those institutions.

The Australian regulatory arrangements depend upon a degree of delegation of decisions which, although technical in nature, nevertheless have significant political implications; or, put another way, although it is sometimes considered politically incorrect to say so (and regulators around the world tend to claim that they don't have the discretion to do any such thing), unelected regulators are, in reality, given policy making powers. At least in democracies, the acceptability/legitimacy of this arrangement tends, therefore, to be highly dependent on performance: regulators need to be able to demonstrate, convincingly, that the existing arrangements deliver in relation to the specified objectives; and in Australia those objectives are summarised in the NEO/NGO.

Given this, if major stakeholders become alienated from regulatory processes, the integrity of the processes themselves can come to be called into question. This can happen in more than one way. The most obvious is that a disenchanted interest group lobbies for political intervention. More insidiously, the regulatory agencies can themselves become politicised, becoming over-sensitive to short-term, often partisan, considerations – exactly the sensitivity that delegated regulation is designed to suppress – and negligent of the longer term, usually much less contentious, objectives.

These points link to the evaluation of consumer and user participation in the LMR process. The evidence is clear that consumer and user representative organisations are, for what the Panel judges to be good reasons, disenchanted with the current appeals process. In the wider context, the Panel also notes that:

- Energy consumers are facing steep rises in prices, in circumstances where there appears to be a dearth of credible accounts, by trusted authorities, of the causes of the increases.

- The AER, which might be expected to take the lead in this difficult, technical exercise, has emphasised the consequences of ACT decisions[41], particularly in relation to cost of capital issues, for prices, and the ACT has not itself convincingly explained how or why such effects are in the long term interests of consumers.

- As a relatively young organisation, created in conjunction with a re-allocation of powers between States and the Commonwealth, the AER does not appear, on the basis of evidence given to the Panel, yet to enjoy a high degree of confidence and trust among many stakeholders.

[41] The AER has also emphasised the constraining effects of the NER on its discretion.

In the Panel's view, these and other factors affecting the legitimacy and credibility of existing regulatory arrangements raise very real problems of regulatory certainty going forward. There is a fragility to things that all stakeholders will need, both individually and collectively, to work hard to correct, if independent regulation is to survive and develop.

The Panel will seek to make its own contribution in this regard in Stage Two of the Review by seeking first those possible developments to arrangements that appear to have the best prospects of underpinning confidence, legitimacy and regulatory certainty in the longer term.

The issue of better or preferable decisions

The most important of the criteria for evaluating the performance of the LMR regime concerns whether or not it has contributed to better or preferable decisions, both in the short term in relation to decisions already made by the AER and in the longer term, by providing better incentives for AER decision making. In the view of the Panel, the evaluation of whether one decision is preferable to another should be made in terms of the NEO and NGO, augmented where appropriate by the revenue and pricing principles set out in legislation.

We have already signalled that we do not think this is the same as improving the degree of AER compliance with the NER and the NGR, and have given an example (relating to the inadequacies of the CAPM in capturing investors' appreciation of regulatory risk), where, notwithstanding the best intentions in crafting sets of rules, there can be circumstances where strict compliance with the rules leads to worse outcomes judged against the NEO and NGO. At this point it may be helpful to give further detail of why we think an approach based only upon correcting deviations from the rules, or correcting 'errors' on an error by error basis, is inappropriate for price control decisions.

The relevant business plans and regulatory determinations encompass many elements, formed on the basis of myriad judgments. Some of these judgments may involve 'close calls' between alternatives, and it is entirely natural that, in resolving such close calls, as in resolving ambiguity more generally, assessors and decision makers tend to resolve matters in ways that are favourable to their own interests or private agendas. Such a tendency is universal, and nowadays it and other decision making biases[42] are much studied by psychologists and behavioural economists. It is not a question of making 'errors', although some tendencies/biases in some contexts can be said to constitute errors. Indeed the concept of 'error correction', which has been the subject of much discussion in the course of Stage One of the Review, is itself problematic in a context where it is

[42] The word bias is not, in this context, meant to be pejorative. Decision making biases are often associated with the use of simple heuristics, and sometimes these can be preferable to less biased, but much more resource intensive forms of assessment. The issue of concern is not bias as such, but potential magnitude of the cumulative effect of common, biasing factors in decisions comprising large numbers of constituent parts.

generally impossible to identify a correct decision, as recognised in references to 'correct or preferable' decisions in the wider discourse on merits review in Australia.

Even with a perfect set of rules that at no point came into conflict with the NEO or the NGO, there would remain the problem of how best to address the decision making tendencies/biases that are common to regulated companies and regulators alike (what differs between the two are the specifics of the tendencies/biases, occurring as they do in different organisational contexts). It is quite possible for an outcome to be the result of many constituent decisions such that, whilst, none of them could be said to be unreasonable, still less incorrect or in violation of a relevant rule, the outcome itself is unreasonable or manifestly dominated by a preferable decision. It can even be argued that, without conscious effort to counter the tendencies/biases, such a situation can be expected to be the norm.

A useful analogy might be the problem facing Treasurers and Finance Ministers, or indeed anyone responsible for an organisational budget made up of allocations to constituent activities. Starting with individual expenditure possibilities, and building up from individual evaluations, almost invariably leads to over-expansive budget claims; not necessarily from any conscious 'gaming' of the process – although that sometimes can be a distinct issue of its own – but simply from the steady accretion of individually small, 'natural' biases/tendencies.

In regulatory organisations it is highly relevant that the biases can go in different directions, depending on context, in ways that are linked to issues of regulatory uncertainty. Faced with political pressures to hold down prices in the face of rising costs, for example, the resolution of close-call judgments by regulators may be tilted toward the decision that contributes to an easing of that political pressure on the organisation. Again this may be unconscious – although again it can be a conscious derogation from delegated duties, the regulatory equivalent of 'gaming' that is generally referred to as 'opportunism' – but the cumulative effect can be material.

More generally, under the current regulatory arrangements, there are intended to be a number of checks and balances against undue tendencies/biases in final decisions (such tendencies can never be removed completely), whichever way the 'tilt' may be in a particular historical period. The first line of defence is senior managements of NSPs, who are intended to have incentives to mitigate ambit forecasts in order, under propose-respond type arrangements, to induce a less challenging response from the regulator. The second line of defence is the AER, which should challenge proposals that it considers involve unreasonably high levels of cost; and we note at this point that, on the basis of what has just been said, this requires top-down, as well as bottom-up assessment. Each individual judgment of a proposal might look 'reasonable' but, when all the close calls between 'reasonable' alternatives have been resolved by a single decision maker (a common influence that, in effect, 'links' the individual decisions), the final outcome may well be 'unreasonable'. The third line of defence is the ACT, which can look at both sides of

contested decisions and form its own views; and we note that this end-stage review process is particularly closely linked to issues of regulatory certainty, since it is the only point in the process where any cumulative bias in regulatory decisions can be mitigated outside the AER itself. This is the 'second pair of eyes' function that merits review is often said to serve.

It is the Panel's view that these checks and balances have not been working well, and that, in particular, it appears to be difficult to conclude that, taking the relevant decisions as a whole, the LMR regime has, in fact, contributed to preferable decisions, judged in terms of the NEO and NGO. As noted earlier, as we understand its position, the AER is not of the view that, in the cost of capital cases, its overall revenue determinations have been replaced with preferable decisions. In a literal sense, because the appeals process has not been much concerned with the overall decision, and with the implications of changes to it for the NEO and NGO, the efficacy of the AER's overall decisions has remained unchallenged/un-assessed.

Whilst there are occasional references to the NEO and the NGO in the ACT's decisions, the Panel has found that they do not occur in the context of an overall assessment of the AER's decisions. The following section of the decision on the Application by United Energy Distribution Pty Limited [2012] ACompT 1 (6 January 2012) at 415 illustrates:

> *It might be thought that the AER included the APT bond estimate in order to derive a DRP that was lower than that derived solely from the FV curve and that its hybrid benchmark provided a better estimate of the DRP. However, the long-term interests of electricity consumers will not be served if, in the long run, DNSPs are not permitted to recover their efficient costs.*

There is nothing to disagree with in the final sentence referring to the relationship between the long term interests of consumers and the ability of Distribution Network Service Providers (DNSPs) to recover efficient costs, and what the Panel is concerned about is simply the gap between the first and second sentences here. To answer the question of whether or not the outcome of the ACT decision is preferable to the AER's determination, it is necessary to assess whether or not the revenues determined by the AER did or did not prevent United Energy from recovering efficient costs. The Panel has no view on the appropriate answer to this question; but does think that the appropriate question was not asked.

The Panel is not saying that it is impossible to point to individual cases where there might be a solid case for concluding that there have been unambiguous improvements in outcomes as a result of the LMR process; only that, considering the performance of the regime as a whole, such evidence is lacking, and that it appears to have been particularly lacking in some of the cases that have had the largest potential impacts on revenue determinations.

The conclusion applies both in the longer-term and the shorter-term. Thus, we can see no obvious, major improvements in the way that the AER has conducted its business as a result of the LMR. In its own submission to the Review, the AER has argued that unreasonable use of discretion should be removed from the grounds of appeal allowed under the LMR regime, which hardly suggests that the regulator believes that its own use of discretion has been improved by the merits review process.

Again there may be individual aspects of the AER's work where examples of improvements attributable to the review regime can be found, but the Panel's sense of wider effects is that the prospect of appearing before the ACT has contributed – and it is not the only factor that has done so – to an approach that affords more weight to narrow legal considerations and less weight to matters of policy substance than is contemplated in the regulatory design. There were indications of this in (a) the view expressed by the AER to the Panel that it is compelled by the NER to take a bottom-up approach to evaluation of NSP proposals, and (b) a continuing unwillingness of the AER to press the ACT to broaden its consideration of issues brought to appeal by NSPs, again based upon an insistence that its hands are tied by the legislation.

The Panel does not, at this stage, have to conclude on whether the AER has acted in the way that it has by virtue of legal necessity, or by choosing not to make use of available discretion. It is sufficient to find that, irrespective of the cause, the outcomes have not been as intended by the MCE.

On the basis of the record to date, the key cases that have led to the Panel's conclusion are those concerned with cost of capital issues where, as we have already stated, we believe the specific provisions of the current version of the NER are in tension with the high level policy objectives set out in legislation. There is a lesser tension in relation to the NGR but since, in practice, gas distribution determinations and appeals have followed a similar course to those in electricity, this tends to indicate that the performance weaknesses are not attributable solely to the structure of the rules.

In the cost of capital cases considered by the ACT, the outcomes have involved significant increases in network charges which have had material, short-term upward effects on consumer prices. It is important to state that there is nothing problematic in this outcome *per se*: as stated earlier, if an increase in charges is warranted in terms of the costs of provision and/or beneficial incentive effects, it would in fact be harmful to the long term interests of consumers not to allow the increase. The Panel's conclusion that these cases reflect serious departures from the intended operation of the LMR regime is based on somewhat different considerations. Specifically:

- As noted, the question of whether or not the adjustments to AER decisions that were made by the ACT could be expected to promote the long-term interests of consumers,

does not appear to have been generally raised as an issue during the review process.[43] The NEO and NGO cannot therefore have influenced decisions in the ways anticipated by policy makers.

- The relevant matters were considered very narrowly in the course of the review process, generally without sufficient reference to the interdependencies among cost of capital parameter estimates, which exist even when working within the narrow confines of the CAPM. The most obvious of these – the effect of global economic contraction on the distribution of systematic risk between debt and equity, and the implications for the *longer term* (beyond five years) distribution of systematic risk of different methods of estimating the 'risk free' rate – do not appear to have featured in the deliberations of the ACT.[44]

It is beyond the capacity of the Panel to say, in relation to the final determinations of the cost of capital, whether the eventual outcomes served to better promote the long-term interests of consumers than the AER's original determinations. That is a matter that can only properly be assessed by a broad review of the determinations in their entirety, for example because operating expenditure (opex) and capital expenditure (capex) decisions themselves have implications for the cost of capital. What we can say is that:

- Relevant questions about how decisions might contribute to the NEO and NGO – which the AER is required to ask in exercising its discretion, and which the ACT is also required to ask when standing in the shoes of the AER – were not, in fact, asked at the review stage, and hence that evidence required to answer those questions was never addressed.

- Relevant interdependencies in cost of capital issues were not identified and addressed.

- Even considered as isolated points, on at least some of the issues where the ACT found fault with the AER in the weighted average cost of capital (WACC) cases, the basis on which it did so is, in the Panel's view, less than convincing.

The Panel recognises that there is an argument that the regulatory authorities (the AER and ACT) were simply 'following the rules' in the way that they approached things, particularly in relation to the second point concerning interdependencies among estimates of cost of capital components, but, having considered the point, the Panel is unconvinced

[43] On an initial examination, recognition of this aspect of the NEO/NGO has been raised in seven decisions (six in electricity and one in gas) in the context of a general discussion of the regulatory framework. In four other decisions the issue of the impact on a particular matter on the long term interests of consumers was specifically addressed (two in electricity and two in gas).

[44] The United Energy Distribution Application, cited above, is a case in point. Aspects of the ACT's consideration of the parameter gamma provide other examples, in particular in relation to the use and value of outer bound estimation procedures. The Panel also found some of the points in a submission by Bruce Mountain/Carbon Market Economics (in support of the Energy Users Association of Australia (EUAA)) on the economic reasoning in relation to the determination of the risk free rate of interest in the Energy Australia decision to have substantial force.

by the argument. In the event that the AER was found to have deviated from the NER, and therefore to have erred in that sense, it was open to the ACT to remit matters back to the AER for further consideration, which, given the greater resources of the AER, might have facilitated a wider look at a number of issues at the same time.

The Panel notes that, given that the NER and the NGR have the force of law, an approach based chiefly on testing whether the AER has or has not correctly complied with the rules would be very close to a process of judicial review, and that the normal outcome of a successful appeal in such a process is remittal of matters back to the administrative decision maker. In opting for a limited merits review regime, however, the MCE clearly intended something more than judicial review. In the Panel's view, under the arrangements established and on the basis of the policy intent, when a deviation from the rules had been found that, if corrected, would lead to a higher cost of capital, the ACT should have gone on to ask whether a higher cost of capital was justified in terms of the NEO or the NGO and, if the answer had been no, should then have desisted from making 'error corrections' that would likely detract from achievement of the NEO and NGO. Again, the Panel does not at this stage have to reach a conclusion on whether or not the divergence between outcomes and policy intentions is attributable to legal drafting or to the use of discretion.

In summary, the Panel is of the view that the NEO and NGO are given inadequate weight during the merits review process. Not only is consideration of the long term interests of consumers neglected, but the fact that it is neglected means that no credible account can be given as to precisely why, at this late stage of the regulatory process, it has been determined that consumers have been required to pay significantly larger amounts of money for their energy supply than the amounts determined by the expert regulatory body. The resulting lack of explanation is not conducive to establishing that ACT decisions have been preferable to those of the primary decision maker that they have displaced, or, more generally, to the development and maintenance of trust, legitimacy and regulatory certainty.

Submissions on the relationships between the NEL/NGL, the NER/NGR and the operation of limited merits review

The Panel has benefited from several learned submissions on a number of issues relevant to the above discussion, in particular relating to the question of why the LMR system operates as it does. Leading the way was Professor Fels's report, commissioned by the Energy Networks Association (ENA), in which it was argued (at paragraph 184) that:

> *... it is abundantly clear that the Energy Rules set out in some detail the methodology that is to be employed by the AER and the various constituent decisions that are to be made along the way. In this context, the AER's decision cannot be viewed as an assessment of the overall reasonableness of the business proposal, but rather a conglomeration of several decisions on various aspects of that proposal. There is no*

provision that gives the AER an overarching discretion to determine a final price outcome that it considers to be the public interest. Ultimately, the AER has little control over the final pricing outcome, as that result follows from the various constituent decisions which the legislation requires it to make, not from any broader exercise of discretion.

Mr Swier goes one step further in saying, at paragraph 25:

... the energy rules do not permit the AER to assess the overall reasonableness of a business's regulatory proposal.

The AER has expressed similar views, to the effect that the NER/NGR confine it to bottom-up examinations of business proposals.

If these views are correct, there is a good case for a change in the relevant rules, and/or in the NEL, since, for the reasons given above, an assessment process that is 'bottom up only' can be expected to be at risk of serious bias, would which not be consistent with the NEO/NGO. However, the Panel can see nothing in the rules that mandates such a restrictive approach to assessment. It is true that the amount of space in the NEL given to the building blocks may lead a reader to 'frame' the matter in that way, but, if so, that appears to be nothing more than the kind of framing/description bias familiar from psychological research.

