Chapter 6

Information asymmetry, incentives to 'game' the regulator and merits review

6.1 Under the current regulatory framework, network service providers propose to the Australian Energy Regulator (AER) the levels of capital expenditure (capex) and operational expenditure (opex) they consider are needed to run their business effectively over the regulatory control period. The AER must either accept the proposal or substitute the elements it does not accept with its own decisions.

6.2 This chapter considers the merits of the current model for considering regulatory proposals and the manner in which electricity network companies have presented information to the AER. This chapter also examines:

- consumer engagement and consultation about regulatory proposals and infrastructure projects; and
- the appeal process available once a determination is made.

The propose–respond method of revenue determinations

6.3 As noted in Chapter 3, the process for determining the amount of revenue that network businesses can recover from their customers is ex-ante—businesses must periodically apply to the AER for an assessment of their revenue requirements in advance. The AER then assesses the expenditure forecasts and proposed revenue requirements before making a determination. This is a 'propose–respond' framework.

6.4 This model recognises the information asymmetry that exists between the regulated entity and the regulator. As the network service provider actually runs a network, it is likely to be best placed to consider what is needed and to develop an initial proposal. The initial proposal can then be scrutinised and if necessary challenged by the regulator and interested parties. Through its benchmarking activities and experience from regulating many network companies, the AER should be able to identify and challenge excessive proposals.

6.5 However, electricity regulation and the concepts involved can be complex. This can have implications for how network businesses interact with the regulator as well as requiring other stakeholders to devote significant effort and resources if they wish to make a meaningful contribution to the process. This report has already outlined some of the problematic incentives provided by the National Electricity Rules (NER) regarding the return on capital, which has been the main driver of increasing electricity prices. Further, this inquiry has been conducted in the context of high electricity prices and allegations that network companies are seeking to 'game' the regulator. The extent to which the propose–respond method of regulation has led to, or exacerbated, these outcomes and whether this method of regulation can lead to

optimal outcomes generally was considered in several submissions received by the committee. This section examines this issue.

Views on the propose–respond model

6.6 Energex considered that a positive feature of the propose–respond model is how it 'gives all stakeholders an opportunity to be engaged in the development and delivery of a regulatory framework that can best deliver on the [National Electricity Objective]'. Energex argued that the consultation undertaken is 'an openly visible process', with a range of stakeholders involved. Specifically, Energex noted that submissions to the AER regarding a regulatory proposal may be made by other market participants, such as retailers, networks and generators; state and federal government departments; and state-based regulators.[1]

6.7 Other submitters, however, consider the propose–respond model benefits the network companies. As noted in previous chapters, submitters have expressed concern about problematic incentives provided in the regulatory framework that encourage network companies to try to secure the highest returns possible by undertaking inefficient investment. These submitters considered the propose–respond model supports this outcome as it allows network companies to promote these high initial revenue proposals and 'frame the discussion'.[2] For example, the Energy Users Association of Australia (EUAA) expressed the view that the propose–respond revenue determination process helps allow the networks to 'game the regulator'. The EUAA explained:

> The networks have much more information available to them than the AER has access to, and they take advantage of this asymmetry in deciding the type and volume of information to provide to the AER in their revenue proposals. An analysis of the networks' expenditure claims and the AER's annual reports suggests that, on average, the electricity networks spend around 20 times the expenditure of the AER on their revenue determinations.[3]

6.8 Similarly, the Agriculture Industries Electricity Taskforce noted that:

> While the AER is free to ask questions during the reviews and to seek information, it is not free to set the agenda—this has been established through the businesses' proposals and the regulator is therefore constrained to respond to those proposals and conduct its reviews accordingly.[4]

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1 Energex, *Submission 14*, pp. 5–6.

2 Big Picture Tasmania, *Submission 4*, p. 2.

3 Energy Users Association of Australia (EUAA), *Submission 17*, p. 14.

4 Agriculture Industries Electricity Taskforce, *Submission 21*, p. 5.

6.9 Two key challenges that the propose–respond model appears to present for the AER were identified. The first issue submitters highlighted was the 'onus of proof' on the AER to disprove the network service providers' justifications for their revenue proposals. If the AER decides not to accept the proposal, the AER is required to provide detailed reasons.[5] The Total Environment Centre argued that this has allowed the network companies to ' successfully "cherry-pick" from AER determinations in the Australian Competition Tribunal…to increase their guaranteed revenue'.[6]

6.10 The second weakness is the level of documentation that can be involved in the process. Mr Bruce Mountain advised that the current regulatory proposals by the three New South Wales distribution network companies total 'around 44,000 pages including around 30 consultant reports', while the proposals by distribution companies in Queensland and South Australia are no smaller with the Queensland proposals containing' 560 separate documents and reports'. The costs of these reports are recovered from customers.[7]

6.11 The EUAA argued that the network businesses take advantage of the inherent information and resource asymmetries and 'swamp the AER with information that detracts from an effective and efficient assessment of their revenue proposals':

