Bulletin

MARCH 2016

Unappealing prospects

The Australian Competition Tribunal's recent judgment found in favour of the businesses that sought merits review of the Australian Energy Regulator's revenue determinations, on most of the grounds on which review was sought. Critics argue that these reviews are too complex, expensive and bad for consumers. A knee-jerk policy response to these criticisms might be to curtail the existing appeal arrangements. In this bulletin, Frontier Economics explains why a merits review regime is essential to a well-functioning regulatory system.

"*Quis custodiet ipsos custodes?*" "Who will guard the guards?" These words, attributed to the first century Roman poet and satirist Juvenal, are a caution against unappealable authority and untrammelled power.[1] The principle of checks and balances on decision-makers, through appeal rights, is a cornerstone of our legal system. It ought also to be a feature of our regulatory systems.

On 26 February 2016, the Australian Competition Tribunal (the Tribunal) handed down its judgment on merits reviews sought by a number of energy networks and consumers on revenue determinations made by the Australian Energy Regulator (AER) in 2015.[2] The Tribunal found in favour of the networks on most issues and did not uphold the appeals brought by consumers.

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These merits reviews were the latest of several that have been sought, and typically won, by networks against the AER over the years. Some have suggested that the repeated success of the businesses is evidence that the appeal arrangements are stacked against the AER. Ill-informed media reports have presented the Tribunal's decision as a disaster for consumers, as though the Tribunal had imposed calamitous price increases on customers.[3] In fact, the Tribunal has overturned some large regulatory errors.

The recent reviews were also one of the largest and most complex of their kind seen in Australia to date. According to the parties that sought review, the regulated revenues at stake totalled in excess of A$8.5 billion. In its judgment, the Tribunal noted that the review-related material for the purposes of hearing the applications was said to extend to more than one million pages. This has prompted criticism that merits reviews are too complex and expensive.

THE MERITS OF MERITS REVIEWS

A knee-jerk policy response to these criticisms would be to dilute or scrap altogether the merits review regime enshrined in the National Electricity Law (NEL) and the National Gas Law (NGL).[4] That would be a mistake.

A well-constructed merits review regime is integral to a system that produces sound regulatory decisions:

- All regulators, no matter how skilled or experienced, can make mistakes. They are human, after all. Merits reviews offer protection to regulated businesses and to consumers against erroneous decisions that would otherwise go uncorrected.
- Merits reviews can be costly to a regulator in terms of time, monetary expense and reputation. The prospect of facing these costs, if it issues poor decisions, can discipline a regulator to make careful, well-reasoned decisions. In short, the threat of review can make regulators more accountable for their decisions.
- Review by an independent adjudicator can protect society against partisan regulatory decisions arising from regulatory capture, where the regulator favours the vested interests it regulates, or from a mistaken notion that it should act as a champion of consumers to the detriment of the legitimate commercial interests of the businesses it regulates.[5]
- Merits reviews can help clarify how complex regulatory rules (in this case the National Electricity Rules and National Gas Rules), and economic and legal principles, should be interpreted and applied. The regulator can use interpretive precedents to refine and improve its future decisions.
- The safeguards against regulatory errors and caprice provided by merits reviews reduces uncertainty for investors in regulated networks, who are typically making very long-lived investments, so face cost recovery over long and

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otherwise uncertain horizons. Such safeguards should keep low regulated networks' cost of capital and, therefore, the long-run costs borne by consumers.

These benefits were recognised in the most recent review of the merits review arrangements in the energy sector in Australia 2012 by an expert panel appointed by the Standing Council on Energy and Resources:[6]

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

REASONS ADVANCED AGAINST MERITS REVIEWS

There are four arguments often cited by opponents of a merits review regime:

1. Merits reviews can become a gaming tool.
2. Merits reviews are costly.
3. Merits reviews tie the hands of the regulator.
4. Merits reviews work against consumers' interests.

As explained below, these arguments either do not apply in the case of the merits review regime available under the NEL/NGL, or are not legitimate reasons to curtail that regime.

Gaming

Detractors argue that regulated businesses can use appeals to stall or circumvent legitimate regulation. A symptom of gaming would be many appeals that are found by the review body to be frivolous, meritless and result consistently in the review body finding in favour of the regulator. That has *not* been the experience with regulated energy networks in Australia. The record of merits reviews show that the businesses' complaints have been overwhelmingly upheld by the Tribunal. This record of 'wins' suggests that the network businesses were not simply forum shopping for a better regulatory outcome. Indeed, this record suggests that the businesses seek review when they feel they have a legitimate concern.

Further, it is not true that recourse to merits reviews leads axiomatically to every regulatory decision being appealed. The statutes governing the regulation of water businesses in Victoria and in Tasmania provide for merits reviews of the decisions of the Essential Services Commission in Victoria and the Office of the Tasmanian Economic Regulator.[7] To date, no reviews of these regulators' decisions have been sought by regulated water businesses. Presumably, this is not because the businesses are unaware of their appeal rights.