The Panel's reading of the rules is that all that is required is that the overall revenue allowance is equal to the sum of the allowances attributed to the individual building blocks. This is an adding up condition, little different from a Treasurer's overall budget provision being the sum of the provisions to individual activities, i.e. an accounting condition not a statement about causality. The Panel infers that its purpose is not to prevent the AER from assessing the overall reasonableness of a business's proposal – a restriction that the Panel would consider to be poor regulatory practice – but rather to ensure that the AER takes account of information relating to the full range of factors that can influence a business's cost (which is good regulatory practice).

There is nothing in the rules that says that the AER cannot make assessments of the overall budget to inform individual building block assessments, whilst at the same time using individual building block assessments to inform the overall assessment. In the experience of the Panel members, this is how things are usually done in this type of exercise. At the end of the day the adding up condition has to be satisfied, but the NER and NGR are, so far as we can see, not prescriptive in relation to the process of reconciliation.

In any event, if there is ambiguity on the matter, Clause 7 of Schedule 2 of the NEL requires the ambiguity to be resolved on the basis of the overall purposes of the NEL. In the Panel's view, the resolution cannot sensibly be made on the basis of a 'bottom-up only

assessment', since that would prevent the use of certain types of information that may be highly relevant to the decision (and neglect of relevant information can render a decision unlawful).

There is also a practical aspect to this matter, related to the original concept of RPI/CPI-X regulation (itself an important element of the NEL and NGL), which was developed to economise on the assessment burdens faced by regulators, and simultaneously to make the process of regulation less burdensome for firms (i.e. to be a 'lighter touch' form of regulation than traditional U.S. rate of return approaches). As indicated above, the MCE was explicit that the AER should, in the event of an appeal and at its own discretion, be able to ask the ACT to consider a determination holistically. We think that such an exercise would, within a limited merits review framework, be infeasible if evaluation were restricted to bottom up approaches: the ACT would likely then not have the capacity to 'stand in the shoes' of the AER.

Submissions of some NSPs were a little more sympathetic to the notion that there could be deficiencies in the current regime associated with a failure to take into account 'inter-related' decisions when the ACT found fault with the AER in relation to a ground of appeal. Mr Swier, for example, urges a distinction between (a) logically interconnected situations and (b) trade-off situations, and argues that it is only assessments of the latter – which involves assessing reasonableness of sets of decisions that are not interconnected in the sense that a change in one decision should necessarily imply an adjustment in another – that are not countenanced by the regime.

The Panel is of the view that the MCE did intend that the ACT be able to make what Mr Swier calls trade-off judgments (and further that, given the nature of regulatory decision making, this is a desirable thing for the ACT to be able to do), but is undecided about whether the way in which the LMR has been specified in the law allows it to do so. Ray Finkelstein QC says starkly that: *"It is not permissible for the ACT to reconsider the whole AER decision."* It is not necessary for us to come to a conclusion on the point at this stage, since it is chiefly relevant to the question of *why* outcomes have not turned out as intended, not whether they have turned out as intended (which implies that we will need to come back to the question in Stage Two of the Review). The reasons for the Panel's view on 'trade-off' judgments are set out in the discussion of gaming below.

Questions surrounding gaming

Concerns about risks of 'gaming' were expressed by the MCE when it was evaluating the various review options before establishing the LMR regime, and concerns about its regulatory equivalent, usually labelled 'opportunism', were influential in developing the broader institutional structure, particularly the creation of a separate rule-maker in the form of the AEMC. Precise definition of the concepts is elusive, although there is a clear association in both cases with lack of trust; and economic environments characterised by low levels of trust tend to be adverse to economic progress.

For our purposes, gaming can be thought of as conduct that is not constrained by formal provisions of contract or by strong social norms – most usually because the relevant circumstances are relatively unusual and acceptable conduct has not been codified – where one party to an economic relationship intentionally takes advantage of the lack of clear restraint to further its own interests by doing things that directly and adversely affect the interests of other parties. It is the latter economic harm that renders the conduct problematic, and which gives the term its pejorative edge in ordinary usage.

In practice, gaming (and opportunism) can be mitigated in a number of ways, of which probably the two most important are:

- Repeated interactions between the relevant parties, which create incentive structures in which the short term advantages of gaming are counteracted by adverse longer term effects (e.g. via loss of reputation).

- Self restraint, which is usually bolstered in repeat situations by the evolution of the aforementioned incentive structures, whether the latter be economic or social in nature. In non-repeat situations, self restraint is usually underpinned by generalised ethical principles.

It is when these counterweights are inadequate that significant policy issues tend to emerge.

An examination of the record of cases appealed, and of the outcomes of those appeals, demonstrates that, considered collectively, NSPs have benefited substantially in the short term from the outcomes, whilst consumers and networks users have lost out, to the tune of over $3 billion.[45] In the face of this record, NSPs made a number of points to the Panel about their incentives to make appeals in general, and about gaming in particular, including:

- It was not in the long-term interests of NSPs to game the appeals system, since there would be negative repercussions for them if they did (i.e. the repeated interactions/ reputation point noted above).

- Appeal was not a one-way street. There was prospect of decisions being made by the ACT that would have negative consequences for the appellant, and, in those cases where the ACT simply rejected the appeal, the NSP would be left facing the costs of appeal, which could be non-trivial. Perhaps more significantly in practice, those within NSPs who had advocated recourse to appeal, might, within their own organisation, suffer loss of reputation for sound judgment.

[45] Relative to a counterfactual in which the ACT found against the NSPs in the relevant cases, and see section 4 above for the health warnings against treating these numbers as indicative of long-term impacts.

The Panel recognises that recourse to appeal is not a one-way street, in particular because of the costs of engaging in the process. Indeed the existence of those costs is one (although only one) of the factors that appear to constrain consumer and user engagement. Nevertheless, it is clear from the record that the flow of traffic has been in predominantly one direction.

In relation to the reputational argument, the difficulty the Panel sees here is that it rests upon repetitions of broadly similar interactions over time. In such circumstances, the Panel believes that the incentives constraining gaming can be powerful. However, one of the features of the situation in Australia is that there is still a 'developmental' aspect to the structure of institutions in the energy sector, which can work against the evolution of stable, long-term perceptions. On the basis of what the Panel has read and heard, the AER has yet to establish a position of legitimacy and trust with other stakeholders, whilst the AER itself appears to be sceptical about the effectiveness of other parts of the regulatory system, and other regulatory bodies, at least in their current form. The Panel also notes that merits review in Australia has, over time and across sectors, taken a variety of forms, and that there is therefore no one, settled model; and, finally, that its own Review of the LMR regime is, considered in isolation, another example of the 'developmental' change noted above (the Panel obviously hopes that, when its deliberations are complete and its conclusions are added to the balance, the net outcome will be a directional movement toward greater stability).

The Panel's overall, provisional conclusion is that the outcomes of the appeals arrangements indicate a structure of incentives and behaviours that detracts from the successful pursuit of the NEO and NGO. Specifically, judged in terms of implications for the interests of consumers, the economic effect of the LMR regime has likely been adverse to consumer interests in the short-run, via higher network charges and, ultimately, higher energy prices.[46] For reasons given earlier, the implications of the regime for the long-term interests of consumers are uncertain; but the Panel has not seen convincing evidence and substantiated reasoning to the effect that the outcomes will lead to countervailing consumer benefits in the longer term, and considers that lacuna to be a significant deficiency in performance in its own right.

The Panel does not, on the other hand, believe that it is accurate or helpful to ascribe these outcomes to 'gaming' behaviour by NSPs; and it holds the same view, *a fortiori*, in relation to references to 'cherry picking', a term that, in utilities policy, has been most frequently deployed by those arguing against market liberalisation. There are a number of reasons for the Panel's view, including:

[46] Price increases have direct and immediate, negative effects on the real incomes of consumers. Where there are counteracting benefits, large parts of those benefits, although not necessarily all of them, tend to accrue more gradually. Thus, when Soviet era price controls were lifted in countries such as Poland, real incomes fell (an immediate consumer detriment) and queues disappeared (an immediate, but smaller, consumer benefit), whilst the much larger benefits for consumers, in terms of the volume and variety of goods in the shops, tended to come later. It is the temptation of the more visible, more immediate benefits of price control that can be a source of problems in regulatory systems lacking appropriate checks and balances.

- There is no fault, when considering their options surrounding appeals, in NSPs choosing to focus on those points that would improve their own positions and on which they perceive themselves to have the better chances of success. That is simply normal commercial behaviour, which can only become problematic if, for some reason or another, it can be expected to lead directly to harm to other parties.[47]

- The MCE explicitly addressed the gaming issue in its original decision, and design features were incorporated into the regime. In particular, s71O(1) of the NEL and s258(1) of the NGL were introduced to give the AER the power to introduce wider considerations in the event that it believed that the ACT was considering matters of appeal on too narrow a basis. Moreover, the ACT itself, when standing in the shoes of the AER, is subject to the same legal requirements as the AER, and in particular to ground uses of its discretion in the NEO and NGO, both of which give primacy to the long term interests of consumers. Whilst recognising that some parties have expressed a view that the ACT is confined to a more limited role than this by the wording of the NEL, the Panel does not think that the MCE's intentions could have been much clearer. In a section of the MCE Decision Paper that has been quoted to us in more than one submission, and following a reference to the fact that the Gas Pipelines Access Law (GPAL) gave no scope for the ACT to widen its assessments beyond issues raised by appellants, the MCE said:

  What is required is a provision to the effect that, if a review is brought by a network or service provider, then the regulator may, in its absolute discretion, seek a review by the ACT of other parts thereof, or of the entire decision, and the review would proceed on that basis, not only on the (limited) grounds of review that the network or service provider advances. This would then enable the regulator to argue such things as: 'yes there was an error but we compensated for it by an adjustment we made elsewhere'.

  The MCE notes that this need not entail a review of the entire decision, but only those additional aspects that the AER says warrant review having regard to the grounds of review advanced by the network or service provider. Allowing for a part re-hearing as well as a comprehensive review limits concerns that the review process could become needlessly expensive without detracting from the overall point that an error should be looked at in context.

We note that: (a) the possibility of comprehensive review is clearly intended, (b) the reference to 'adjustments made elsewhere' appears to be intended to be exemplary (via the reference to "such things as") of a broader set of arguments that might be made in the context of a widening of the scope of a review, (c) the MCE was concerned that the scope of the review should be no wider than necessary to secure the relevant policy purposes,

[47] Whilst higher prices that might eventuate from a successful appeal reduce the real incomes of consumers in the short-term, the price effects can be expected to be in the long term interests of consumers *when they reflect efficiently incurred costs*.

and hence the reference to the part-hearing option, (d) discretion is afforded to the AER, and (e) the arrangements are not unlike the new appeals system introduced in the UK in November 2011 (see section 5.2), although the UK Competition Commission has much greater assessment resources than those possessed by the ACT.

The Panel does not consider that NSP's could have anticipated the failure of these intentions, and in particular the failure of the regulatory system to address issues using approaches that are broad enough to allow for (a) the cumulative implications of 'natural' decision making tendencies/biases in business plans and regulatory determinations, and (b) the interactions among sub-sets of decisions made in the course of regulatory determinations. It would, therefore, be unreasonable to hold them responsible for failing to do things that were explicitly entrusted to the regulatory authorities.

However, given the weight of evidence in relation to appeals outcomes, the Panel is of the view that NSPs now do have a responsibility to recognise the problems, and to be active in seeking solutions to them. These will be matters for Stage Two of our Review, but we are encouraged by submissions made in Stage One that at least some NSPs are already thinking this way.

The s71O(1)/s258 puzzle

A major question that has arisen in the context of evaluating the operation of the LMR to date is: *why has the AER systematically declined to use its s71O(1) powers in electricity (s258(1) powers in gas), even in circumstances where it was manifestly the case that (a) the matters being appealed were economically related to other aspects of the AER's determinations which were not being appealed, and (b) decisions on the contested matters could be expected to have very significant implications for the long term interests of consumers.* Given the nature of the appellate body (the ACT) under the Australian system of (non judicial) merits review, a similar question arises in relation to the conduct of the ACT as well.

In relation to the AER, the Panel has posed the question to stakeholders and to the AER itself, without receiving an answer that it has yet found convincing; although Ray Finkelstein QC has at least provided a definite answer, to the effect that the relevant powers are much more limited than other stakeholders suggest, notwithstanding the MCE's intentions. The implication of this position, at least if the Panel's view of the MCE's intentions is broadly correct, is that the execution of the policy, in the form of its codification in law has been flawed. Among stakeholders the dominant response to the Panel can be loosely characterised as "we just don't know", most vividly illustrated in the submission of Liza Carver in which a range of cogent views on a variety of issues is punctuated by the statement, on this particular point: *"I cannot speculate as to why the AER has not availed itself of the rights under s.71O(1), nor do I think there is much utility in doing so"*. From the AER itself, perhaps the nearest to an answer the Panel received was that that the regulator was constrained by the model litigant code for public bodies.

The Economic Regulation Authority (ERA), in a late June submission that the Panel has not yet had time to digest, also suggests that, among other things, the requirement to act as a' friend of the court' may constrain the willingness/ability of regulators to challenge decisions. More generally the ERA alludes to a potential conflict for regulators arising from the fact that ACT may remit matters back to the regulator for further consideration.

The Panel fails to see, however, how compliance with such a code could be construed as preventing the AER from discharging its duties under the NEL/NGR, by use of s71O(1) and s258(1), when appropriate. If there are wider issues that should be taken into account, it is reasonable for a 'friend of the process' to draw attention to them, if only to help the ACT perform its functions in the ways intended. This does not necessitate that an adversarial stance be taken. Moreover, if there were to be a conflict between the two (the legal provisions and the code), the Panel's view is that it would be duties in relation to the NEO and NGO that should prevail.

Reference to the model litigant code was also used to explain the lack of robustness of the AER in defending its decisions before the ACT, although here the evidence was mixed and the Panel has formed no definite views. Whilst the AER suggested that it was limited by the code, some submitters said that the AER did defend its decisions vigorously before the ACT; others said that it did so on some occasions but not on others, and that it was not easy to detect precisely why there was such variation.

Turning to the ACT, it is perhaps easier to understand why it might not be inclined to ask broader questions when faced with appeals grounded in relatively narrow issues, even if, contrary to the views of some submitters, the legislation allows it to do so. The ACT lacks the assessment resources of a regulator such as the AER, and is placed under significant time pressures by the nature of the LMR regime, which is designed to deal with matters quickly. If the AER does not raise a matter, resource constraints might be expected to lead to a 'let sleeping dogs lie' approach. We note that, like all human institutions, the ACT cannot be expected to be free of the tendency to resolve ambiguities and close calls in ways that are favourable to its own agendas.

The situation is, however, an unsatisfactory one. If the ACT does not have the resources to consider matters on a wider basis when it would contribute to the NEO or NGO to do so, that too appears to be a flaw in the current regime. Unlike in the case of the NSPs, the ACT cannot reasonably proceed on an assumption that the task of deciding whether broader issues need to be considered falls to others, and specifically to the AER. In making decisions, the ACT is required to act on the same principles as the AER which, among other things, means asking questions about implications of decisions for the long term interests of consumers and, at least if the regime is to operate as intended, about relationships among different sub-sets of the decisions and judgments that go to make up a regulatory determination.

The Panel's conclusion on these points is that the current review regime is not working as intended. The appeals process appears to be dominated by narrow, formalistic, and sometimes arcane considerations that fail to pay heed to wider economic effects and consequences, and in particular that fail to pay sufficient attention to consideration of the long term interests of consumers.

This links with other of the Panel's conclusions set out above, and together they constitute the main part of the Panel's findings. Consumer and user groups feel excluded not simply because of costs and discomfort, but also (and perhaps mainly) because, at the appeal stages, although the decisions have potentially major consequences for consumers and users, their voices are not relevant to the narrow, formalistic points that are being contested. It is difficult to believe that demonstrably preferable decisions are being made, if for no other reason that the question "is this a preferable decision, judged against the NEO and revenue and pricing principles of the NEL?" is not being asked.

As explained, the Panel is concerned that regulatory uncertainty in the longer term will be increased by this state of affairs, because such narrow approaches are inherently fragile in the face of major economic change: they lack not only legitimacy but also the adaptive and innovative capacities that are as necessary for regulatory institutions as they are for market participants in changing economic conditions.