> The volume of the networks' revenue proposals is excessive, with some networks' current proposals amounting to around 40,000 pages. This makes it extremely difficult and time consuming for the AER and other stakeholders to respond effectively.[8]

6.12 The implications of this amount of documentation given the limited time available to the AER to assess it were also noted. Major Energy Users made the following observation:

> The [network service providers (NSPs)] have much more information available to them than the AER can access in the time available to complete a revenue review. This means that the NSP is in a much better position to argue with the AER over what capex and opex the NSP considers it wants.[9]

6.13 Similarly, it was argued that the volume of material provided to the regulator negatively affects the ability of other interested parties to engage in the process. While summaries of revenue requirements are included in the main regulatory proposal document, Cotton Australia wrote that the detailed information about

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5 EUAA, *Submission 17*, p. 14.

6 Total Environment Centre, *Submission 43*, p. 3.

7 Mr Bruce Mountain, *Submission 19*, p. 24. The AER provided details of the number of pages it has received in submissions to support regulatory proposals and revised regulatory proposals for the upcoming regulatory control periods. See AER, *Answers to questions on notice 8*, received 10 April 2015, p. 8.

8 EUAA, *Submission 17*, p. 14.

9 Major Energy Users, *Submission 7*, pp. 2–3.

investment decisions, forecasted demand, revenue and the WACC are provided in 'largely impenetrable' supporting documents.[10] The Agriculture Industries Electricity Taskforce asserted that the difficulty encountered by interested parties in reviewing significant numbers of documents to understand and respond to regulatory proposals was a consequence 'the network businesses intend'. The Taskforce remarked:

> While the network businesses argue that they are customer focussed and seek to take account of consumer views, 1000 megabyte proposals with 500+ documents and spreadsheets and 20+ consultancy reports, suggests exactly the opposite.[11]

6.14 Mr Mountain argued that the current propose–respond model 'has failed badly as can be seen in the profit, price and expenditure outcomes'. He added that large differences between actual and forecast demand growth and the cost of capital was further evidence of this failure.[12] Mr Mountain also noted that although the network businesses seem able to exploit the information asymmetry between them and the regulator, the AER, 'mindful of criticism from industry, consumers and merits reviews of its decisions' has responded by seeking to 'avoid risks through ever more forensic analysis'.[13] Mr Mountain concluded that the rationale underpinning the overall regulatory approach, that is the provision of incentives for monopolies to reveal their efficient costs, 'has been lost and in its place is a system of regulation that follows its form rather than its function'.[14]

6.15 Recent efforts to address weaknesses in the NER may also present further challenges for the AER when utilising a propose–respond model. Major Energy Users explained that the AER is now able to 'regulate by comparison' by developing tools to benchmark regulatory proposals. However, it added that the network businesses 'attempt to overcome this regulation by comparison by countering the AER assessments with arguments that they are "different" to their comparators'.[15]

Proposals to limit the volume of information provided by network companies

6.16 Several submitters argued that the propose–respond model would be enhanced by changes to how information is provided to the AER or limits on the amount of documentation that may be presented. For example the EUAA suggested that a limit on the volume of information that is allowed to be submitted to the regulator as part of a network service provider's regulatory proposal would go some way to address the

10 Cotton Australia, *Submission 3*, p. 2.

11 Agriculture Industries Electricity Taskforce, *Submission 21*, p. 6.

12 Mr Bruce Mountain, *Submission 19*, p. 24.

13 Mr Bruce Mountain, *Submission 19*, p. 24.

14 Mr Bruce Mountain, *Submission 19*, p. 25.

15 Major Energy Users, *Submission 7*, pp. 2–3.

information and resource imbalance in the determination process. The EUAA suggested that the limit could be a cap on the number of pages that can be submitted.[16]

6.17 The development of a template was also suggested. Mr Phillip Barresi, the chief executive officer of the EUAA, informed the committee that he had raised with the AER the idea of a template based on the model used in the United Kingdom; however, he was told that implementing the template in Australia would be 'problematic'. Nevertheless, he argued that some form of template would be useful:

> …we do not have to adopt the UK model but we can certainly look at that concept. We are an inventive nation and I am sure we can come up with our own template which will help users and consumers to better wade their way through a lot of the information. They have an army of consultants out there. As I said in my introduction, we are one of the better equipped advocacy organisations for energy users and even we struggle, absolutely struggle, to get through the submissions and what it means.[17]

6.18 The Public Interest Advocacy Centre also suggested that a limit to the number of pages network companies could submit or a requirement that network companies supply information in a template designed by the AER could be beneficial. Alternatively, it argued that a limit could be imposed on the total cost associated with the preparation of a regulatory proposal that can be passed through to consumers. The Centre explained that under this model, which is its preferred option, network businesses could still provide additional information that led them to exceed the cap, however, the cost of doing so would come from their profits.[18]

6.19 The AER noted that the NER and the AER's guidelines specify the form in which network businesses must present certain classes of material to the regulator. Despite this, the AER stated that 'dealing with the volume of material associated with regulatory proposals is resource intensive for the AER and other stakeholders'. Further, the AER acknowledged that the volume of material lodged may detract from efforts to better engage consumers in network regulatory decision-making.[19] The AER recognised that it 'is worth considering changes to the framework that could make the regulatory process more effective'.[20]

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16 EUAA, *Submission 17*, p. 14.