Finally, the simple view that businesses use merits reviews as a gaming device ignores the fact that appeals are costly to businesses (consuming experts' fees and management time), and are risky because they may not succeed. A rational business would only seek review if the likelihood of demonstrating regulatory error were high, and if the expected benefit from correcting the error outweighs the costs (including the opportunity costs) of appealing.

Cost

The Australian Competition and Consumer Commission (ACCC), of which the AER is a part, argued recently that merits reviews are expensive:[8]

> *Based on evidence from the energy sector, which has a limited merits review mechanism, the actual review of a decision can be very costly.*

Merits reviews *are* costly, but that is desirable. If appeals were costless to potential appellants, merits reviews would likely become an attractive gaming tool rather than a measure of last resort. If appeals were costless to the regulator, the threat of review would exert a much weaker disciplining effect on its decision-making. Indeed, the ACCC itself has recognised this:[9]

> *However, the actual costs of making an appeal mechanism available depend on the level of use of the mechanism. If the possibility of merits review has the effect of producing regulatory decisions that are not appealed (for example, via providing increased assurance that regulators apply sufficient rigour to their decisions and explanation of their decisions), there may in fact be little actual cost incurred in relation to the mechanism.*

Constraining regulators

Merits reviews can and do limit the discretion of regulators. That is a very good thing for, without limits, *any decision*, no matter how poor, would be permissible.

It is not the case that merits reviews render the regulator helpless. They constrain the discretion of the regulator to the limits prescribed by the rules and law. In its most recent judgment, the Tribunal found that the AER had over-reached in its exercise of discretion in a number of areas. However, the Tribunal also concluded that the AER had acted within the discretion available to it when determining return on equity allowances. So, merits reviews can delineate the boundaries of the discretion available to the regulator when those boundaries are unclear, and prevent decisions that are *ultra vires*.

Consumer protection and participation

A common complaint against merits reviews is that they favour businesses over the interests of consumers. That is not the case in relation to the merits review regime for energy networks in Australia. In 2013 the merits review regime was amended in a number of ways to strengthen the protections afforded to customers:

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- The Tribunal may now only allow a merits review to proceed if it can be satisfied that the grounds for appeal would, or would be likely to, result in a "materially preferable" regulatory decision that contributes to the achievement of the National Electricity Objective (NEO) or National Gas Objective (NGO). The NEO/NGO are expressed explicitly in terms of the "long term interests of consumers".

- In order for parties to succeed in their appeals, it is no longer enough to show that the AER made an error. The Tribunal may now only vary or set aside the AER's decision if it is satisfied that doing so will, or is likely to, result in a decision that is materially preferable to the AER's, in terms of promoting the "long-term interests of consumers".

- Before making a merits review determination, the Tribunal must take reasonable steps to consult with users, consumer associations or consumer interest groups. This requirement was added to the NEL/NGL to ensure that consumers have a voice in any review process.

Furthermore, the NEL/NGL allows consumers to seek merits reviews of the AER's decisions. The Public Interest Advisory Centre and South Australian Council of Social Service both sought merits reviews of decisions made by the AER in 2015.

Consumers are also increasingly active in the AER's regulatory process. For instance, the AER has published best practice guidelines to help regulated networks engage more effectively with their consumers, particularly when developing their regulatory proposals.[10] The AER has also recently established a Consumer Challenge Panel comprised of experts in economics, law, regulation, energy networks and consumer advocacy to provide feedback to the AER on:

- whether networks' regulatory proposals are in the long term interests of consumers; and

- the effectiveness of the networks' engagement with their customers and how that engagement has been reflected in their proposals to the AER.

The AER takes account of this feedback explicitly in its regulatory decisions.

The greater involvement of consumer groups through the regulatory process means that they are increasingly well-informed and positioned to seek review if the AER's decisions are against their long term interests.

REGULATORY FALLIBILITY

Regulators can and do make mistakes — sometimes repeatedly, as the two examples below demonstrate.

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Valuation of imputation credits

In the AER's 2009 WACC review, it concluded that an appropriate estimate for a parameter known as gamma, which reflects the value of dividend imputation tax credits, was 0.65.[11] Three electricity networks, ETSA Utilities, Energex and Ergon Energy, successfully sought review of this decision. The Tribunal's 2010 judgment on the matter resulted in gamma being reset to 0.25.[12] When developing its 2013 Rate of Return Guidelines, the AER took the opportunity to "re-evaluate the conceptual framework and estimates underpinning the value of imputation credits," and settled on a new estimate for gamma of 0.4. This figure was used in its 2015 final decisions for networks in New South Wales, ActewAGL and Jemena Gas Networks. All of the businesses involved in the latest appeals sought review of this decision. In its judgment, the Tribunal found error in the AER's decision on gamma, and ordered it be set aside and re-determined using a gamma estimate of 0.25.