Accountability

In relation to accountability, which was one of the MCE's stated goals in establishing the LMR regime, it appears to be uncontested that the regime has provided for greater accountability (compared say with reliance on judicial review alone) for the AER. Although the Panel notes the view of Professor Fels that merits review and judicial review are very different animals, it also notes the view of Professor Cane that *'... to say that judicial review and merits review are categorically different is not to say that they are entirely dissimilar. For instance, both are concerned with enforcing the legal limits of decision-making powers;..."*[48]. Although the two types of review can be more similar or more distinct depending upon details of the relevant context, in general, merits review provides the greater scope for reviewing the substantive content of regulatory decisions, and therefore widens the range of conduct over which the AER is held accountable.

The position in relation to the accountability of the ACT is less clear. Its decisions are subject to Judicial Review, but, notwithstanding the points made above, the ACT was not challenged by any party in the energy sector in the period up to end March 2012. That position has changed recently, and an appeal has been made on one of the issues that potentially distinguishes legal and administrative approaches to decision making (whether a non-appellant is entitled to the same, final outcome of an administrative process as an

[48] Cane P (2010) "Judicial Review and Merits Review: Comparing Administrative Adjudication by Courts and Tribunals" in SR Ackerman and PL Lindseth (eds.) *Comparative Administrative Law* (Edward Elgar, Cheltenham), page 446.

appellant who is in an otherwise equivalent position). This is one of the issues that the Panel will need to come back to in Stage Two of its Review.

When the ACT was challenged in the past on a telecommunications matter, and its decision was struck down by the Federal Court, the ACT subsequently made it clear that it did not agree with the reasoning of the higher court, and suggested that the Federal Court was not in a good position to make judgments about the ACT's decisions on technical matters of regulation.[49] That might suggest that, in practical terms, there is only limited accountability for those of the ACT's decisions that it makes when it is standing in the shoes of the AER.

The Panel does not consider that such absence of formal accountability is a problem by and of itself: any process of review has to end somewhere, sometime. However, there are two related problems that lead us to conclude, once again, that outcomes have not worked out as intended:

- Where the ACT does substitute its own decisions for those of the AER, this leaves the final (and therefore formally unchallengeable 'on the merits') decision with a body whose own assessment resources are extremely thin. However expert the ACT panel members may be, they have no significant staff to assist them with the 'heavy lifting' of economic and financial assessment, and an extremely limited sub-set of colleagues with whom they can engage in the kind of discourse that is central to good economic policy making.

- In democracies, accountability is ultimately to the public, both directly and via the public's elected representatives. At the end stage of the formal, technical assessments of regulatory issues, therefore, the responsible body must be able to account for its decisions to the public and its representatives in a way that is understandable. There are no indications that a requirement for such accountability is currently being met. The Panel conjectures that this may in part be linked to the court-like aspects of the ACT. In liberal democracies, there is a justifiable reluctance for the judiciary to be wary of accountability to the public and to the executive and legislative branches of government; but the ACT itself is a non-judicial body that makes administrative decisions. The Panel recognises that there are difficult issues here relating to the boundary between administrative and judicial authorities and cultures; and it therefore restricts itself to the limited conclusion, that, if the purpose of merits review is to establish arrangements for the administrative review of administrative decisions, then there are weaknesses in those arrangements in relation to the accountability of the end decision maker in the chain.

[49] Application by Chime Communications Pty Ltd (No 2) [2009] ACompT 2 (27 May 2009)

Time delays and costs

The LMR regime was designed to keep delays and costs low, but the evidence indicates that, once again, intentions have not been realised in this area. Reviews have frequently lasted longer than the time periods contemplated as norms in the legislation, and in some cases have lasted much longer. More specifically, the duration of cases has been at levels comparable to Judicial Review on the one hand[50] and to less limited forms of merits review in other jurisdictions. As noted earlier, one of the consequences of such delays has been increased uncertainty for energy suppliers, whose own pricing is dependent upon the charges that will be made for use of electricity and gas networks.

Some of the most critical comments about the implications of current arrangements for delays and costs were made in the submission of Ray Finkelstein QC. We do not repeat them here, but they leave no doubt that there is scope for improvement, and Mr Finkelstein has made a number of suggestions for improvements, to which the Panel will return in Stage Two.

There have also been many more appeals than appears to have been anticipated by the MCE, which likely based its expectations on the incidence of appeals in previous periods and in other sectors where some or other variant of merits review applied. Several submissions made the point that the number of appeals can be expected to fall significantly in future years, since (a) the initial upsurge was likely influenced by the learning and 'testing out' processes that occur when a new regime is introduced, and (b) a substantial fraction of the cost of capital issues arose from excessively constraining features of the NER in those sections of the rules that deal with the estimation of the cost of capital, which can be expected to be eased via the AEMC rule change process.

In response, the Panel notes that the future is inherently uncertain, and finds itself unable to form an expectation that the level of appeal activity can be expected to fall over time. Whilst it might be the case that, in a stable economic environment, there would be tendencies for this to be the case, ever evolving economic contexts indicate that new challenges will need to be addressed in the energy sector, which may, by virtue of necessary adjustments and innovations in regulation, give rise to new and different grounds for testing out aspects of the changes. In relation to the cost of capital issues, the Panel notes that the relevant provisions of the NGR are much more general than those of the NEL but that this hasn't prevented similar WACC cases arising in relation to gas distribution – and the Panel also notes that this may, in part, reflect a tendency to seek to harmonise application of the NGR and the NER, leading to certain constraining features of the NER having influence in gas. The recent ATCO decision appears to point in this direction.

A tendency to harmonise the two sets of rules on the basis of convergence to a more constraining, and in our view more problematic, set of requirements is not encouraging for

[50] Fels, A "*The Merits Review Provisions in the Australian Energy Laws"* March 2012, paragraph 99.

the notion that performance will improve if things are left as they are. A 'one size fits all' approach, based on convergence to the more constraining sub-sets of existing rules, may become a source of increased appellate activity in circumstances where those to whom the rules are being fitted are, in fact, of different sizes. Finally, the Panel notes that there have been other changes to merits review processes in Australia, both over time and across sectors, and that, at least on materials before the Panel at the moment, there is no suggestion of similar upsurges in appeals activity consequent on those changes.

As a general matter, the Panel's preliminary view is that, whilst the procedures of the ACT may have contributed to delays and higher costs, at least part of the reason for the difference between outcomes and intentions/expectations is that, on this aspect of policy (i.e. delays and costs), the goals were a little too ambitious. An appropriate response might be to lower expectations somewhat, and to adjust the legislation to reflect this where it is over-constraining in relation to matters such as time to make appeals, time for the ACT to make decisions, etc. One of the things that the cases to date indicate is that substantial sums of money may be at stake in some (although far from all) cases, and that it may be preferable not to rush the relevant matters for fear of reducing the quality of final decisions (e.g. by forcing narrow consideration of relevant issues). Unduly constraining the resources devoted to any one particular appeal can, if through its impacts it increases the number of appeals, have the unintended effect of increasing the total costs of the merits review process as a whole. The Panel will be considering the trade-offs involved in Stage Two of its Review.

7. NEXT STEPS

In Stage Two of the Review the Panel is required to provide advice to the Standing Council on Energy and Resources on what, if any, changes it might be appropriate to make to the limited merits review regime, and it is therefore to this task that the Panel will now direct its principal efforts. That said, there remain one or two outstanding questions from Stage One that will need to be addressed, since the answers will have implications for any recommendations for change.

Chief among these outstanding issues is the question of why s71O(1) of the National Electricity Law and s258(1) of the National Gas Law have not been used more actively by the Australian Energy Regulator, to seek a broadening of the issues and to draw the Australian Competition Tribunal's attention toward the layers of small (and sometimes not so small), inter-related judgments that go to make up a regulatory determination, and away from the notion that the way to improve a regulatory decision is to seek to correct only that sub-set of 'errors' identified by appellants. Similarly, there is the related question of why the ACT itself, when standing in the shoes of the AER and making decisions of its own, has not sought to broaden the scope of review to allow for assessment of inter-relatedness among judgments, and to take account of the implications of any decision for the long-term interests of consumers.

The Panel has received a range of answers to these questions, which can be grouped into four broad sets: (i) don't know, (ii) there have been performance failures on the part of the AER and ACT, including failures of legal interpretation, (iii) the facts were such that in none of the cases considered by the ACT was it appropriate for the AER or ACT to widen the scope of the review, and (iv) under the current legislation, the AER and the ACT are either unable to widen the scope of review beyond the points raised by appellants, or are severely constrained in the extent to which they can do so. Since the Panel is of the view that the policy intention was that the scope of reviews should be capable of being widened, the implication of explanation (iv) is that the legal drafting at the time of the introduction of the LMR regime was flawed in some way.

It will, therefore, be a priority for the Panel to seek authoritative legal advice on whether or not the AER and the ACT are indeed seriously impeded by the law in seeking to widen the scope of assessments; since the answer to the question has obvious and direct relevance for potential advice to the SCER concerning changes to the LMR regime aimed at better achieving the regime's purposes. The Panel also invites the assistance of stakeholders in arriving at a sound answer, whether it be yes, no or 'there is ambiguity in the law'.

Consistent with its views that the nature of regulatory decision making requires that review be sufficiently broad as to encompass all material inter-relationships among decisions and judgments, the Panel will want to consider a range of possible options in the

course of its Stage Two deliberations. Nevertheless, since the merits of alternative options are dependent on the deficiencies that stand to be corrected, the reasoning of earlier sections of this Report has implications for the type of options that, subject to that reasoning not being overturned by new evidence or more convincing arguments, are most likely to be considered appropriate, and to which the Panel's attention might reasonably be first directed.

Specifically, the Panel's agreement with bodies such as the Administrative Review Council, Independent Pricing and Regulatory Tribunal and the Victoria Department of Primary Industries about the nature of major regulatory decisions – i.e. they comprise numerous, inter-related decisions and judgments, where the inter-relatedness might arise from logical connections between different decisions or simply from the fact that it is a single decision maker that resolves ambiguities and close calls, and therefore that each individual judgment tends to be subject to common influences – suggests that, at least in its current form in Australia, Judicial Review is probably not well adapted for the task of improving regulatory decisions. The Panel notes that this was the view expressed by the ARC in its 2005 submission to the Standing Committee of Officials. On this basis, the Panel currently sees a 'Judicial Review only' recommendation as a default option, which would, in effect, accompany a conclusion that no variant of merits review is likely to be workable, in the sense of contributing positively to the National Electricity Objective and National Gas Objective.

The Panel's preliminary view that its first priority in Stage Two should be to evaluate alternative options for making merits review more effective is reinforced by the prevalence of merits review processes of various kinds in other Australian contexts and in network regulation in overseas jurisdictions. There does appear to be something of an international consensus that there is value in having the opportunity for a 'second pair of eyes' to take a look at the substantive content of significant regulatory decisions; and also that restriction of review to error correction, whether errors of law or errors of fact, is inadequate, perhaps because it is too remote from the underling objectives of delegated regulation.

At the same time, it was obviously the Ministerial Council on Energy's intention to place some hindrances in the way of developments that could lead to excessive delays in reaching final decisions, and to excessive costs for the appeals arrangements themselves, whether these be direct financial costs or indirect costs arising from factors such as the persistence of uncertainty caused by delay. The Panel is therefore minded to invite creative thinking on the potential to develop arrangements that allow for the scope of review to be widened where appropriate, without encouraging such widening in those contexts where matters can, in fact, be addressed both expeditiously and effectively on a narrower basis.

Finally, there are two other areas of potential development that have implications for the assessment of possible reforms to the LMR regime, namely the possibility of changes to the National Electricity Rules and the evolution of consumer engagement policies by

Network Service Providers. In relation to the NER, the Panel's own reading of the rules (which we recognise is contested, and on which we will be seeking legal advice) is that there is already scope for the AER and the ACT to widen the issues beyond the narrow grounds for appeal raised by the NSPs, and, to the extent that this hasn't happened in cases where it might have been most expected to happen (particularly the cost of capital cases), the way in which the relevant sections of the NER are drafted may have been instrumental in inducing the narrow approaches observed. If so, any future decisions by the AEMC that lead to less prescriptive rules in relation to the determination of the cost of capital might be expected to be complementary to any measures recommended by the Panel which are aimed at promoting improved assessment of inter-related aspects of regulatory decisions. Rule change by the AEMC might, therefore, reduce the scope of the problems that LMR regime reform should be required to address, and the Panel will stay in close touch with the AEMC in regard to proposed rule changes that are currently under evaluation.

Similar remarks apply also in relation to consumer engagement. The Panel has expressed its view that, whilst the barriers to user and consumer involvement in appeals processes is a deficiency of the current regime, reducing those barriers does not appear to be the major priority for the interests concerned. The bigger problem is, to put matters simply, the inadequate attention given to the long term interests of consumers, first by the NSPs, then by the AER, and then by the ACT. Whilst the Panel can make recommendations to address the third leg of this chain of neglect, more effective improvements in performance are likely to come from change that starts at the beginning of the chain, with NSPs.

We have remarked above that the outstanding characteristic of effectively competitive markets is the attention that suppliers pay to understanding their customers. This follows from the feature of such markets that, if the requirements of customers are neglected, business failure can be expected to follow. NSPs are monopolies, as, in a looser use of the term, are the AER and ACT; and these organisations do not face the same over-riding pressures to focus on consumer interests. All is not lost, however: monopolies are not compelled to be attentive to their customers, but they can choose to be; and that choice will be easier to make if other parties with whom they deal do likewise.

To the extent, therefore, that there is a shift in the attention given to the long term interests of consumers in decisions upstream of the appeals process, the burden of inducing change can be expected to fall less heavily on reforms to the LMR regime. In that event, the Panel, and later the SCER, could think of the potential reform options that are within the scope of the current Review more as supporting measures in a general change of culture in the regulatory system, and less as a battering ram to break down resistance to adaptations that may be needed if the legitimacy of delegated, independent regulation is to be sustained in the face of what might be continued and protracted upward cost and price pressures over the coming years.