17 Mr Phillip Barresi, Chief Executive Officer, EUAA, *Proof Committee Hansard*, 18 February 2015, p. 20.

18 Public Interest Advocacy Centre, *Submission 18*, pp. 17–18.

19 Although the AER added that, following efforts to better engage consumers, it is seeing greater involvement in its consultation processes from a wider variety of interested parties. AER, *Answers to questions on notice 8*, received 10 April 2015, p. 9.

20 AER, *Answers to questions on notice 8*, received 10 April 2015, p. 9.

Alternative approaches

6.20 The replacement of the propose–respond model with another model was also suggested. The EUAA explained that prior to 2006, a receive–determine model was used. Under this model, the regulator 'received and considered the networks' proposals, and had the flexibility to determine an outcome that in the regulator's view best met the criteria'. The EUAA and Major Energy Users endorsed the reintroduction of a receive–determine model.[21] The Agriculture Industries Electricity Taskforce supplied further details about how the model operated:

> …in the economic regulation performed by the ACCC (for transmission networks) and state regulators (for distribution networks), the regulators determined the information requirements and businesses responded to the regulator's requests. While the networks also submitted their intentions and proposals, there was no obligation on the regulators to respond to these proposals. This arrangement mirrored those in Britain where there is not (and never has been) a formal obligation on the regulator to respond to the network businesses' proposals.[22]

6.21 A model based on negotiation and arbitration was also put forward. The Public Interest Advocacy Centre suggested that the AER should 'facilitate negotiation and arbitrate between networks and consumers on total revenue' to seek a negotiated settlement. The Centre noted that this option was discussed and canvassed in the PC's 2013 electricity regulation report:

> The PC noted that in theory, such an approach should maximise community welfare, as 'the only contract that two parties with equal bargaining power would mutually agree to would be one involving no removable inefficiencies'. The PC also noted that if the AER was acting as an arbitrator rather than a consumer advocate pitted against the regulated businesses, its decisions would not be subject to merits review. This would be the case 'because, as an arbiter, the regulator would already have fairly addressed both parties concerns'.[23]

6.22 Mr Bruce Mountain provided an overview of other possible determination processes that are used in various jurisdictions:

> In the United States, in most cases in Germany and in Denmark, co-operative or municipal distributors are usually not explicitly regulated but are restricted from using profits from electricity distribution to cross-subsidise other services. In the United States investor-owned utilities are not subject to federal or state regulatory reviews unless they wish to raise prices. In some cases, prices have not risen for decades and so there has been no regulatory review. In some states of the US, prices are set through negotiated settlements with consumers. In several Scandinavian

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21 EUAA, *Submission 17*, p. 14; Major Energy Users, *Submission 7*, p. 3.

22 Agriculture Industries Electricity Taskforce, *Submission 21*, p. 5.

23 Public Interest Advocacy Centre, *Submission 18*, p. 14.

> countries, price caps for municipal distributors are established through high-level productivity-based formulae rather than decisions on the detail of various inputs as in Australia. The system of regulation in Britain has also evolved, and much can be learned from this.[24]

6.23 Mr Mountain did not endorse any particular model; rather he suggested that the possibilities should be explored without being constrained by whether alternative approaches are consistent with other clauses of the NER or are beyond the current powers of the AER or AEMC. He concluded:

> I suggest that fresh eyes need to be brought to this…There are many possibilities. The size of the industry and its economic importance means that effort at improvement will be well rewarded.[25]

Consumer engagement and public consultation

6.24 Despite the importance of revenue determinations given their effect on electricity prices, it is evident that the determination process is not well-understood. Inputs to determinations such as rates of return and expenditure forecasts are matters that external parties would find difficult to challenge. Further, as already highlighted, the current system can also encourage lengthy regulatory proposals and substantial amounts of other information and documents being provided to the regulator. This makes it even more difficult for energy users to review and comment on the overall proposal.

6.25 Accordingly, the committee gave particular consideration to how energy consumers fit into the determination process. This section considers whether the framework encourages and supports consumers to make a meaningful contribution to the process.

Views on consumer and stakeholder engagement

6.26 The committee received a variety of responses regarding network service providers' approach to consultation from consumer groups and stakeholders that represent energy-intensive businesses.

6.27 The Public Interest Advocacy Centre noted that the AER has recently expressed criticism of certain network service providers' consultation efforts, such as a comment that Ausgrid 'has significant work to do to give consumers more say in the services it provides'. The Centre acknowledged that 'there has been a significant increase of the amount of consumer engagement being undertaken by networks across the NEM'.[26] An increase in the amount of consultation, however, did not mean that the consultation is meaningful. Representatives of the Public Interest Advocacy Centre

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24 Mr Bruce Mountain, *Submission 19,* p. 25.

25 Mr Bruce Mountain, *Submission 19,* p. 25.

26 Public Interest Advocacy Centre, *Submission 18,* pp. 16–17.

told the committee that the consultation they have been engaged in with network businesses went as follows: '[t]hey get you in and they tell you what is going to happen, pretty much'.[27]

6.28 The Public Interest Advocacy Centre also observed that there were different views of what consumer engagement actually entails. Brochures, focus groups and Facebook pages produced by the network companies were noted, however, it was argued that meaningful consumer consultation was more complex than that. Dr Gabrielle Kuiper told the committee:

> …engaging with consumers who have no understanding of how the energy market works is one thing. Engaging with the consumer advocacy sector and also the community welfare organisations who deal on a day-to-day basis with people who have thousands of dollars of electricity debt is quite different. The Productivity Commission report…said that currently end users, whether households or commercial users, are disenfranchised from the regulatory process and would absolutely endorse that. We, in fact, have liaised with our counterparts in Queensland and it sounded like they had significantly greater engagement with their network businesses in Queensland than we did in New South Wales.[28]

6.29 The EUAA reported that it has had a variety of responses from network businesses; while it had been 'inundated' with consultation offers from some network businesses, it has not been contacted by others. Even so, the EUAA's chief executive officer characterised the consultation that does take place as efforts 'to kill us with kindness' as part of a 'tick the box exercise':

> It is one of just simply letting us know what is taking place, rather than actually working through the issues with us.[29]

6.30 The New South Wales Irrigators' Council (NSWIC) told the committee that it was 'aghast' at the following comment in Essential Energy's regulatory proposal that it considered formed the basis of the company's approach to customer engagement:

> Customers do not fully understand why charges are rising but accept it is inevitable and out of their control.[30]

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27 Mr Oliver Derum, Senior Policy Officer, Energy and Water Consumers' Advocacy Program, Public Interest Advocacy Centre, *Proof Committee Hansard*, 17 February 2015, p. 13.

28 Dr Gabrielle Kuiper, Senior Policy Officer, Energy and Water Consumers' Advocacy Program, Public Interest Advocacy Centre, *Proof Committee Hansard*, 17 February 2015, p. 13.

29 Mr Phillip Barresi, Chief Executive Officer, Energy Users Association of Australia (EUAA), *Proof Committee Hansard*, 18 February 2015, p. 22.

30 Essential Energy, *Regulatory proposal 2014–19*, May 2014, p. 16; cited in New South Wales Irrigators' Council (NSWIC), *Submission 5*, p. 4.

6.31 The NSWIC noted that, given the complexity of electricity pricing, consumers are disengaged from the process and do not fully understand why electricity prices are rising. However, the NSWIC argued:

> …it is simply not correct that customers accept recent price rises and see them as inevitable. Irrigators, in particular are acutely aware of their electricity charges and are taking drastic measures to reduce their costs.[31]

6.32 Cotton Australia noted the recent efforts by Ergon and Essential to reach out to agricultural groups. While some of this has been positive, Cotton Australia claimed it occurred too late in the regulatory process for the organisation to understand the network businesses' positions and to engage with them.[32] One representative of Cotton Australia advised that Essential Energy relied 'very heavily on the outcomes around their scenario modelling to justify their case going forward and their continued expenditure.[33] Another representative stated that 'you could not help but get the sense that all they were trying to do was scaremonger and try to justify the proposal'.[34] The NSWIC's evidence indicated that it had a similar experience:

> Unfortunately, every discussion that we have had with Essential Energy has led to us asking quite detailed questions where we were referred back to their submission, attachments or Excel spreadsheets, which does not really help a small organisation like us to get an understanding of where the underlying costs are. So, in that sense, we have had discussions, but unfortunately the results that are coming out of that are not really useful for stakeholders like us to engage.[35]

6.33 Groups aggrieved by actions taken by certain network service providers were unsurprisingly scathing of the approach taken by the network business to consultation. A case study of this is the experience of the Veto Energex Towers Organisation (VETO). VETO is a Queensland community organisation that was formed in 2008 after Energex informed certain landowners that it intended to build a duplicate sub-transmission line from Loganlea to Jimboomba. VETO provided the following summary of the early consultation sessions on the proposal that its members attended:

> Energex conducted community consultation sessions where Energex staff said they were there to tell us what they would do, not to consider alternatives as the route had been selected in the Corridor Selection Report (CSR) based on scoring by Energex and Aurecon in an in-house workshop.

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31 NSWIC, *Submission 5*, p. 4.