ANNEX 1

Table 1.1 - Elements (other than WACC parameters) appealed

Case	Other elements of decisions appealed[i]	Remittal to AER[ii]
Application by United Energy Distribution Pty Limited [2012] ACompT 1 (6 January 2012)	1) Whether AER erred in its decision with respect to public lighting (intervener's complaint).[iii] 2) Operating expenditure (opex) (viz internal and related party costs) - whether AER should have included $3.946 million per year for United Energy Distribution (UED) direct costs in UED's forecast opex. 3) Closeout of the ESCV's 'S' Factor Scheme - whether AER had power to adopt and implement the close out methodology in respect of the ESCV 'S' Factor Scheme. 4) Establishment of the regulatory asset base (RAB) (capitalised related party margins) - whether the AER erred in permitting the inclusion of related party profit margins in the applicants' capital expenditure actually incurred in the 2006-2010 regulatory period in establishing the opening RAB for the regulatory control period 2011-2015 as at 1 January 2011 (intervener's complaint). 5) Establishing the RAB as at 1 January 2016 (depreciation) - whether the AER erred in determining that the depreciation for establishing the RAB as at 1 January 2016 is to be based upon actual, rather than forecast, capital expenditure (intervener's complaint). 6) Whether AER erred in its methodology for indexing the RAB for inflation. 7) Capital expenditure - AER accepted that it erred in its decision to substitute zero	(1) Affirm (2) Affirm (3) Remit (4) Affirm (5) Affirm (6) Remit (7) Vary (8) Vary (9) Affirm (10) Unknown (reasons for decision are confidential) (11) Vary (12) Affirm

Case	Other elements of decisions appealed[i]	Remittal to AER[ii]
	capital expenditure for 2011 for a project in place of the direct costs amount proposed by Jemena Electricity Networks (JEN). 8) Whether AER erred in disallowing certain enterprise support function costs in JEN's forecast opex. 9) Materiality threshold for nominated pass through events - whether AER erred in fixing a materiality threshold of 1% of the smoothed forecast of the revenue of the regulatory year in which the costs are incurred in respect of insurance pass through events. 10) Whether AER erred in approving the reworked definition of 'insurance event' which included a rider confining the costs which might be the subject of a pass through payment as a result of the happening of such an event to costs incurred which exceed the level of insurance cover provided by policies the premiums for which were provided for in SP AusNet's forecast opex for the 2011–2015 regulatory control period. 11) Efficiency carryover mechanism (ECM) (vegetation management opex) - AER accepted that in calculating the ECM amounts to be included in Powercor's annual revenue requirement for each year of the regulatory control period it erred by not making an adjustment for certain expenditure necessarily incurred by Powercor in 2008 and 2009 in respect of vegetation management in order to comply with its mandatory statutory line clearance obligations. 12) Whether AER erred in not nominating as an additional pass through event the costs of and incidental to the implementation of relevant recommendations made by the Victorian Bushfire Royal Commission.	(13) Vary (14) Remit

Case	Other elements of decisions appealed[i]	Remittal to AER[ii]
	13) Whether AER erred in applying to Powercor's annual revenue requirements for the 2011-2015 regulatory control period an accrued negative carryover from the 2001-2005 regulatory control period. 14) Whether AER erred in its decision with respect to vegetation management opex step change.	
Application by Envestra Limited (No 2) [2012] ACompT 3 (11 January 2012)	Forecast operating expenditure: 1) Whether AER erred in its decision not to approve the applicant's proposed network management fee included in its revised operating expenditure forecasts. 2) Whether the AER erred in its decision to reject the applicant's proposed unaccounted for gas (UAG) volumes and to require a reduction in the UAG volumes forecast by the applicant.	(1) Vary (2) Affirm
Application by Jemena Gas Networks (NSW) Ltd (No 3) [2011] ACompT 6 (25 February 2011)	1) Calculation of the capital base: a) whether mine subsidence expenditure is capital expenditure as opposed to operating expenditure (applicant's complaint) b) whether the AER has power to reduce the applicant's opening capital base in order to remove the effect of the rate of return on capital of the difference between the applicant's estimated and actual capital expenditure in the 2005-10 access period (applicant's complaint) 2) Terms of supply - in addition to specifying that Jemena Gas Networks (JGN) retains liability for wilful misconduct and negligence whether the liability and indemnity clause should also specify that JGN retains liability if it fails to meet the standard expected of a reasonable service provider (applicant's complaint).	(1)(a) Remit (1)(b) Affirm (2) Vary (3) Affirm (4) Affirm

Case	Other elements of decisions appealed[i]	Remittal to AER[ii]
	3) Terms of supply - whether there should be an objective standard which regulates the circumstances in which JGN may require a user to provide security, call upon the security and review and release the security (intervener's complaint). 4) Terms of supply - whether AER erred by not preventing JGN from issuing invoices more frequently than monthly (interveners' complaint).	
Application by Ergon Energy Corporation Limited (Service Target Performance Incentive Scheme) (No 5) [2010] ACompT 13 (24 December 2010)	Setting Service Target Performance Incentive Scheme (STPIS) targets - whether national distribution STPIS targets for Ergon Energy should be set 10% lower than its minimum service standards under the Queensland Electricity Industry Code.	Affirm
Application by Ergon Energy Corporation Limited (Non-system property capital expenditure) (No 4) [2010] ACompT 12 (24 December 2010)	Non-system property capital expenditure (capex)- whether applicant's capex proposals for two projects were prudent and efficient for the purposes of cl 6.5.7(c) of the NER.	Vary[iv]
Application by Ergon Energy Corporation Limited (Labour Cost Escalators) (No 3) [2010] ACompT 11 (24 December 2010); Application by Ergon Energy Corporation Limited (Labour Cost Escalators) (No 9) [2011] ACompT 3 (10 February 2011)	Labour cost escalators: Whether the AER erred in rejecting applicant's proposal to base its labour cost escalators on rates specified in a 2008-2011 Union Collective Agreement (UCA): 1) for the pre-regulatory control period of 2009-2010 during which the UCA applied; 2) for the first year of the regulatory period, 2010-2011 during which the UCA continues to apply; and 3) for the remainder of the regulatory period 2011-2015 when the UCA no longer applies.	(1) Vary (2) Vary (3) Affirm

Case	Other elements of decisions appealed[i]	Remittal to AER[ii]
Application by Ergon Energy Corporation Limited (Customer Service Costs) (No 2) [2010] ACompT 10 (24 December 2010)	Customer service costs - whether AER erred in not accepting applicant's forecast customer service costs allocated to standard control services.	Affirm
Application by Ergon Energy Corporation Limited [2010] ACompT 6 (13 October 2010)[v]	Prices for quoted services - whether AER erred in its decision that it was not satisfied that the inclusion of a component of other one-off costs in a control mechanism formula the applicant proposed to derive its prices for quoted services reflects the recovery of efficient costs and that therefore it was not appropriate to include that component in the applicant's formula.	Vary[vi]
Application by ETSA Utilities [2010] ACompT 5 (13 October 2010)	Opening regulatory asset base (RAB) - whether AER erred in its rejection of the applicant's claim for an addition to be made to its RAB in respect of easements extant as at 1 July 1999..	Vary[vii]
Application by United Energy Distribution Pty Ltd [2009] ACompT 10 (23 December 2009)	Proposed budget for metering services - whether AER erred in rejecting the inclusion in the proposed budget for metering services a management fee paid by the applicants for delivery of the Advance Interval Meter Rollout program.	Vary
Application by EnergyAustralia and Others [2009] ACompT 8 (12 November 2009) Application by EnergyAustralia and Others (No 2) [2009] ACompT 9 (25 November 2009)	4) Forecast operating expenditure (opex): a) whether AER erred in not accepting 15 ‘step changes’ (used by Energy Australia (EE) to denote a step up or step down in the operating costs of an activity) totalling $151.3 million in EE's forecast opex; b) whether AER erred in reducing EE's forecast maintenance opex costs by $22.4 million.. 5) Pass through - EE and the AER contended in common that AER's pass through decision was affected by error, specifically that there were three errors in AER's	(1)(a) Affirm AER's decision in respect of 14 of the step changes. Vary step change No 8 (Finance and Commercial - Business

Case	Other elements of decisions appealed[i]	Remittal to AER[ii]
	definition of the 'general nominated pass through event'. 6) Defect maintenance - whether AER erred in reducing Transgrid's forecast opex by $13.5 million, a figure arrived at by reducing its forecast defect maintenance for new growth assets by $15 million and then allowing $1.5 million for non-recoverable and non-routine costs.	Systems)[viii] (1)(b) Affirm (2) Vary (3) Remit
Application by EnergyAustralia [2009] ACompT 7 (16 October 2009)	Public lighting: 1) AER conceded that it erred in its calculation of 'other' operating expenditure amount. 2) Whether AER erred in determining bulk lamp replacement program should be 3-4 years rather than the proposed 2-3 years thereby reducing the target opex. 3) Whether AER erred in rejecting the applicant's spot lamp recycle labour productivity assumptions as inefficient. 4) Whether AER erred with respect to the assumed average cost per luminaire. 5) Whether AER erred with respect to the regulatory depreciation allowance that it adopted in determining the opening regulatory asset base (RAB) for public lighting rolled forward from the closing RAB in 2004-2009 regulatory period. 6) Whether AER erred in using the forecast inflation rather than actual inflation to calculate the fixed price path. 7) Whether the AER erred with respect to the control mechanism it proposed by which changes in asset inventories from year to year are accounted for. 8) AER accepted that an allowance should be made for operating expenditure on pre	(1) Remit[ix] (2) Affirm but AER may reconsider the issue on remittal. (3) Affirm but AER may reconsider the issue on remittal. (4) Affirm but AER may reconsider the issue on remittal. (5) Affirm but AER may

Case	Other elements of decisions appealed[i]	Remittal to AER[ii]
	July 2009 connections operating assets. 9) Capital contribution on the sunk value of any assets replaced early in their economic life - whether the AER specified a sufficiently clear or specific control mechanism for the determination of the charge for the residual capital value of the asset being replaced early. 10) Capital expenditure - AER concedes that allowance should be made for the labour costs of construction of public lights located on traffic routes. 11) The parties accept that in the material put to the AER there is an error in the use of 'VLOOKUP' formulas that are used to look up values, such as prices and quantities, from a list of values based on the name of the public lighting component.	reconsider the issue on remittal. (6) Affirm (7) Affirm (8) Remit (9) Remit (10) Remit (11) Remit
Re: Application by ElectraNet Pty Limited (No 3) [2008] ACompT 3 (30 September 2008)	Regulatory asset base (RAB): 1) Whether AER erred in rejecting the applicant's proposal to adjust its opening RAB by including $52.8 million in respect of easement transaction costs incurred in acquiring easement rights prior to 1 July 1999 (applicant's complaint) 2) Whether the AER should not have included in the applicant's opening RAB $29.1 million in respect of easement compensation costs (intervener's complaint)	(1) Vary (2) Affirm

[i] The table covers electricity and gas decisions of the Australian Competition Tribunal since 2008.
[ii] In this table, there are 25 issues which were successfully appealed. Ten of these issues were remitted to the AER.
Application by EnergyAustralia [2009] ACompT 7 (16 October 2009) involved remittal of five issues to the AER. The Tribunal determined that a further four issues with respect to which no reviewable error had been established could be reconsidered by the AER on remittal.

[iii] In particular, the Streetlight Group of Councils submitted that:
(a) Despite there being no material change in services provided by the DNSPs, the AER approved increases in OMR charges. They are said to be "excessive".
(b) Capex charges had been removed from OMR charges as long ago as 1993 but were re-introduced in 2004 by the ESCV. The AER adopted the approach taken by the ESCV. This approach is flawed.
(c) The AER's modelling is flawed because:
(i) It allowed capital charges by DNSPs for depreciation and interest for replacement lights even though the DNSPs did not fund the cost of replacement lights. The capital cost of replacement lights is funded directly by customers via a component in the OMR charges;
(ii) The AER allowed inappropriate and excessive cost component inputs including PE cells, lamps, luminaires, labour rates, geographical information system (GIS), overhead allocations and other components.
(d) The AER models did not establish a separate OMR charge for DNSPs to maintain lights installed directly by public lighting customers or their contractors.
(e) The AER failed to require the DNSPs to establish OMR charges in a way which is consistent with cl 2.1(c) of the Victorian Public Lighting Code (PLC) by minimising costs to public lighting customers.
(f) The AER should have determined that the cost of replacement lights is opex not capex. The capital component of the OMR charges is actually an operating expense disguised as capital.
(g) The AER failed to determine OMR charges that took account of the funding of new light installations by persons other than the DNSPs. The members of SGC had funded some lights. Only the T5Zx14w lights were appropriately recognised. SGC (and VicRoads) should not be required to pay in their OMR charges a sum of money to provide for the eventual replacement of new public lighting which is provided free of charge to the DNSPs. The customers (including SGC) have been providing to the DNSPs a return on capital which has never been outlaid by the DNSPs. This is made worse for the 2011–2015 regulatory period because capex is to be calculated not on the basis of actual expenses but upon the basis of forecast costs. (The AER rejected these submissions. It said that they were based upon questionable assumptions re asset ownership.)
(h) The AER failed to consider that the market for OMR and other public lighting services could be made more contestable and failed to consider how the control mechanism might influence that potential. The AER failed properly to consider tiered pricing.
(i) The AER failed to take into account that it is the customers and not the DNSPs which decide upon the replacement light types and the type of technology involved. This circumstance affects the determination of whether the OMR will be treated as an alternative controlled distributive service or a negotiated distribution service.
(j) The AER took into account a claim by the DNSPs for accelerated recoupment of the cost of residual life for the early retirement of MV80 lights even though the DNSPs have not invested in such lights. Members of SGC who wish to replace MV80 lights with T5 luminaires are required to pay the full capital and installation costs of the new T5 lights and, in addition, to pay to the DNSP the written down value of the MV80 lights which have been replaced before the end of their useful life. This is wrong because, for the most part, the DNSPs will not have paid for the original cost of the installation of the MV80 lights or their replacement until now.
(k) The AER allowed an excessive GIS component as distributors already receive payment for maintaining inventory and light type data. GIS was never intended to be used in this way. It was originally allowed for system development costs and has long since become redundant.
(l) The AER has failed to adhere to its May 2009 Framework and Approach Paper. The AER failed to check materials costs submitted by the DNSPs.
(m) All of the above matters lead to the ultimate conclusion that the AER erred in its application of the NEL and the NER.

[iv] See *Application by Ergon Energy Corporation Limited (Non-System Property Capex)* (No 8) [2011] ACompT 2 (10 February 2011) (*Application No 8*). In *Application by Ergon Energy Corporation Ltd (No 4)* [2010] ACompT 12 the Tribunal rejected AER's argument on how to vary the determination but was not yet satisfied that the proper way to proceed was to make the variation suggested by Ergon Energy. The Tribunal requested a submission by the AER on whether the Tribunal should accept Ergon Energy's estimate of the costs of projects planned in Townsville and Rockhampton. In *Application No 8* AER submitted that the Tribunal could accept the estimate, and consequently the Tribunal accepted the estimate.

[v] In *Application by Ergon Energy Corporation Limited (Street Lighting Services) (No 6)* [2010] ACompT 14 (24 December 2010) the Tribunal gave reasons for its decision that due to the operation of s 71O(2) of the NEL the applicant was precluded from raising a challenge to the AER's decision to classify street lighting services as alternative control services.

[vi] See *Application by Ergon Energy Corporation Limited (Other Costs)* (No 7) [2011] ACompT 1 (10 February 2011). The Tribunal received submissions pursuant to directions made by the Tribunal in *Application by Ergon Energy Corporation Limited* [2010] ACompT 6. The parties agreed to variation relating to Quoted Services supplied by Ergon Energy.

[vii] That the AER's decision would be varied as opposed to remitted was foreshadowed in this case. The Tribunal had made directions regarding estimates as to easements that 'would allow a proper assessment to be made by the Tribunal'.

[viii] The AER conceded that step change No 8 should normally be part of the applicant's base year expenditure. The Tribunal accepted this concession and stated that the determination of the Tribunal would need to reflect this conclusion.

[ix] *Application by EnergyAustralia and Others (No 2)* [2009] ACompT 9 (25 November 2009) deals with Tribunal directions and recommendations on remittal.