32 Mr Michael Murray, Policy Manager, Cotton Australia, *Proof Committee Hansard*, 17 February 2015, p. 22.

33 Mrs Angela Bradburn, Policy Officer, Cotton Australia, *Proof Committee Hansard*, 17 February 2015, p. 22.

34 Mr Michael Murray, Cotton Australia, *Proof Committee Hansard*, 17 February 2015, p. 22.

35 Ms Stefanie Schulte, Policy Manager, NSWIC, *Proof Committee Hansard*, 17 February 2015, p. 22.

> Our community considered this consultation to be a sham, where Energex pushed their pre-determined outcome and trivialised community issues.[36]

6.34 Some positive comments about the approach to consultation were received. Bell Bay Aluminium reported that its experience in Tasmania has improved since the creation of TasNetworks, which manages both the electricity transmission and distribution networks in Tasmania. Bell Bay Aluminium's general manager described the consultation and discussions with TasNetworks as 'very businesslike'. He added:

> It is the sort of relationship that we would have with our key suppliers and our key customers. It is a commercial arrangement, but it is a productive relationship and an honest one where you can be quite frank about the issues and your problem becomes my problem. TasNetworks are operating in that space. With the previous entity—and I am not drawing at the individuals, and we also had a different government at that time so I do not know where the rules of engagement came from—we found it nigh on impossible to make any progress on any of the issues we raised.[37]

Recent developments in consumer consultation

6.35 The representation of consumer interests in the determination process has been considered in recent reviews of the electricity sector.[38] Following these reviews, efforts have been made to improve the standing of consumers. For example, the AER has established a consumer challenge panel to provide expert input on 'issues of importance to consumers'. The panel is tasked with advising the AER on:

- 'whether a network business's proposal is justified in terms of the services to be delivered to customers; whether those services are acceptable to, and valued by, customers; and whether the proposal is in the long term interests of consumers'; and
- 'the effectiveness of network businesses' engagement with their customers and how this engagement has informed, and been reflected in, the development of their proposals'.[39]

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36 Veto Energex Towers Organisation (VETO), *Submission 55*, p. 2.

37 Mr Ray Mostogl, General Manager, Bell Bay Aluminium, *Proof Committee Hansard*, 17 February 2015, p. 37.

38 For example, see Senate Select Committee on Electricity Prices, *Reducing energy bills and improving efficiency*, November 2012, pp. 134–35.

39 Australian Energy Regulator (AER), 'Consumer challenge panel', www.aer.gov.au/about-us/consumer-challenge-panel (accessed 20 March 2015).

6.36 The AER's chief executive officer, Ms Michelle Groves, noted that the panel is 'enhancing consumer input into some of the more complex technical issues that arise in network regulation'. Ms Groves added that the AER has received positive feedback from customer groups about the consumer challenge panel.[40]

6.37 Some submissions expressed their support for these efforts. Mr Warren Males from Canegrowers commended the AER for seeking to address the imbalance in industry knowledge and resources between networks and energy users by establishing the consumer challenge panel. He provided the following comments:

> Canegrowers as an organisation and the Australian Sugar Industry Alliance—the Australian sugar industry overall—has devoted an enormous amount of resources and effort to understand what is a very complex and complicated system. We have come to that over the last couple of years, from a very low base, to what we hope now is a moderate level of understanding. But we sit here this morning and see before you the chief executive of Ergon surrounded by nine of his executives. We simply do not have that level of resources. So I say to the AER: thank you for providing the resources of the consumer challenge panel.[41]

6.38 The EUAA, however, considered that the effectiveness of the consumer challenge panel 'is yet to be determined', as it will depend on the results of the current round of determinations.[42]

6.39 Another entity established following recent reviews is Energy Consumers Australia (ECA). COAG agreed to create a national energy consumer advocacy body as part of the energy market reform package agreed to in December 2012. Despite this, the ECA was only established on 30 January 2015. The lengthy process involved in setting up the ECA was criticised. Dr Kuiper from the Public Interest Advocacy Centre argued that the delay means that consumers 'have not had a strong voice' during the current determination process. She stated:

> The point of setting up that body in December 2012 was such that it would participate in this round of revenue determinations. The round is almost over, effectively. The precedent that is set by the determinations in New South Wales will likely flow on to other states. So we have missed out again on another five-year regulatory determination process; consumers have not had a strong voice.[43]

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40 Ms Michelle Groves, Chief Executive Officer, AER, *Proof Committee Hansard*, 18 February 2015, pp. 2, 3.

41 Mr Warren Males, Head, Economics, Canegrowers; and Chairman, Sugarcane Gene Technology Group, Australian Sugar Industry Alliance, *Proof Committee Hansard*, 16 February 2015, pp. 25–26.

42 Mr Phillip Barresi, EUAA, *Proof Committee Hansard*, 18 February 2015, p. 22.

43 Dr Gabrielle Kuiper, Public Interest Advocacy Centre, *Proof Committee Hansard*, 17 February 2015, p. 14.

6.40 More effective consultation processes have also been required as a result of changes to the NER. The chief executive of the Australian Energy Market Commission (AEMC) explained that following the recent rule changes, network companies 'must consult about the tariff structures that they propose to put in place prior to making a submission to the AER about those tariff structures'.[44]

6.41 The AER is now also considering, and publishing comments on, the quality of the consultation that network companies undertook for both revenue determinations and annual pricing proposals. In particular, for pricing proposals, the AER will have regard to how effectively the business has consulted with its consumers and other stakeholders. The AEMC chief executive made the following observation:

> It is important that tariff structures are meaningful to consumers and are structures that consumers can understand, so, unless there has been a proper consultation process, it will be difficult for the AER to be satisfied that the businesses are meeting the new rules.[45]

6.42 Nevertheless, suggestions for further improvements were outlined. The Consumer Action Law Centre expressed support for the AER's consumer challenge panel and noted the creation of the ECA. However, it suggested that the effectiveness of consumer consultation should be subject to regular reviews. The Centre envisaged that these reviews would take place at the end of the regulatory determination process and would consider both the effectiveness of the consultation and whether the consultation framework promotes the interests of consumers.[46]

Limited merits review

6.43 Another area of the determination process that some submitters considered needs reform is the limited merits review regime.

Overview of the limited merits review regime

6.44 Merits review is 'the process by which a person or body other than the primary decision-maker reconsiders the facts, law and policy aspects of the original decision and determines what is the correct and preferable decision'. The merits review process has been described 'as "stepping into the shoes" of the primary decision-maker'. Merits review seeks to ensure that administrative decisions made by government agencies are 'correct', in that they are made according to law, and 'preferable', in 'the sense that, if there is a range of decisions that are correct in law, the

44 Mr Paul Smith, Chief Executive, Australian Energy Market Commission (AEMC), *Proof Committee Hansard*, 17 February 2015, p. 4.

45 Mr Paul Smith, AEMC, *Proof Committee Hansard*, 17 February 2015, p. 5.

46 Consumer Action Law Centre, *Submission 20*, p. 6.

decision settled upon is the best that could have been made on the basis of the relevant facts'.[47]

6.45 Under the National Electricity Law (NEL), a limited merits review regime is in place with the Australian Competition Tribunal able to review certain types of regulatory decisions. Reviewable decisions include the AER's pricing and revenue determinations for electricity transmission and distribution. An application for review needs to be made on one or more permitted grounds. These grounds are that:

- the AER made an error of fact in its findings of facts, and that error of fact was material to the making of the decision;
- the AER made more than one error of fact in its findings of facts, and that those errors of fact, in combination, were material to the making of the decision;
- the exercise of the AER's discretion was incorrect, having regard to all the circumstances; and
- the AER's decision was unreasonable, having regard to all the circumstances.[48]

6.46 In deciding whether to affirm, vary or set aside the decision (remitting the matter back to the AER), the Tribunal must be satisfied that such action will, or is likely to, result in a decision that is materially preferable to the reviewable regulatory decision in making a contribution to the achievement of the national electricity objective (NEO), which is the overall objective of the NEL.[49] If not, the Tribunal must affirm the decision.[50] Another key element of the merits review process is that costs incurred by the network service provider in seeking a review must not be recovered from consumers.[51]

Overall views on the regime

6.47 The limited merits review regime was strongly supported by industry stakeholders. The Energy Networks Association (ENA) stated:

> Merits review remains a fundamental part of ensuring accountable, high-quality regulatory determinations, and promoting the required investor

47 Administrative Review Council, *What decisions should be subject to merit review?*, 1999, www.arc.ag.gov.au/Publications/Reports/Pages/Downloads/Whatdecisionsshouldbesubjecttomeritreview1999.aspx (accessed 24 March 2015).

48 National Electricity Law, s. 71C(1).

49 Further, if deciding to vary a decision, the Tribunal must be satisfied 'that to do so will not require the Tribunal to undertake an assessment of such complexity that the preferable course of action would be to set aside the reviewable regulatory decision and remit the matter to the AER to make the decision again'. National Electricity Law, ss. 71C(1a), (2)(d).

50 National Electricity Law, s. 71C(2).

51 National Electricity Law, s. 71YA.

> confidence for major long-lived network infrastructure investments required to be made on an ongoing basis…[A]vailability of merits review on decisions of a national access and pricing regulatory body is a fundamental principle.[52]

6.48 Energex argued that the limited appeal rights available to network businesses 'ensure' that the AER's decision will only be overturned if an alternative decision would make a materially better contribution to the NEO.[53]

6.49 However, it is clear that aspects of the limited merits review regime have not, at least in the past, led to optimal outcomes.[54] It has been estimated that network service providers' appeals to the Tribunal following AER determinations have added $2 billion to $3 billion to the overall network costs paid by consumers.[55] The Public Interest Advocacy Centre explained that the successful appeals against the first AER determinations:

> …were based on a ruling that there was no valid reason why one consultant's report about the rate or return was more valid than another. As a result, the networks had won increases based on expert evidence that the AER has considered overstated the true cost of borrowing.[56]