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Table 1.2 - Cases in which WACC parameter is in dispute

CASE/S	REGIME	ELEMENT OF DECISION APPEALED	GROUND/S OF REVIEW	DECISION of REGULATOR	FINDINGS OF TRIBUNAL/PANEL/COURT	EXERCISE OF DISCRETION	REMIT, VARY OR AFFIRM AER DECISION[x]
NGL + NGR							
Application by Envestra Ltd (No 2) [2012] ACompT 3 (11 January 2012); Application by Envestra Ltd (No 2) [2012] ACompT 4 (11 January 2012) Application by APT Allgas Energy Limited (No 2) [2012] ACompT 5 (11 January 2012). The reasons of the Tribunal largely mirror the reasons of the Tribunal on debt risk premium in Application by Envestra Ltd (No 2) [2012] ACompT 3 (11 January 2012) and Application by Envestra Ltd (No 2) [2012] ACompT 4 (11 January 2012). The note is therefore confined to the Envestra decisions.	NGL + NGR	Debt risk premium	s 246(1)(a), (b), (c) and (d): Material error/s of fact; incorrect exercise of discretion; unreasonable decision	Reject proposed debt risk premium value of 4.67% determined solely by reference to extrapolated Bloomberg value of 18 bonds with maturities up to 6 years. Adopt debt risk premium value of 3.81% based on an average of the extrapolated Bloomberg value and a single 10 year APA bond.	<u>Background</u> The AER believed that a sample of 3 (later expanded to 7) long-dated bonds (of up to 11 years maturity) including the APA bond provided a basis for rejecting the use of the extrapolated Bloomberg value (EBV) alone and supported the use of an average of the EBV and the single APA bond. In response, the applicant relied upon an expert report which suggested that AER's analysis was flawed in that it excluded several long-dated bonds that were relevant to establishing the reliability of the EBV. The yields on these bonds, in the report's analysis, supported sole reliance on the EBV: [66]-[70]. The AER considered the additional bonds noted in the report as 'immaterial' to its final decision. <u>Unreasonable decision and incorrect exercise of discretion</u> The AER did not investigate or methodically analyse the inclusion of the bonds proposed by the report. The AER's analysis only extended to noting that bonds issued by financial institutions often have higher yields than those issued by infrastructure service providers and that several of the bonds in the report's proposed sample were subordinated debt: [93]-[94]. The decision to reject the adoption of the EBV on the basis of the APA bond and the weighting chosen amounts to reviewable error by the AER. The AER in the circumstances made a decision which was unreasonable by adopting a rate of return for the debt risk premium based upon the simple averaging of the EBV value and the APA bond. The AER regarded the bonds referred to in the report as 'immaterial' without sufficient grounds for doing so. Given the common understanding of the applicant and the AER as to the nature of the bonds considered in the formulation of the Bloomberg curve, there was no apparent reason to exclude those bonds because they were issued by financial institutions. That step on the part of the AER rendered its decision unreasonable because the consequences of its error were of significant magnitude. It is also an error capable of being expressed as an incorrect exercise of AER's discretion in selecting the rate of return for the debt risk premium as it did without considering the increased bond sample proposed by the applicant: [108]-[109]. Vary debt risk premium value to 4.67% based upon the EBV: [120].		Vary

CASE/S	REGIME	ELEMENT OF DECISION APPEALED	GROUND/S OF REVIEW	DECISION of REGULATOR	FINDINGS OF TRIBUNAL/PANEL/COURT	EXERCISE OF DISCRETION	REMIT, VARY OR AFFIRM AER DECISION
Application by ActewAGL Distribution [2010] ACompT 4 (17 September 2010).	NGL + NGR	Debt risk premium	s 246(1)(d): Unreasonable decision[xi]	Debt risk premium of 3.35% based on CBASpectrum fair value curve. (Applicant argued for debt risk premium to be based on an average of the Bloomberg and the CBASpectrum fair value curves which produces a debt risk premium 53 base points higher than the AER's estimate.)	AER fell into reviewable error. The five bonds selected by the AER did not provide a basis for comparison with the fair value curves because the number of bonds was too small and their maturities too short to be sufficiently representative of the yield on 10-year bonds: [38]–[39]; It was unreasonable for the AER not to include floating rate bonds in its population: [55]; Floating rate bonds ought to have been taken into account and treated equivalently to fixed rate bonds: [58]; Even if it was reasonable not to include A- and BBB bonds in the population (because they were not representative of BBB+ bonds), it was unreasonable for the AER not to consider whether useful information could be obtained from taking these bonds into account without including them in the population: [63]. The AER will likely need to rely on published fair value curves. If they differ significantly it may be necessary to choose which of them provides the best fit: [75–76]. In the absence of a basis for distinguishing between them, then it is appropriate to average the yields of the two curves, provided that the curves relied on were widely used and respected by the market:[78] (The Tribunal determined the debt risk premium by using the average of the Bloomberg and CBASpectrum curves.)[xii]	s 245: Leave granted for review of decision	Vary
Application by Jemena Gas Networks (NSW) Ltd (No 5) [2011] ACompT 10 (9 June 2011)	NGL + NGR	Debt risk premium	s 246(1)(d): Unreasonable decision[xiii]	Derive debt risk premium from CBASpectrum fair value curve.	The AER concedes that its determination was in error since it applied broadly the same three step methodology rejected in ActewAGL [2010] ACompT 4. Reject AER's argument that consistent with the ActewAGL decision an average should be taken of the CBASpectrum and Bloomberg fair value curves. In ActewAGL the Tribunal considered it appropriate to average the yields provided by the CBASpectrum and Bloomberg curves because it had no satisfactory grounds on which to distinguish between the two curves. It has not adopted a 'default' position merely because comparison of the curves may be difficult or may involve the exercise of difficult judgments: [54]. The appropriate curve from which the debt risk premium should be calculated is the Bloomberg fair value curve which is a much better fit than the CBASpectrum curve. The latter is so poor a fit to the data that it would not even be appropriate to consider averaging it with the Bloomberg curve: [86].[xiv]		Not specified.

CASE/S	REGIME	ELEMENT OF DECISION APPEALED	GROUND/S OF REVIEW	DECISION of REGULATOR	FINDINGS OF TRIBUNAL/PANEL/COURT	EXERCISE OF DISCRETION	REMIT, VARY OR AFFIRM AER DECISION
NEL + NER							
Application by Energex Limited (No 2) [2010] ACompT 7 (13 October 2010) Application by Energex Limited (Distribution Ratio (Gamma)) (No 3) [2010] ACompT 9 (24 December 2010) Application by Energex Limited (Gamma) (No 5) [2011] ACompT 9 (12 May 2011)	NEL + NER	Assumed utilisation of imputation credits (gamma)	s 71 C(1)(a),(c) and (d): Material error of fact, incorrect exercise of discretion and unreasonable decision[xv]	The value of gamma is 0.65 - the value adopted in the Statement of Regulatory Intent.[xvi]	[2010] ACompT 7: The AER fell into error in its treatment of both the distribution ratio and the utilisation rate (aspects of the gamma). The distribution ratio that the AER derived from a study was a long-term distribution ratio, that is, the average annual ratio of the amount of credits distributed in a year (regardless of whether the credits had been created in that year or retained from an earlier year) to the amount of credits created in that year. There was evidence before the AER that identified the error and the evidence was persuasive evidence justifying departure from the value of gamma in the Statement of Regulatory Intent (SORI) for the purposes of cl 6.5.4(g) of the NER: [51]-[52]. <u>Material error of fact and incorrect exercise of discretion</u> With respect to the utilisation rate, there is persuasive evidence justifying a departure from the value of gamma in the SORI. In that regard, the AER made a material error of fact and exercised its discretion incorrectly:[66]. The AER made an error of logic by taking an upper bound on the value of the utilisation rate from a tax statistics study and deciding to be 'conservative' by adjusting the figure downwards. Any downward adjustment to a properly derived upper bound would be inappropriate as a means of deriving an estimate of the utilsation rate: [93]-[95] [2011] ACompt T 9: Vary value of gamma to 0.25 (derived by multiplying the value 0.7 for the distribution ratio with the value 0.35 for the utilisation rate).[xvii]	s 71B(1): Leave granted for review of decision s 71Q: Standard period for making determination extended	Vary
Application by EnergyAustralia and Others [2009] ACompT 8 (12 November 2009); Application by EnergyAustralia and Others (No 2) [2009] ACompT 9 (25 November 2009).	NEL + NER (including Transitional Rules)	1. Nominal risk free rate - averaging period; 2. Debt risk premium	1. s 71C(1)(c) and (d): Incorrect exercise of discretion; Unreasonable decision[xviii]	1. Disagree with proposed averaging period. Need to apply averaging period closer to the start of the regulatory control period. 2. Benchmark corporate bond rate derived using Bloomberg estimates of fair yields. (Applicants argued that AER should have used an average of the Bloomberg and CBASpectrum-based estimates.)	1. RISK FREE RATE <u>Unreasonable decision or incorrect exercise of discretion</u> The applicants have demonstrated that the AER exercised its discretion incorrectly, or its decision was unreasonable for the purposes of s 71C(c) and (d). AER unreasonably withheld agreement to the proposed averaging period within the meaning of cl 6.5.2(c)(2)(i) of Ch 11 of the Transitional Rules. Given the scheme as set out in the Transitional Rules, there is no virtue in setting the risk free rate at values that prevailed close to the start of the regulatory control period. The AER otherwise had no sufficient basis to reject the proposed averaging period. 2. DEBT RISK PREMIUM Reviewable error not established. Once AER was persuaded that Bloomberg series provided more accurate estimates it would have been an error to average the two series.[xix]	s 71B(1): Leave granted for review of decision; s 71K: Leave granted to two parties to intervene in EnergyAustralia's and Transend's applications respectively; s71Q: standard period for making determination extended[xx]	1. Vary (averaging period) and Remit (to apply that averaging period)

CASE/S	REGIME	ELEMENT OF DECISION APPEALED	GROUND/S OF REVIEW	DECISION of REGULATOR	FINDINGS OF TRIBUNAL/PANEL/COURT	EXERCISE OF DISCRETION	REMIT, VARY OR AFFIRM AER DECISION
Application by United Energy Distribution Pty Ltd [2012] ACompT 1 (6 January 2012)	NEL + NER	Debt risk premium	s 71C(1)(a),(c) and (d): Material error of fact, incorrect exercise of discretion and unreasonable decision	Reject proposal deriving debt risk premium from the Bloomberg fair value curve. Instead determine debt risk premium by averaging the estimate provided by the Bloomberg fair value curve and the information in relation to the APT bond with a weighting of 75% given to Bloomberg and 25% to the APT bond.	It was unreasonable for the AER to reject the applicant's proposal to rely on the Bloomberg fair value curve and instead to incorporate also the yield from a single bond (the APT bond) which it had not demonstrated in any way to be a relevant benchmark or comparator bond: [434]. The applicant's proposal to rely on the Bloomberg fair value curve was consistent with cl 6.5.2 of the NER as it provided for an appropriate representation of the relevant corporate bond rate. It was unreasonable for the AER to adopt its novel approach to estimating the debt risk premium. Since the value for the debt risk premium in the proposal was derived in a way that was compliant with cl 6.5.2 of the NER, no amendment by the AER was permitted under cl 6.12.3. AER's use of the APT bond to estimate the debt risk premium is therefore inconsistent with the requirements of the NER: [441]-[442]. Vary debt risk premium in accordance with applicant's proposal to rely on the Bloomberg fair value curve for the derivation of the debt risk premium. This produces a debt risk premium of 4.34%: [462].		Vary
Multinet Gas Distribution Partnership, Essential Services Commission Appeal Panel (11 November 2008)	Gas Pipelines Access (Victoria) Law + National Third Party Access Code for Natural Gas Pipeline Systems	1. Equity beta; 2. Imputation credits (gamma)	s 39(2)(a)(i), (ii) and (iii) of Schedule 1: Error of fact; Incorrect or unreasonable exercise of discretion; Occasion for exercise of discretion did not arise	Reject proposed equity beta of 1.0 (neutral risk) and substitute with 0.8 (lower risk). Reject proposed gamma of 0.35 and substitute with 0.5	The applicant argued that on the basis of the *GasNet* principles the occasion did not arise for the exercise of the Commission's discretion to reject the proposed values of equity beta and gamma and substitute its own since in the present case there are no tensions or conflicts in the application of the Reference Tariff Principles and the applicant's proposed values of equity beta and gamma fell within the range of choices reasonably open to it and were consistent with the reference tariff principles. Reject applicant's argument. Distinguish *GasNet*. *GasNet* should be construed, within the confines of its facts, to apply to a situation where a regulator departs from a methodology, which is within the entitlement of a distributor to select, in circumstances where conflicts or tensions are not produced.[xxi] That is quite a different situation to the present case where there are conflicts arising in relation to the choice of expert opinion as to the appropriate values for equity beta and gamma. These conflicts centre on the application of s 2.24 factors and must fall to the regulator to resolve by exercising its discretion. The choice between varying expert opinions relates to forecasts and squarely raises the need for the regulator to satisfy itself as to a best estimate on reasonable grounds: [34] and [36]-[37]. There was no error of fact on the part of the Commission nor any incorrect or unreasonable exercise of discretion with respect to its assessment of the values of the equity beta and the gamma.[xxii]		Affirm[xxiii]

CASE/S	REGIME	ELEMENT OF DECISION APPEALED	GROUND/S OF REVIEW	DECISION of REGULATOR	FINDINGS OF TRIBUNAL/PANEL/COURT	EXERCISE OF DISCRETION	REMIT, VARY OR AFFIRM AER DECISION
Envestra Ltd v Essential Services Commission of South Australia (No 2) [2007] SADC 90 (27August 2007).	Gas Pipelines Access (SA) Law + National Third Party Access Code for Natural Gas Pipeline Systems	1. Equity beta; 2. Imputation credits (gamma) 3. Debt margin	s 39(2)(a)(i), (ii) and (iii) of Schedule 1: Error of fact; Incorrect or unreasonable exercise of discretion; Occasion for exercise of discretion did not arise[xxiv]	Reject the proposed real pre-tax WACC of 7.3% based on parameters within the following ranges: equity beta (0.9-1.1), gamma (0.00-0.35), debit margin (1.38%-1.48%) and applying a 'Monte Carlo' simulation. Substitute with WACC of 6.14% based on equity beta of 0.8-1.0, gamma of 0.35-0.6, debt margin of 124.5 basis points	When assessing whether to approve Access Arrangement proposals the Regulator is not free to substitute its own preferred arrangements. Only once the threshold of non-approval is properly crossed is the Regulator at liberty to set the content of its own access arrangements within the framework of the Code. Apply principles in Re GasNet (Operations) Pty Ltd (2004) ATPR 41-978 at [29]. 1. EQUITY BETA - No reviewable error is disclosed. The Commission identified a proper 'threshold of non-approval' and having done so was at liberty to set its own range of values within the parameters of the Code. One of the expert opinions relied on by the applicant was not borne out by the empirical evidence and regulatory precedents that were cited in the opinion. The other experts the applicant relied on had defects in his methodology and expressed opinions which were for the Commission to form in accordance with the Code not his: [67]-69]. 2. GAMMA - Review allowed as an unreasonable or erroneous exercise of discretion. It was not open on the material available for a reasonable regulator to form the view that an upper range for gamma of 0.6 was consistent with s 8.30 of the Code (rate of return commensurate with prevailing conditions in the market for funds and the risk involved in delivering the Reference Service). The material before the Commission was too scant, too qualified, not rigorous enough and runs against the trend of recent regulatory decisions in this country. It was pushing the boundary too far at least at the present time and tended to give insufficient effect to the objective of regulatory consistency. Vary range of gamma to 0.35-0.5. 3. DEBT MARGIN - No ground of intervention is made out by the applicant. In updating the debt margin in light of market data by the time of the Final Decision the Commission adjusted the estimate downwards by 18 points. The applicant asserted a drop of only two points was needed. Applicant's argument is based on a limited choice of data that is too restricted to be reasonable: [128]-[129].		1. Affirm 2. Vary 3. Affirm

[x] The Tribunal has indicated its approach to the appropriateness or otherwise of remitting a matter to the AER in *Application by Energy Australia* [2009] ACompT 7 at [30-38]: The Tribunal is mindful that Pt 6 Div 3A of the NEL evinces a strong legislative intention to promote the expeditious resolution of an application (see s 71Q). The Tribunal should endeavour to reach a final determination and make its own variation of the determination of the AER.

[xi] See para [35] for discussion of the test for what is an unreasonable decision: provisions such as s 246 not intended to include the concept of unreasonableness as applied in judicial review proceedings ie 'Wednesbury unreasonableness'. The attack on AER's decision, while relying upon each of the available grounds of review, is best considered under the 'unreasonableness' head: [37].

[xii] [72] There is another point worth noting about the AER's methodology. It arises out of the difficulty in identifying a sufficient number of long term bonds to determine yield. The reason a 10 year bond was originally chosen was because, in the past, many firms favoured long term debt, albeit that it came at a higher cost, because it reduced refinancing or roll-over risks. The high rate was then hedged via interest rate swaps. That may no longer be the position. If not, the AER may need to be reconsider its approach in light of more current strategies of firms in the relevant regulated industry. Further, there seems to be little point in attempting to estimate the yield on a bond which is not commonly issued.

[xiii] This case did not specify the ground of review.

Section 246(1)(d) unreasonable decision was the ground of review in *ActewAGL*. In the present case the AER conceded its determination was in error for the same reason that it was in error in *ActewAGL*.

[xiv] [73] One pertinent question raised during the hearing was whether the yields on infrastructure bonds issued by regulated natural monopoly-type infrastructure companies might be most relevant in determining which fair value curve is a better fit.

[74] As far as the Tribunal understands, no standard BBB+ rated infrastructure bonds existed during the relevant period. However, even if there existed infrastructure bonds of other risk classes, the inclusion of only those differently rated bonds that are classified as infrastructure bonds would need to be carefully considered. The benchmark BBB+ rated bonds necessarily include bonds across all industry types. If we needed to expand the reference group to include differently rated bonds in order to estimate the benchmark, it would seem prima facie inconsistent to exclude bonds on the basis of them not exhibiting certain industry characteristics when the benchmark makes no such distinction.

[75] The Tribunal is of the view that bonds should only be excluded from the sample on strong grounds (as stated in *ActewAGL*), and so classification of bonds by industry categories and the exclusion of bonds other than natural monopoly bonds is not a desirable approach.