6.50 The Consumer Action Law Centre outlined a discouraging experience it had with the limited merits review process. The Centre explained that in the AER's final determinations for the Victorian electricity networks' 2011–2015 price review, the AER agreed to increase capital expenditure by 45 per cent and operating expenditure by 32 per cent, compared to the previous regulatory period. Despite these increases, each of the distribution network service providers appealed the AER decisions. The Consumer Action Law Centre decided to intervene in the appeal with another consumer group to 'ensure that consumer views were put forward' to the Tribunal. However, the result was as follows:

> Despite putting significant resources into the intervention, ultimately senior counsel advised us to withdraw, citing the immense task in producing new

52 Energy Networks Association, *Submission 31*, p. 14.

53 Energex, *Submission 14*, p. 14.

54 This has been recognised by the Standing Council on Energy and Resources (SCER), the precursor to the COAG Energy Council. See SCER, *Statement of policy intent: Review framework for the electricity and gas regulatory decision making*, December 2012, https://scer.govspace.gov.au/files/2012/12/LMR-Statement-of-Policy-Intent-December-2012.pdf (accessed 25 March 2015).

55 G Yarrow, M Egan, J Tamblyn, *Review of the limited merits review regime: Stage one report*, June 2012, www.scer.gov.au/files/2012/06/Stage-One-Report-to-SCER-29-June2.pdf, pp. 18–21; cited in Consumer Action Law Centre, *Submission 20*, p. 3. See also Public Interest Advocacy Centre, *Submission 18*, pp. 10–11.

56 Public Interest Advocacy Centre, *Submission 18*, pp. 10–11.

> expert evidence to counter that of the energy businesses and the adverse costs risks that could have financial implications for our organisations.[57]

6.51 Although the Consumer Action Law Centre's highlighted the difficulties an interested party faces when seeking to be involved in the merits review process, it suggested that this was a secondary issue given the flaws in the NER. The Centre argued that the network service providers' successful appeals demonstrate that it 'wasn't so much the AER's decisions, but the poor rules that enabled businesses to recover so much money'.[58]

6.52 The EUAA argued that there is 'no downside risk' for networks in deciding to appeal AER decisions. It argued that appeals have 'become the norm rather than the exception' and that network companies 'typically "cherry pick" elements of the AER's decision', such as the WACC allowances, with their appeals 'usually successful'.[59] The EUAA claimed that Australia's limited merits review regime 'contrasts sharply' with the process in the United Kingdom. It explained:

> The UK appeals process effectively re-opens the complete revenue determination, thereby exposing the networks to the risk of an unfavourable outcome on the complete decision rather than their 'cherry picked' elements. As a result, appeals are very rare in the UK.[60]

6.53 The EUAA added that various stakeholders have extensively criticised aspects of Australia's limited merits review regime. Key concerns included that the process involved significant costs and was litigious in nature; the decisions made are 'focused on quasi-legal/economic theory, resulting in outcomes that are not in consumers' long-term interests'; and the processes 'deter and disenfranchise participation by energy consumers'.[61] Like the Consumer Action Law Centre, the EUAA advised that it too has previously found it necessary to withdraw from a merits review process:

> A few years ago the EUAA actually tried to mount an appeal in the Australian Competition Tribunal against one of the rulings, and we sought and received contributions from a number of members, companies, to finance that, to employ a QC, and we were just overwhelmed by the resources that the network was able to bring to that process, and we had to withdraw.[62]

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57 Consumer Action Law Centre, *Submission 20*, p. 3.

58 Consumer Action Law Centre, *Submission 20*, p. 3.

59 EUAA, *Submission 17*, p. 18.

60 EUAA, *Submission 17*, p. 18.

61 EUAA, *Submission 17*, p. 18.

62 Mr Mark Grenning, Board Director, EUAA, *Proof Committee Hansard*, 18 February 2015, p. 20.

6.54 It was also noted that the AER is constrained by the requirement to act as a model litigant. The conclusion Major Energy Users drew from this is that the Tribunal has 'exhibited a tendency' to accept network service providers' arguments as the AER is unable to defend its own views.[63]

Recent changes to the limited merits review regime

6.55 A review of the limited merits review regime was required by legislation to be initiated by 2016; however, in December 2011 the Standing Council on Energy and Resources, the forerunner to the COAG Energy Council, agreed to bring forward the review. The review was conducted in 2012 and chaired by Professor George Yarrow.[64] Amendments to the NEL were made following the review. Specifically, the following aspects of the limited merits review process were introduced:

- the requirement that the Tribunal consider the overall outcome of its decision and the long-term interests of consumers;
- costs cannot be awarded against consumer groups that intervene in the process; and
- networks cannot pass on the costs of appeals to consumers through the regulatory revenue process.[65]

6.56 The evidence received by the committee revealed that consumer and energy user groups were generally unimpressed by the limited extent of the changes. The Public Interest Advocacy Centre was perhaps the most positive; it described the changes as 'welcome developments', although it qualified this remark as 'the reforms are yet to be tested'.[66]

6.57 The Consumer Action Law Centre considered the changes should alter the 'risk/reward' equation businesses face when considering Tribunal action. The Centre 'hope[s] that the reform will significantly reduce the number of appeals'.[67]

6.58 Other submitters, however, pointed out that the COAG body rejected the significant changes recommended by the expert panel. In their separate submissions, Mr Bruce Mountain and the EUAA explained that the review panel made 36 recommendations that would have addressed the issue of networks 'cherry picking' elements of the decision they considered could be successfully appealed. Also, the expert panel recommended that the merits review should be undertaken by an economic institution, rather than by a quasi-judicial commission. The EUAA advised that it 'strongly supported' the expert panel's recommendations. Mr Mountain stated

63 Major Energy Users, *Submission 7,* p. 3.

64 Dr John Tamblyn and the Hon Michael Egan were the other members of the expert panel.

65 Public Interest Advocacy Centre, *Submission 18,* p. 11.

66 Public Interest Advocacy Centre, *Submission 18,* p. 11.

67 Consumer Action Law Centre, *Submission 20*, p. 5.

that it is not clear why the recommendations were rejected and, in his view, it 'is difficult to see' how the changes put in place will address the problems that the expert panel identified. [68]

Committee view

6.59 Fundamentally, the committee considers that for economic regulation to be effective with outcomes accepted as legitimate by the community, the processes underpinning it need to be transparent and accessible to external stakeholders. In this regard, the interactions network businesses have with both their customers and the regulator are important.

6.60 The committee is sympathetic to the arguments about how the propose–respond model and the limited merits review regime may encourage the network businesses to inundate the regulator with information, as well as allowing network businesses to frame the initial discussion and 'cherry pick' unfavourable aspects of the AER's decision on appeal. The committee also notes that even the most-engaged interested parties struggle to contribute to the process.

6.61 However, information asymmetry is a common problem in regulation. The committee does not consider that changing the determination process from a propose–respond model to another model will change that. In general, optimal regulatory decisions can only be made if the regulator has access to all of the information it needs and if the process is transparent. Provided the regulator is resourced appropriately, and exercises appropriate scepticism when assessing claims by regulated entities, the propose–respond model that is currently used fulfils this requirement.

6.62 While the case has not been made that the propose–respond model needs to be replaced, the committee considers that the framework could be improved. The ability of a regulator with limited resources to assess regulatory proposals would be negatively affected if it is overwhelmed by information. Similarly, a mass of supporting documentation is also likely to make it more difficult for businesses, industry associations, consumer groups and other interested parties to understand and provide feedback on the regulatory proposals. There are also clear challenges these organisations face when participating in the appeals process.

6.63 Proposals to address this, such as a template or cap on the number of documents (or pages) that can be submitted, could be beneficial, but may be overly restrictive given that the regulator should, as a matter of principle, be provided with all the information it needs. While it may be necessary to revisit these proposals in the future, an initial improvement can be made that may rationalise the number of supporting reports and other documents provided to the regulator, while still ensuring the regulator receives all of the information relevant to its decision-making.

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68 EUAA, *Submission 17*, p. 18; Mr Bruce Mountain, *Submission 19*, p. 16.

6.64 The committee considers a limit should be imposed on the expenditure linked to a regulatory proposal that network businesses can recover from their customers. Network businesses could be permitted to recover costs up to a reasonable amount—any expenditure above that amount would not be recoverable.

6.65 The consultation with consumers that network businesses engage in about their regulatory proposals and network projects must be meaningful. The committee considers that more work needs to be done to make it easier for stakeholders to provide meaningful input into revenue and investment proposals. The recent revenue determination processes provide an opportunity to assess the progress of efforts to enhance consumer input. Over time, Energy Consumers Australia may also provide a vehicle that can advise the AER and policymakers about the effectiveness of network service providers' consultation efforts. Consumer engagement in AEMC and AER processes may also be assisted if clear, consolidated guidance about electricity regulation was published. This guidance should outline the processes involved, define key terms and explain relevant concepts.

6.66 The committee has not made any recommendations about limited merits review. Although some stakeholders expressed concern that recent amendments to the merits review process did not go far enough, the committee considers that further changes should only be made if it has been demonstrated that the recent changes have not been effective. It is necessary for the changes to be tested before any consideration can be given to further enhancements to the limited merits review regime.

Recommendation 5

6.67 The committee recommends that the National Electricity Rules be amended to cap the costs associated with the preparation of a regulatory proposal that a network service provider may recover from its customers.

Recommendation 6

6.68 The committee recommends that the COAG Energy Council request the Australian Energy Market Commission to review the consumer engagement activities of network service providers. As part of this review, proposals for enhancing the effectiveness of consumer engagement efforts should be invited from consumer advocacy groups. Particular focus should be given to the effectiveness of consumer engagement in ensuring that network planning outcomes respond to the long-term interests of consumers.

Recommendation 7

The committee recommends that the Australian Energy Market Commission and the Australian Energy Regulator jointly develop and publish consolidated guidance on the regulatory determination process to better inform members of the public, consumer groups and other energy user stakeholders.