[xv] [2010] ACompT 7:s 71C(1)(a) and (b) includes errors in findings as to matters such as opinions based upon approaches to the assessment of facts or methodologies which have been chosen to be applied: [29]

[xvi] [2011] AComptT 9:Response to argument of AER that the Rules establish a regime of regulatory inertia whereby the values of the WACC parameter set in the Statement of Regulatory Intent (SORI) will govern the distribution determinations that are made during the following five years unless, and to the extent that, it is shown that a departure from the SORI values is justified - The Tribunal does not accept that its task is to determine a value of gamma that is appropriate and not too different from the previously determined value of gamma. That gives too little policy weight to the objective set out in s 7A of the NEL that a regulated DNSP should be provided with a reasonable opportunity to recover at least the efficient costs it incurs. That objective must outweigh any presumption of regulatory inertia. In any event, within the SORI framework by which the AER argues for the principle of regulatory inertia, the Tribunal has persuasive evidence justifying a departure from previously determined values of gamma: [35]-[37].

[xvii] [2011] AComptT 9:

Response to argument of AER that the Rules establish a regime of regulatory inertia whereby the values of the WACC parameter set in the Statement of Regulatory Intent (SORI) will govern the distribution determinations that are made during the following five years unless, and to the extent that, it is shown that a departure from the SORI values is justified -

The Tribunal does not accept that its task is to determine a value of gamma that is appropriate and not too different from the previously determined value of gamma. That gives too little policy weight to the objective set out in s 7A of the NEL that a regulated DNSP should be provided with a reasonable opportunity to recover at least the efficient costs it incurs. That objective must outweigh any presumption of regulatory inertia. In any event, within the SORI framework by which the AER argues for the principle of regulatory inertia, the Tribunal has persuasive evidence justifying a departure from previously determined values of gamma: [35]-[37].

[xviii] See discussion of grounds of review at [59]-[64]

The s 71C(d) 'unreasonable' ground is not, as in the Gas Law, related to the error of an incorrect exercise of discretion. The term 'unreasonable' does not just provide a basis for informing the presence of one or more of the established grounds which render a decision 'incorrect'. It is a separate and distinct ground of review: [59] The separate ground of review of 'unreasonableness' set out in NEL goes somewhat beyond Wednesbury unreasonableness. To a certain extent there is overlap between the incorrect exercise of discretion and an unreasonable decision. If the reasons for a decision contain an element of arbitrariness, in the sense of unexplained discretionary choice made in reaching a conclusion then it may readily be concluded that the decision itself is unreasonable and the exercise of discretion was in error: [63].

If a decision is not determined by reference to the applicable criteria in the NEL and the Rules then it will readily lead to a conclusion that the exercise of discretion in reaching the decision was incorrect and the decision was unreasonable in all the circumstances: [64].

[xix] The averaging period must be in accordance with the NEL, specifically the objective and principles set out in ss 7 and 7A: [74].

The AER practice of applying an averaging period closer to the start of the regulatory control period (RCP) has been supported by economic experts. But the views of economic experts appear to be based on a model where the RCP is considered to be a single period (of five years), not five consecutive one-year periods. In the scheme set out in the Transitional Rules, the nexus is broken between the period to which the rate of return applies and the period for which the rate of return is estimated: [87]-[88] What averaging period should apply? The Rules do not provide for the specification of a particular risk free rate. (They could simply have deemed one.) Rather, they provide for the choosing, either by agreement or by specification by the AER, of an averaging period. The objective and principles of the NEL are best met, and can be met under the Transitional Rules, by agreeing to the Applicant's revised proposals. Doing so is in accordance with the scheme by which an NSP proposes an averaging period which cannot be rejected unreasonably:[111] - [112]

[xx] South Sydney Organisation of Councils was granted leave to intervene in Energy Australia's application.

Nyrstar Australia Pty Ltd was granted leave to intervene in Transend's application.

[xxi] The applicant in Multinet relied upon the following principle in GasNet:

Where the Reference Tariff Principles produce tension, the Relevant Regulator has an overriding discretion to resolve the tensions in a way which best reflects the statutory objectives of the Law. However, where there are no conflicts or tensions in the application of the Reference Tariff Principles, and where the Access Arrangement (AA) proposed by the Service Provider falls within the range of choice reasonably open and consistent with the Reference Tariff Principles, it is beyond the power of the Relevant Regulator not to approve the proposed AA simply because it prefers a different AA which it believes would better achieve the Relevant Regulator's understanding of the statutory objective of the Law.

However, the Appeal Panel in Multinet found that the applicant could not rely on the above principle. At issue in GasNet was the application of the CAPM methodology by the Regulator. The application of the CAPM methodology did not produce tensions with respect to the Reference Tariff Principles. Therefore, the Regulator's overriding discretion to resolve tensions did not arise and the Regulator could not substitute its own decision for the applicant's proposal.

By contrast, in Multinet the application of the CAPM was not at issue. Rather, the issue was the choice of inputs. This issue, unlike the application of the CAPM in GasNet, did involve resolving tensions in the application of the National Third Party Access Code for Natural Gas Pipeline Systems (the Code). Specifically, there were conflicts in relation to the choice of expert opinions as to appropriate values for the equity beta and gamma which centred on the application of factors in s 2.24 of the Code. This meant that the Regulator's overriding discretion to resolve the tensions arose and the Regulator could substitute its own decision for the applicant's proposed values for equity beta and gamma.

[xxii] The applicant argued that the principle of regulatory precedent and the need for regulatory consistency and stability required the Commission accept the applicant's proposal of a value of equity beta of 1.0: [44]

In response the Panel stated that whilst these concepts are appropriately to be taken into account by a regulator, they will not themselves be decisive if there are other countervailing issues which are of greater weight. In this regard, the proper application of the Code to the prevailing conditions must be of more significance: [49]

[xxiii] The power of remission is excluded by s 38(9) of the Access Law. The available powers are limited to affirming, setting aside, or varying.

[xxiv] See [34]-[41] for discussion of the tests for these grounds of review.s 39(2)(a)(iii) occasion for exercise of discretion did not arise - includes where having regard to the proposed Access Arrangement and its compliance with the Code including its principles, methodologies and relevant factors, there was no justification for the Regulator to embark upon the exercise of substituting its own Access Arrangement for that proposed.

ANNEX 2

Table 2.1: Appeal arrangements in other regulated sectors in Australia

Sector/Activity	Type of appeal	Scope of appeal	ACT's powers
Economy-wide third party access regime (rail, airports etc.) Part IIIA Competition and Consumer Act 2010 (CCA 2010)	Merits review of arbitration determinations of the Australian Competition and Consumer Commission (ACCC)	ACT 're-arbitrates' the access dispute, and has the same powers as the ACCC. Following changes introduced in January 2011, the information available for review by the ACT is that which was submitted to the original decision-maker. However, the ACT can, by written notice, require the ACCC to give information, and to make reports.	The ACT can either affirm or vary the ACCC's determination. Appeal from ACT decision to Federal Court on points of law only.
Telecommunications – Part X1C CCA 2010	No merits review of regulatory arbitration decisions or regulatory undertaking decisions of the ACCC available. (Up until January 2011, the ACT could conduct merits review of ACCC undertakings).	Judicial review only on points of law. (Previously, when reviewing the ACCC's decision, the ACT was required to assess the undertaking in its entirety having regard to the same statutory criteria by which the ACCC was bound.)	None.

Table 2.2: 'Appeal' arrangements in the energy sector in other jurisdictions

Jurisdiction	First Instance Appeals mechanism	Scope of appeal	Further appeal possible for contested matters
United States (Federal and State level)	At the Federal level, 'contested' matters may be referred for hearing by an Administrative Law Judge (ALJ) who is typically situated within the regulatory authority, but has a degree of independence from the authority. At the state level, ALJs may be situated outside energy agencies in centralised administrative review boards. They perform a similar role to that described above.	ALJ's are responsible for investigating contested matters and for producing a factual 'record' of this investigation. After conducting a trial–like process known as administrative litigation, the ALJ issues an Initial Decision, or makes a recommendation, about the resolution of the dispute. This is remitted back to the Commissioners of the Regulator. This Initial Decision will then be subject to review by the full Commission, who have all the powers that it has in making the original decision, and can choose to undertake a *de novo* review.	A party dissatisfied with regulatory authority decision may petition for Judicial Review. The Federal Courts of Appeal hears appeals from FERC decisions. The grounds for appeal are circumscribed. (i.e.: it is not a full merits or *de novo* review). Among the factors on which the reviewing court can set aside a decision include where it is found to be: "*arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law*" or where it is *"unsupported by substantial evidence"* Appeals from the decisions of state energy regulators lie to State courts.

United Kingdom	Price control decisions of energy agency, Ofgem, can be appealed to the Competition Commission (CC), an independent public body.	The CC has wide ranging powers and can collect and assess new evidence (evidence not before the initial decision maker) as part of its investigation. The CC will investigate whether the price control conditions operate, or may be expected to operate, against the public interest, and, if this is the case, whether any adverse effects can be remedied or prevented by modification of the Licence of the energy company. In the event that the CC allows the appeal, it can: quash all or part of Ofgem's decision; refer the matter back to Ofgem for reconsideration; or substitute its own decision for that of Ofgem.	
Germany	Decisions of the Bundesnetzagentur can be appealed in the first instance to a panel within the special cartel division of the Higher Regional Court of Düsseldorf. The panel that hears the cases comprises	The Court may make *ex officio* inquires regarding the facts, can assign participants to comment on points or evidence, and can engage expert witnesses in relation to technical and economic	Appeals from the decisions of the Higher Regional Court are on the basis of judicial review only to the Federal Court of Justice.

	three judges, and examines both the facts and legality of a decision under a special procedure similar to an administrative court proceeding.	matters.	
Netherlands	The appeals process operates in a number of phases. In the first phase, contested decisions can be re-considered within the regulatory agency, by a separate team, often as a first step before the appeal is then made to an external review body. If the matter is still contested, an appeal can be made to a specialist section of an administrative court with judges who specialise in matters relating to the regulated industries and competition law.		
Ireland	Certain regulatory decisions in the energy and aviation sectors can be subject to review by an appeals panel, which is specifically constituted to hear specific appeals as and when they arise.	Although to date, no appeals panel has been established in the energy sector (there have been some in the aviation sector) the legislation provides that the panel shall be independent, and have all the powers and duties of the regulator that are necessary to	

		carry out its functions.	
New Zealand	A merits appeal is available to the High Court against an input methodology determination. The reviewing Court is comprised of one judge and two lay members with relevant economic, accountancy or related experience (or only one lay member if the court determines only one is required).	The appeal is conducted by way of rehearing, with the Court limited to considering the material before the Commission when it made the determination. To succeed on appeal, the appellant has an onus of establishing to the court that its own proposed methodology will be 'materially better' in meeting the purposes of the relevant legislation	Appeals for judicial review of Commission decisions can be made to the High Court in New Zealand. Appeals against High Court decisions go to the New Zealand Court of Appeal, followed by the Supreme Court of New Zealand.

ANNEX 3

Review of the Limited Merits Review Regime

Consultation Paper

Preliminary Statement of Issues and Questions

Background

A limited merits review (LMR) regime was introduced into the National Electricity Law (NEL) on 1 January 2008 and the National Gas Law (NGL) on 1 July 2008. The regime provides parties affected by the decisions of the energy regulator, or other relevant decision maker under the NEL or NGL, with recourse to a review mechanism.[51]

In establishing the limited merits review regime, the Ministerial Council on Energy (MCE) agreed that a review of the effectiveness of the regime would be required. The review was to be undertaken within the first seven years of the commencement of the LMR regime, with the intention of assessing how the regime had operated since its commencement.

On 9 December 2011, the Standing Council on Energy and Resources (SCER, previously the MCE) agreed to bring forward the review of the limited merits review regime (the Review) in light of increasing concerns relating to the operation of the regime.

On 7 March 2012, an Expert Panel (the Panel) consisting of Professor George Yarrow as Chair, Dr John Tamblyn and the Hon. Michael Egan was established by the SCER for the purpose of undertaking the Review.

The purpose of this Review is to assess the effectiveness of the limited merits review regime under both the NEL and NGL since its introduction and to advise on what, if any, amendments or restructuring of the limited merits review framework are required. The assessment will be against the MCE's original policy intention, as reflected in the MCE's Decision Paper *Review of Decision Making in the Gas and Electricity Regulatory Framework*, the National Electricity Objective, the National Gas Objective and the revenue

[51] Decisions subject to limited merits review include;

- Ministerial decisions in relation to coverage of gas pipelines (including binding no-coverage determinations);
- decisions by the Australian Energy Market Commission (AEMC) on the form of regulation to apply in gas;
- Australian Energy Regulator (AER) decisions to draft and approve (or revise) gas access arrangements;
- AER ring fencing decisions, including non-approval or voiding of associate contracts, in gas;
- AER pricing and revenue determinations for transmission and distribution in electricity (including application of regulatory test); and
- AER decisions not to exempt entities from ring fencing guidelines or impose additional ring fencing requirements, in electricity

and pricing principles set out in the underlying rules. The review is required to conclude by 30 September 2012 and will be undertaken in two stages:

- Stage One will be a preliminary review to assess the performance of the LMR regime and will provide an overview of how it has operated to date in the electricity and gas sectors against the original policy intent; and
- Stage Two will present recommendations to SCER on whether amendments are required to better deliver against the objective of the review mechanism.

A report on the first stage of the review will be presented to the SCER by 30 June 2012; the report on the second stage will be provided to the SCER by 30 September 2012.

The members of the Panel are keen to start hearing views on the various underlying issues at an early stage, and have prepared this preliminary statement of issues as an aid to that process. The Panel is seeking initial submissions (which need not be detailed) that will help guide it quickly to an understanding of the trade-offs that will need to be considered.

The issues and questions identified here relate chiefly to the first stage of the Review, which is focused on assessing the performance of the regime to date. They are not exhaustive, and are likely to be developed as the Review proceeds.

This document has been prepared by the Panel, and has not been considered by the SCER or its officials.

The performance of the limited merits regime

The policy intent

Since we are asked to evaluate effectiveness in relation to the MCE's original policy intentions, we will necessarily take the latter as given. There may, however, be some issues surrounding the interpretation of those intentions on which interested parties wish to comment.

Is it reasonable for us to rely on the MCE's document Review of Decision-Making in the Gas and Electricity Regulatory Frameworks in identifying and interpreting the relevant policy intentions?

Are there other factors that we should consider?

The Panel's broad approach

We are of the preliminary view that we need, as an initial priority, to develop a better understanding of what factors have driven (a) appeals to the Australian Competition Tribunal (ACT) and (b) outcomes of those appeals, and that this will involve evaluation of both structural features of the regulatory system (such as the powers and duties of the Australian Energy Regulator (AER) and the ACT, and the characteristics of the NER and NGR or parts thereof) and also the interests, conduct and approaches of participants and potential participants in appeals (the ACT, the AER, network service providers, network users,

consumer bodies). We will also want to assess the decisions made by the ACT under the current LMR regime, to better understand how it has interpreted its role and the extent to which its decisions have delivered outcomes that are consistent with achieving an appropriate balance between consumers and investors.

Are there any further types of factors to which we should give particular attention in assessing performance?

The cases to be considered

At the centre of the evidence that we will need to consider are the various (electricity and gas) cases that have come before the ACT in the period since the introduction of the new regime. These cover a variety of issues, and although the matters of concern that have been most influential in giving rise to the current Review appear to have centred on assessments of the cost of capital, we are minded, at least in the initial stages, to consider all types of cases.

Is it reasonable for the Panel to look first at all significant issues raised in ACT cases, or should we focus on a more limited sub-set of cases from the outset?

Specifically, have ACT reviews of ministerial decisions in relation to gas pipeline coverage raised any issues of relevance to the Review which we should be aware of?

If consideration of all issues is appropriate, are there nevertheless sub-sets of cases that are more or less important in making an overall assessment of the performance of the regime? Can you assist us in identifying any such sub-sets of cases?

Specifically, bearing in mind time and resource constraints, should we concentrate our efforts chiefly on cases centred on determination of the weighted average cost of capital (WACC)?

Structural influences on the performance of the regime

One intention of the MCE in determining the structure of the regime was that, partly in the interest of maintaining balance between consumers and Network Service Providers (NSPs), the arrangements should not lead to undue costs and delays in reaching final outcomes. The Panel is therefore considering the nature of the incentives created by the structure of the regime, and welcomes comments on the following questions, and on related issues:

Whether the structure of incentives is such that appeal to the ACT has become, or is becoming, the norm? Alternatively, is it more likely the that the numbers of appeals will fall, as interested parties become more familiar with the arrangements and there is less 'testing out' of the possibilities?

Are there incentives for NSPs to appeal irrespective of the actual merits of AER decisions, for example because, given the inevitable uncertainties in assessments, there is always a chance of incremental improvements in outcomes for NSPs?

Do incentives deriving from the structure of the regime inhibit the AER in any way in defending its decisions before the ACT? Specifically, is the AER impeded by the prospect that vigorous defence of a decision may be prejudicial to its fair re-consideration of the issue in the event that the ACT eventually decides to remit the matter back to the AER?

Given the policy objectives, are the grounds for appeal appropriately specified in the law? Do they (a) require or (b) permit an unduly narrow focus by the Tribunal on reviewing and correcting detailed 'error'?

Has the imposition of limits on the timing and on the ground for appeal been effective in containing costs and reaching timely decisions, whilst allowing for the correction of errors and achieving the desired, overall balance between consumers and NSPs?

The decisions/conduct of the ACT

The Panel is developing a range of questions about the role of the ACT within the appeals process, the linkages of appeals with other parts of the regulatory system (e.g. the NER and NGR), and the ACT's actual conduct and decision making in relation to electricity and gas cases. Comments are invited on the following initial questions:

Can the ACT legitimately conclude that some of the AER's calculations/estimations are incorrect but nevertheless substitute an equivalent Tribunal determination reaffirming the AER's relevant 'bottom line' number (e.g. for allowable revenues or an allowable cost of capital), based on its own judgment that, given the policy objective, such a determination remained appropriate??

Within the LMR framework, to what extent is the Tribunal empowered to take account of policy objectives in its judgments? Has it done so to date?

Is the Tribunal adequately resourced to take other than a narrow approach to appeals? To what extent, if any, has the Tribunal sought to encourage the production of evidence, particularly by the AER, on matters wider than those initially brought to its attention?

How does the Tribunal's approach in electricity and gas compare with its approach in other sectors and in competition law cases?

Are there equivalents in other aspects of the Tribunal's work where it has got involved in the technical detail of economic/financial analysis in the way that it has in recent cost of capital cases in the energy sector?

On what basis does the ACT decide when, if an appeal is upheld, to remit matters back to the AER?

How does the frequency of remittals in electricity and gas cases, or in sub-sets of these cases (e.g. cost of capital cases), compare with remittals in other areas of the ACT's work?

Are there any significant patterns in the frequencies of appeals upheld, and in successful appeals remitted, among different types of cases appearing before the ACT, including cases other than in electricity and gas?

How does the ACT approach expert evidence? Are expert witnesses normally subject to oral examination, or does the Tribunal tend to rely exclusively on written reports?

To what extent, when substituting its own determination for a determination of the AER, does the Tribunal tend to develop its own reasoning, without reference to expert evidence?

Are there other aspects of the structure of the ACT and/or of the conduct of the ACT to which the Panel should direct its attention?

The decisions/conduct of the AER

Without in any way prejudging answers to questions about the significance of non-WACC cases for our deliberations (these being matters we will consider carefully over the next few months), it appears striking to us that there has been a sequence of ACT decisions in relation to cost of capital issues which have been adverse to the AER. We will be seeking to discover why this is the case given (a) what the NER and NGR say on cost of capital issues and (b) that, as we understand matters, the AER has in the past expended significant effort on developing its approach to WACC issues, including by developing a quite extensive issues paper on WACCs for electricity transmission and distribution networks (August 2008) and holding an associated roundtable with finance experts (October 2008).

The panel would like to better understand the underlying reasons for the several appeals on aspects of the WACC, and the extent to which they are primarily a function of the role of the ACT, within the LMR regime, in correcting material errors or, alternatively, whether other aspects of the regulatory framework and its institutions are contributing factors. For example:

What might be the relative contributions of (a) the particular specification of the WACC estimation methodology in the rules and (b) the propensity of the AER to make material errors of methodology and computation that require correction?

To what extent has the design and administration of the LMR regime been a contributing factor? Have those 'limitations' that have been embedded in the LMR regime with a view to reducing the costs and increasing the timeliness of reaching final decisions unintentionally encouraged an undue number of appeals on the minutiae of WACC methodology and estimation?

The Panel recognises that, to the extent that the specification in the NER and NGR of the WACC methodology to be applied by the AER is found to hinder the achievement of the relevant objectives, the AEMC's ongoing examination of network regulation rule change proposals is the appropriate forum for addressing that issue.

Further questions about the WACC cases that we are asking at this early stage are:

Whether the aspects of the AER determinations subsequently appealed did or did not fall within the range of expert views obtained by or submitted to the AER?

If these determinations did not fall within the range of expert views, was that because the relevant points were not considered by the experts; and, if they weren't so considered, why not?

How does the AER's approach to WACC estimation in the energy sector compare with similar regulatory exercises in other sectors, such as telecommunications?

In relation to cases more generally, it is our current understanding that the AER has the power to seek a review by the ACT of other parts of a determination being appealed. *Prima facie* this power potentially enables the scope of an appeal to be widened when it appears that an overly narrow focus on one or more specific issues could, via 'cherry picking' or 'one way street' effects, lead to a revised determination that, taking all things into account, might be considered unbalanced, unjust or unreasonable.

Are we correct in our preliminary understanding of the relevant power, and of its implications? If not, why not?

Has the AER sought to exercise the relevant power?

Are there significant barriers to the AER attempting to widen the ACT's deliberations in this way?

Similarly, the AER can appeal decisions of the ACT, and we will be exploring the implications of this particular aspect of the 'checks and balances' of the regulatory arrangements.

What is the record in relation to AER appeals against ACT decisions? What types of decisions have been appealed in this way, for example?

Specifically, has the AER ever challenged, or contemplated challenge to, an ACT decision to settle a technical economic or financial matter itself, rather than to remit it to the AER?

The participation of network users and energy consumers or their representative bodies in the appeals process

One of the matters that the Panel is seeking to assess at an early stage is the level of participation of network users and consumers or their representative bodies in the appeals process, and the factors that have influenced their levels of engagement. Basic factual information is available from the case record, but views and evidence on a number of questions would help us develop a fuller understanding of the roles played by network users and energy consumers.

Do representative bodies consider that participation in the appeals process is a (a) legitimate part of their own activities, (b) a potentially productive part of their activities?

If the answer to either part of the question is 'no', why not?

We are aware that the potential existence of a number of barriers to participation – some of which are of an almost universal nature and some of which may be more specific to the Australian context – is a matter that has been raised in public debate. The Panel would welcome views on the significance of such barriers, in both absolute and relative terms.

Do the costs of participation appear prohibitively high in relation to the perceived potential benefits?

If so, what are the chief features of the structure and/or administration of the LMR regime that contribute to such relatively high costs?

If costs are a major issue, have cost-mitigating strategies been adopted or contemplated by consumer bodies, such as seeking the pro bono support of sympathetic experts in the legal process?

Are the time periods for lodging appeals, making interventions, submitting opinions, etc, too compressed when viewed in the light of resource constraints on user and consumer organisations?

Other issues and questions

As indicated, the Stage One issues and questions identified at this early point in the process are not exhaustive and will likely be developed over course of the next two or three months.

Are there any other issues/questions that interested parties believe it is important for us to consider at an early stage?

The Review Process

The review will be undertaken in two stages and in accordance with the Terms of Reference for the review. The Terms of Reference is available online, at: www.scer.gov.au

The indicative timetable for the Review is as follows:

Milestone	**Date**
Preliminary consultation paper released	30 March 2012
Target date for receipt of initial views	13 April 2012
Interim Stage One report provided to SCER Senior Committee of Officials (SCO) and the Panel's refined statement of issues published no later than	30 April 2012 (target date for statement of issues 27 April 2012)
First round consultation – public forum	9 May 2012 (Sydney)
Target date for submissions on Stage One issues	1 June 2012

Final Stage One report provided to SCER and Panel statement concerning its approach to Stage 2 issues published by	30 June 2012
Second round consultation – public forum	July 2012 (*date and location to be advised)*
Interim Stage Two report provided to SCER SCO by	31 August 2012
Final Stage Two report provided to SCER by	30 September 2012

Consultation and Submissions

The Panel welcomes any submissions relating to, but not limited to, the issues raised in this paper. Stakeholders are encouraged to raise specific matters as early as possible in the Review process to enable the Panel to give them the fullest possible consideration. As previously noted, the members of the Panel are keen to start hearing views on the various underlying issues at an early stage and initial submissions need not be detailed.

It would be particularly helpful if any initial views could be received by 13 April, since this will assist in preparing a refined statement of issues, provisionally planned for publication on 27 April, and to be developed in conjunction with the interim Stage One Report. Similarly, it would be helpful to receive submissions that are less preliminary in nature by 1 June, to allow good time for their consideration in preparing the Panel's final Stage One report.

Submissions will, however, be accepted at any time, and there will be other opportunities for stakeholders to present their views on the operation of the limited merits review regime. In particular, the Panel proposes to hold two public forums for discussion of the Review. The first public forum will be held in Sydney on Wednesday 9 May 2012. All stakeholders are welcome and encouraged to attend.

The Panel has no preference relating to the format of submissions and informal submissions are welcome. All submissions will be made available from the SCER website (www.scer.gov.au), unless stakeholders have indicated that a submission should remain confidential, either in whole or in part.

All submissions can be emailed to the Review of the Limited Merits Review Secretariat at: LMR.Secretariat@ret.gov.au.

Alternatively, submissions can be mailed to:

Attn: Review of Limited Merits Review Secretariat
Energy and Environment Division
Department of Resources, Energy and Tourism
GPO Box 1564
Canberra ACT 2601

The Panel looks forward to hearing your views on these important issues.

Professor George Yarrow (Chair)
Dr John Tamblyn
The Hon. Michael Egan

30 March 2012

ANNEX 4

Review of the Limited Merits Review Regime

Consultation Paper Two

Additional Statement of Issues and Questions

Background

The Panel published a preliminary statement of issues and questions (PSIQ) at the end of March because it was keen to start hearing views on the various underlying issues at the earliest possible date. The Panel explained that it was seeking initial submissions, however lacking in detail, that would help guide it quickly to an understanding of the trade-offs that will need to be considered in the course of its Review.

Particularly given the short time period involved, and the fact that the period included the Easter weekend, Panel Members are very appreciative of the efforts expended to assist the process. The early submissions, made from a variety of perspectives, have been read with great interest and have, as hoped, proved to be extremely useful.

At this stage of the process, it was open to the Panel to draw up a revised statement of issues and questions, in effect on a *de novo* basis, but it has chosen not to do so for two reasons:

- First, we indicated in the PSIQ that we would welcome responses to the questions raised at any time, and not just within the very tight target period that was required if responses were to inform the current document. It may be, therefore, that some potential responders have been pondering the initial questions, and, given what was said at the outset, the Panel is of the view that there is merit in letting the initial document stand as an open invitation for comment.

- Second, the approach would be more resource alternative than proceeding on an incremental basis, and we prefer to use the limited resources at our disposal on other, more substantive matters.

The current statement of issues and questions should, therefore, be considered to be incremental to the initial document. We recognise that this may not be the tidiest of approaches, and that, given a month of fact finding, reading, reflection and discussion, we would not frame a number of the initial questions now as we framed them then. On the other hand, none of the questions initially raised can be regarded, at this stage of the process, as being a settled issue, so each and all of them remain relevant in one way or another.

This document has been prepared by the Panel, and has not been considered by the SCER or its officials.

Policy Intent

The PSIQ started by focusing first on policy intent, since we are asked to assess the historical record against the MCE's anticipations of outcomes at the time it decided in favour of the Limited Merits Review (LMR) Regime. It has been suggested we look at objectives in a broad context, which is an approach the Panel tends to favour, but thus far we have not seen material that would cause significant adjustment to inferences that can be drawn from the MCE Decision document. For example, the Panel is minded to infer that the MCE's criterion of "making the best decisions possible" refers to both short-term outcomes (e.g. getting to a good decision in a given case) and long-term outcomes (e.g. improving the quality of decisions over time), and hence that it is highly consistent with the more general objectives of merits review processes, such as those set out by the Administrative Review Council.

The Panel recognises that it will need to consider how the various criteria are most appropriately to be balanced when they come into conflict, and is proceeding on the basis that this requires reference back to overarching policy objectives, particularly as set out in the NEO and NGO. There is, however, a further question that the Panel wishes to raise at this stage:

> *Is it appropriate to supplement statements made in the MCE Decision document and interpretation based on overarching policy objectives with inferences that might be derived from the decisions themselves?*
>
> *Specifically, given that the SCO's Regulatory Impact Statement set out four options (Status Quo, Judicial Review only, Limited Merits Review[52], Full Merits Review), can the Panel reasonably use the choices made (first the reduction to two options, then the choice of Limited Merits Review) to make inferences about the relative weights to be given to the various criteria set out in the Decision document?*

To avoid any potential confusion, it should be noted that here we are not asking about the merits of these options, but rather about what might be inferred about the MCE's expectations of the LMR regime from the way in which the options were assessed at the time. Nor does the question imply that this should be the only way, or the principal way, of making the assessment. It simply asks whether there is any material information about objectives that is revealed by the earlier choices made.

The Panel's broad approach

The Panel has been gently advised, in more than one submission, to tread lightly when considering how the Australian Competition Tribunal (ACT) has gone about its tasks. At this stage in the process, the Panel is reluctant to close off areas of investigation, and is therefore not minded to ignore the ACT's contributions to the outcomes that we are asked to assess.

[52] We use this as shorthand for Judicial Review + Limited Merits Review, since the former is always with us.

Nor does it seem to the Panel that it should refrain from asking whether it is clear that eventual decisions have been improved by the appeal process. Accepting that no decision process is perfect, it is clear that the MCE expected that successful appeals should, on average, be preferable to the initial decisions; and it is appropriate to consider whether this is always so.

In order to test the water on this issue, the Panel seeks views on two questions related to cost of capital assessments, the first concerning the parameter 'gamma' which plays a key role in developing forecasts of future tax payments attributable to NSP activities, and the second concerning assessment of the debt risk premium:

> *In the appeals concerning the estimation of the parameter 'gamma', is it clear that the outcome at the end of the administrative process (gamma = 0.25) is more correct, or preferable to, the AER's original decision (gamma = 0.65)?*
>
> *In the appeals concerning the estimation of the debt premium, which we understand to be a constituent decision of the relevant reviewable decision (the cost of capital), is it clear that the adjusted cost of capital that emerged at the end of the administrative process (i.e. at completion of the appeals) is more correct, or preferable to, the AER's original decision?*

In relation to the second of these cases, the Panel draws attention to the possible interactions between estimation of the debt risk premium and equity beta, in that the systematic risk facing a NSP will tend to be distributed between these two types of capital.

The suggestion that the ACT should be assessed differently from the AER also opens up a line of questioning concerning the 'administrative' status of the ACT, and more specifically what it means for the ACT to 'stand in the shoes' of the AER.

> *If the ACT acts as a regulator when substituting its decision for that of the AER, what is the case for saying that its decisions should be considered by the Panel in ways that are materially different from those on which the AER's decisions should be considered?*

By way of clarification, the Panel is asked in Stage One of the review to assess outcomes, and it is therefore seeking to form a view about all aspects of the LMR regime that might have a significant effect on outcomes. We are of the view that this requires us to examine what one responder called 'execution', and what we have called the 'conduct', of the regulatory bodies. To avoid possible linguistic confusion the Panel stresses that this question has nothing to do with the proprietary of the behaviour of the ACT or the AER.

To sharpen matters somewhat, the Panel is asking:

> *Is the now extensive knowledge base on how administrative regulation works in practice – that discretions exist, that multiple agendas are not necessarily always absent, that language matters, that the 'character' of the regulator matters, that there*

is often no bright line boundary between policy decisions and 'administration' – relevant when considering the ACT's contributions to outcomes? If not, why not?

The cases to be considered

The initial evidence we have seen indicates that different types of cases are associated with different patterns of outcomes. The Panel's view of this evidence is that:

1. The Review should take account of a wide range of cases, including cases outside the electricity and gas sectors, in order to be able to extract the maximum amount of relevant information from the patterns and correlations.

2. Different subsets of cases also merit separate study, in order to be able to understand their characteristics at a finer level of detail.

In relation to the second of these exercises, the Panel seeks responses to an additional question:

Can the Panel's consideration of the WACC cases be simplified on the basis that, although the cases were many, there were only a few, common issues that appeared repeatedly?

Structural and behavioural influences on the performance of the regime

Prima facie it appears to the Panel that the MCE did not anticipate quite so much appeal activity as there has been, but that whether this deviation between expectations and outcomes actually matters very much may, in part, depend upon the future evolution of the case load. At the time of the PSIQ we were aware of potential, opposing arguments to the effect that:

- The case load might be temporarily high on account of the testing out and discovery of how the new institutional architecture would work.

- Appeals might become the norm because the incentive structure created by the new regime was tilted that way.

The PSIQ set out some exploratory questions on this issue, and we are grateful for the views submitted. These, together with the most recent round of ACT decisions, relating to the Victoria DNSPs, have prompted a further series of questions which, collectively, the Panel believes may be of particular significance to its Stage One evaluations. They are as follows:

What has been the relative contribution to the ACT case load to date of:

- *The global financial crisis (GFC). In particular, is it likely that the debt premium appeals would have eventuated in the absence of the GFC? In more stable financial circumstances, would the estimation issues at stake have been sufficiently material to have satisfied the appeal thresholds?*

- *The transitional nature of the period under examination, reflecting a change in the architecture of State and Federal regulatory institutions?*
- *The absence of the potential for merits review of decisions made at the time of general WACC reviews? Would the number of WACC cases have been significantly reduced if the ACT had been able to review WACC issues holistically, following the AER reviews?*

These are contextual factors that might be expected to have increased the ACT case load, and what would be most useful to the Panel would be evidence on the *quantitative* significance of each factor. We recognise that the third of the factors is possibly closer to potential Stage Two issues than to the current focus of the Review, but it may be expedient to consider it now, at least in a preliminary way, as part of getting a sense of the causes of the record to date. In particular, we note that there is a general issue of attribution to be addressed in that outcomes to be assessed are influenced not only by the appeals regime but also by the NER and NGR, and part of the Panel's task is to take account of the relevant interactions

Against these past influences on outcomes, it can be argued that new contexts may emerge that could have the opposite effect of increasing the future case load. For example, energy regulation globally is currently facing massive challenges of adapting to circumstances in which climate change and other environmental issues have become major policy priorities; and thus far the international record does not appear to be densely populated with policy successes.

> *Given the structure of the LMR regime, and assuming continued attachment to the capital asset pricing model for the purposes of estimating WACCs, can new areas of contention be expected to open up in consequence of the possible deficiencies of that model in tomorrow's contexts?*

In relation to future developments, the Panel has noted the ACT's decisions of 5 April 2012 in relation to DNSPs in the State of Victoria, which could potentially have the effect of increasing the number of appeals in the future. The Panel therefore asks.

> *Does the prospect that a common error might <u>only</u> be adjusted for those who appeal create incentives to appeal on a larger number of issues?*

An outcome in which DNSPs that have similar costs of capital wind up being allowed materially different costs of capital, on the basis of whether or not they appealed a decision, has an anomalous feel to it when viewed from the perspective of regulatory/administrative best-practice, however consistent it might be with legal norms that a court can only respond to appeals actually made. The Panel is asking itself whether, when it substitutes its own decision for that of the AER, the ACT really is 'standing in the shoes' of the AER. The immediate question for Stage One is:

> *Are the differential allowances for costs of capital between appellants and non appellants implicit in the April 5 decisions of the ACT in line with the MCE's expectations in establishing the Limited Merits Review?*

Behind this, however, is the question:

> *Is the structure of the LMR regime such that, when making decisions, the ACT is required to take account of factors other than those that would, in practice, have governed the decisions of the AER? Put metaphorically, when substituting its own decisions for those of the AER, does the ACT bring some distinctive footwear of its own? Is the answer clear from the existing law and regulations?*

A related set of issues concerns the language used in the appeals process. English is not a precise language, and words such as 'errors', 'decisions' and 'facts' can have different meanings in different contexts. The Panel notes that language can be a barrier to participation in regulatory discourse for some groups and stakeholders (see below in relation to network users and energy consumers), but here our concern is more to do with the 'Humpty Dumpty question', a question contemplated in the past by the US Supreme Court and which derives following passage from *Alice Through the Looking Glass:*

> *'When **I** use a word,' Humpty Dumpty said, in rather a scornful tone, 'it means just what I choose it to mean — neither more nor less.'*
>
> *'The question is,' said Alice, 'whether you **can** make words mean so many different things.'*
>
> *'The question is,' said Humpty Dumpty, 'which is to be master — that's all.'*

It seems to the Panel that the MCE intended the LMR to be an expedient, relatively low cost way of improving regulatory decisions and outcomes, against criteria implied by, or adopted in furtherance of, the NEO and the NGO. On that basis, the notion of 'correcting errors' is arguably qualified by the higher order priority of improving decisions (i.e. of arriving at a 'preferable' decision).

The significance of this point is that, from the perspective of improving outcomes, *it is not always the case that correcting a single 'error' or a subset of 'errors' will lead to a preferable outcome*: depending on context, correcting an error may lead to a worse outcome (from the perspective of the relevant objective, whatever that objective may be). This is because, in a complex decision problem, 'errors' may be offsetting, and eliminating only some may actually increase the cumulative effect of 'error'.

Economists will recognise this possibility as an example of the type of logic underlying the 'theory of second best'. The implication of such reasoning is that, in assessing a matter such as the merits of final decisions that comprise a number of component parts (such as the determination of a revenue allowance in a price review), it is appropriate to take account of holistic considerations, rather than simply to seek to correct an individual 'error' without further ado. And if, for whatever reason, some things can not be corrected, this should affect the approach to those that can.

The point is closely related to the issues surrounding 'cherry picking', and the Panel notes that, in the final paragraph of the *Envestra* Decision of 6 January 2012, the ACT itself appears to share the views of those responders who consider 'cherry picking' to be a problem. Our initial view is that what those who have used the term 'cherry picking' are driving at is the undesirability of insufficiently holistic error correction in the appeals process, and we think that this latter way of putting things is the more precise.

Do stakeholders agree or disagree with the above points?

Is the ACT able to look at things in this way, or is it required to consider the notion of 'error correction' in a less holistic way (e.g. if it is determined that there has been a material error in some aspect of the reasoning or analysis, must the ACT correct it or remit the matter to the AER without any requirement that it (the ACT) first assess the merits of the relevant, reviewable decision as a whole?)

If there are no constraints on the ACT in this regard (because it is fully able to 'stand in the shoes' of the AER), has there nevertheless been a tendency toward narrow interpretation of the requirement to correct errors?

The Panel has similar concerns about the interpretation of words such as 'decision' and 'fact', and the implication of such interpretations for outcomes. In relation to decisions, it seems that, in price control cases, the most important decision is the determination of the revenue allowance. Under the Australian arrangements, the AER is required to build this up from a number of 'building block' decisions but, even so, the level of disaggregation is constrained to some extent. Thus, as the Panel reads the relevant rules, the AER is required to make a 'reviewable decision' in relation to the cost of capital as a whole, but not, say, in relation to the debt risk premium (the assessment of which is only a constituent part of a reviewable decision). On this basis it seems that all aspects of the cost of capital determination should be assessed whenever an appeal is made on the grounds of error in the determination of any one of the constituent parts. Similarly, the NER and NGR seem to imply that the reviewable decision in relation to capex is the decision about capex allowances as a whole, not the view taken on a particular project or part of a capex programme.

Is this a correct reading of the rules?

Is the ACT constrained to adopt another meaning of the word 'decision'?

Turning to the meaning of 'facts' and of 'errors of fact', the Panel notes that many of the AER's decisions are, or are based upon, forecasts of the future (future levels of opex, capex, tax liabilities, depreciation, cost of capital (at least in CAPM-based approaches), etc.). The judgments involved sit uneasily with the legal notion of a 'future fact', which makes little obvious sense in terms of economics or ordinary language.

If the ACT finds an error in relation to a finding of a future fact by the AER, is that anything other than a euphemism for disagreeing with the AER's forecast?

If not, how is a 'future fact' to be distinguished from a forecast?

To sum up, the Panel is puzzling over the questions:

Is legal usage the 'master' of the meaning of relevant words in merits review?

If it is, should it be, given the administrative/policy aims of the limited merits review regime and given the MCE's intentions?

Is language a significant barrier to participation in regulatory discourse (e.g. by network users and consumers)?

Other questions

The Panel asked quite a number of questions about the ACT in the PSIQ, and some of the questions raised above are directly related to the Tribunal's work. The only further issue that we wish to raise concerns the length of time taken to complete decisions, and the significance of the possible consequences of delays. These are points that have been raised in some submissions to the Review, but we would be interested in the views of others.

At one level, the fact that the ACT has taken significantly longer to complete cases than is implied in the legislation governing the limited merits review regime indicates that this is an area where outcomes have not been in line with anticipations. On the other hand, the Panel recognises strength in the argument that, since the matters the ACT has been asked to address have been financially important and often complex, it would be unwise to induce a 'rush to judgment' by imposing tight and over-rigid time constraints.

This may, therefore, be a case where the original intentions were simply too ambitious, or where the intentions were appropriate for a sub-set of cases where delay has significant costs, but over-constraining in the majority of cases. The Panel would like to know:

Have protracted proceedings materially damaged any participants in the appeals process, or significantly increased the risk of material damage?

At this stage of the process the Panel is having more difficulty in understanding the significance of the AER's s.71O(1) powers, and there appears to be some divergence of views within the material that has been submitted to the Review thus far. Indeed there seem to be tensions in interpretations between different documents submitted by the same stakeholder, and sometimes even within an individual document. We infer from this that the matter is far from straightforward, and would welcome further assistance from stakeholders.

At the risk of oversimplification, the central tendency of opinion appears to be that s.71O(1) was intended to be an antidote to potential 'cherry picking' in appeals (i.e. to non-holistic error correction), but that it hasn't been actively used by the AER. Thereafter, views appear to diverge. For example, among the submissions are views that: (a) the AER is inhibited in

how it can approach the ACT by virtue of being the primary decision maker, (b) the AER is not so inhibited and it is not clear why the power has not been actively used; and (c) the AER has not used the power because no cherries have yet been picked.

> *The Panel seeks further views on why the AER's s.71O(1) powers have not been actively used, and whether, given the nature of the appeals made and the MCE's intentions, this represents a significant performance weakness of the regime.*

Consumers and users

There also appears to be some variation in views about the most appropriate role for network users and representatives of energy consumers in the appeals process. Responses thus far indicate that network users and consumers do not think that the LMR regime has been working well for them, and at least some of the problems encountered are related to issues discussed above. For example, if the hire of barristers is necessary to play an effective role, that may significantly increase the costs of participation for consumer organisations.

> *If such problems exist (and no submission has yet claimed that they don't), would the Panel be correct in concluding, at the end of Stage One of the Review, that this is an aspect of outcomes where MCE intentions in introducing the LMR regime have not been realised?*

At this stage, the Panel has not reached any clear view on whether network user and representative consumer body participation in the LMR process was a factor that was considered to be of major importance in the design of the system. We will consider the matter further, but may be impeded by an underlying lack of clarity about the roles that different parties are expected to play in the regulatory system more generally (which, we hasten to add, is not a uniquely Australian problem).

The Panel's initial view is that the AER has not been expected to act as a consumer 'advocate' or 'champion', in effect bargaining with regulated companies on behalf of energy consumers (as happens, sometimes explicitly and sometimes implicitly, in some other jurisdictions).

> *Is this right?*

This does not resolve all ambiguities, however. For example:

> *Given the NEO and NGO, is the AER expected, when exercising those discretions afforded it under the rules, to give priority to the long term interests of consumers in its decision making?*
>
> *Or is the AER expected to arbitrate in some way to balance the interests of consumers, users and network service providers?*

What the Panel is trying to understand is whether network users and consumer bodies were, according to the original policy intentions, expected to act as what Professor Fels has called

effective ‘contradictors’ in the review process. If that was the case, it seems straightforward to conclude that expectations have not been fulfilled. On the other hand, if this was not the intention – for example because regulation was seen as a technical exercise in which all necessary consumer protection is provided by the rules and by national objectives – then the Panel’s interpretations of actual outcomes (e.g. negative network user and consumer organisation experiences of the appeal process) will necessarily be somewhat different.

The Expert Panel
27 April 2012

ANNEX 5

List of Submissions Received

- Energy Networks Association (Received: 3 April 2012)

Consultation Paper One

- APA Group (Received: 11 April 2012)
- Australian Pipeline Industry Association (Received: 20 April 2012)
- Consumer Action Law Centre (Received: 13 April 2012)
- Consumer Utilities Advocacy Centre (Received: 13 April 2012)
- Energy Networks Association (Received: 19 April 2012)
- Energy User Association of Australia (Received: 9 May 2012)
- Ergon Energy (Received: 18 April 2012)
- ETSA Utilities, CitiPower and Powercor Australia (Received: 17 April 2012)
- Financial Investors Group (Received: 13 April 2012)
- Jemena (Received: 13 April 2012)
- Major Energy Users (Received: 13 April 2012)
- Total Environment Centre (Received: 17 April 2012)
- The National Competition Council (Received: 18 April 2012)

Consultation Paper Two

- The Australian Energy Regulator (Received: 7 June 2012)
- Australian Pipeline Industry Association (Received: 1 June 2012)
- Consumer Action Law Centre (Received: 31 May 2012)
- Consumer Utilities Advocacy Centre (Received: 12 May 2012)
- Victoria Department of Primary Industries (Received: 15 June 2012)
- Energy Networks Association (Received: 1 June 2012; 22 June 2012)
- Energy User Association of Australia (Received: 13 June 2012)
- Ergon Energy (Received: 1 June 2012)
- ETSA Utilities, CitiPower and Powercor Australia (Received: 1 June 2012)
- Financial Investors Group (Received: 6 June 2012)
- Grid Australia (Received: 1 June 2012)
- The Honourable Ray Finkelstein QC (Received: 12 June 2012)
- IPART (Received: 1 June 2012)
- Jemena (Received: 1 June 2012)
- Major Energy Users (Received: 30 May 2012)
- SP Ausnet (Received: 1 June 2012)
- One confidential submission

ANNEX 6

Attendees at the Public Forum, Wednesday 9 May 2012

- Australian Competition and Consumer Commission
- ActewAGL
- Australian Energy Market Commission
- Australian Energy Market Operator
- Australian Energy Regulator
- Australian Government Department of Resources, Energy and Tourism
- APA Group
- Australian Pipeline Industry Association
- Chris Harvey Consulting
- Ausgrid
- Australian Council of Social Services
- Carbon Markets
- CitiPower and Powercor
- Consumer Action Law Centre
- Consumer Utilities Advocacy Centre
- Dampier to Bunbury Pipeline
- DLA Piper
- Energy Networks Association
- Energex
- Energy Retailers Association of Australia
- Economic Regulation Authority of Western Australia
- Ergon Energy
- Ernst & Young
- Energy Supply Association of Australia
- Essential Energy
- Energy Users Association of Australia
- Gilbert + Tobin
- IPART
- Jemena
- Major Energy Users
- MinterEllison
- NERA
- NSW Department of Trade & Investment, Regional Infrastructure and Services
- Origin
- Powerlink Queensland
- Productivity Commission
- PriceWaterhouseCoopers
- Queensland University of Technology
- South Australian Department for Manufacturing, Innovation, Trade, Resources and Energy
- Synergies
- TransGrid
- United Energy and Multinet Gas
- UnitingCare Wesley Adelaide
- Victoria Department of Primary Industries

Stakeholder meetings:

Tuesday 1 May 2012:

- Grid Australia
- New South Wales Department of Trade and Investment, Regional Infrastructure and Services
- Australian Energy Market Commission

Thursday 3 May 2012:

- The Energy Retailers Association of Australia

Friday 4 May 2012:

- Australian Competition Tribunal
- Australian Energy Regulator
- Commonwealth Minister for Energy and Resources the Hon Martin Ferguson AM MP
- Victorian Department of Primary Industries
- Consumer Utilities Advocacy Centre

Tuesday 8 May 2012:

- Consumer Action Law Centre

Wednesday 9 May 2012:

- Economic Regulatory Authority of Western Australia
- South Australian Department for Manufacturing, Innovation, Trade, Resources and Energy

Thursday 10 May 2012:

- Australian Pipeline Industry Association
- Energy Users Association of Australia
- Energy Supply Association of Australia

Friday 11 May 2012:

- Financial Investors Group
- IPART
- Queensland Department of Energy and Water Supply
- Major Energy Users
- Energy Networks Association

By Teleconference:

- Jemena
- Ausgrid
- Representatives from the State, Territory and Commonwealth governments