Forecasts of labour costs

In its 2009 regulatory proposal to the AER, Ergon Energy proposed to forecast the rate of real increase in labour costs using the rates of change specified in Enterprise Bargaining Agreements (EBAs) that it had negotiated with unions representing its workers. The AER rejected those rates of change and instead substituted forecasts of a wage price index (WPI), which had been derived by its own consultants. The AER argued that accepting the EBA rates would reduce Ergon Energy's incentives to negotiate efficient labour outcomes and would represent a shift from an incentive based regulation framework to cost of service regulation.

In its judgement on the matter, the Tribunal found that, whilst the AER's concerns about the undermining of efficiency incentives were legitimate, it had been wrong to automatically reject Ergon Energy's proposal in favour of its consultant's forecasts, without investigating the circumstances in which the EBAs had been negotiated.[13]

In its 2014 regulatory proposal to the AER, another business, SA Power Networks, proposed the same approach that Ergon Energy had used, and which the Tribunal had accepted in its 2010 judgment. In a replay of its previous decision for Ergon Energy, the AER rejected SA Power Networks' EBA rates, without investigating the circumstances in which SA Power Networks' EBAs had been negotiated, and instead substituted WPI forecasts derived by its consultant. Its reasons for doing so were very similar to those given when it rejected Ergon Energy's forecasts. In other words, the AER appears to have repeated the error that the Tribunal had corrected in 2010. SA Power Networks has since sought a merits review of the AER's decision, and the Tribunal's judgment on the matter is pending.

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Errors forever

Errors such as those described above would remain unaddressed (or at least untested) without the opportunity for merits reviews. As a case in point, consider the ACCC's 2014 determination on State Water's regulated prices. In that decision, the ACCC explicitly rejected State Water's proposal to adopt more cost-reflective tariffs (i.e. higher fixed charges and lower volumetric charges). It did so despite Pricing Principles that it had published three years earlier, which specified that:[14]

> *…charges must promote the economically efficient use of water infrastructure assets. In practice, this can be best achieved where the fixed and variable components of a charge recover the fixed and variable costs of providing services.*

Since its 2014 State Water decision, the ACCC has stated that:[15]

> *The ACCC is of the view that operators should…continue to move towards cost-reflective and upper bound pricing where practicable, but that operators should generally retain the discretion to set fixed and variable charges in a manner which best reflects their individual circumstances…*

Thus, we have a situation where the ACCC has issued clear guidance in published Pricing Principles that businesses should implement cost-reflective pricing, and has since reiterated that view. However, the ACCC appears to have abandoned its own Pricing Principles when actually making a regulatory determination.

Some have argued that this is a clear regulatory error that ought to be corrected. However, as no merits review regime is available to businesses regulated under the Water Charge Rules, there was no opportunity for State Water to even test the ACCC's decision with an independent review body.

CONCLUSION

Effective regulators should push boundaries in their decisions. As no regulator is perfect, those boundaries will sometimes be crossed, and the result will be a regulatory error that requires correction. Merits reviews protect society against such errors by providing checks and balances on regulators' decisions. They can also clarify how complex regulatory rules and the law should be applied in future.

The occurrence of appeals is not necessarily a sign of an unhealthy regulatory system. It indicates a regulator that is willing to take risks and challenge the businesses it regulates. That can be good for consumers. What to do, then, when a regulator's decisions are reviewed and found repeatedly to be in error? In such circumstances, the policy response should *not* be to reflexively scale back or remove the merits review regime. That would be akin to banning traffic cameras because too many drivers were caught speeding.

A better response would be for the regulator and policymakers to learn from the Tribunal's findings, and work towards improving the quality of future decisions.

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1 The idea was perhaps most memorably brought to life in modern times by Lisa Simpson, who challenges Homer on his meting out of vigilante justice, when she asks: "If you are the police, who will police the police?"

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

3 See, for instance: *Get set for bill shock: inside the legal fiasco pushing up electricity prices*, The Sydney Morning Herald, 3 March 2016.

4 At issue is whether the review mechanism should extend beyond judicial review – where a Court examines the lawfulness of the decision-making process – to a merits review which, as its name suggests, examines the underlying merits of the decision itself.

5 In its judgment, the Tribunal stated: "Indeed the AER (and the Tribunal on review) has a delicate task. Both must be conscious of the interests of consumers and the AER is bound to carefully scrutinise the information provided to it in support of a DNSP's opex allowance. It must also have regard to the legitimate business interests of a DNSP and should not put itself in an adversarial position in relation to the DNSP so that it may be perceived as a champion of consumers – cf: Re East Australian Pipeline Limited [2004] ACompT 8 at [16] and [33]."

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

7 Essential Services Commission Act 2001, section 55; Water and Sewerage Industry Act 2008, Part 5.

8 ACCC, Review of Water Charge Rules: Draft Advice, November 2015, p.137.

9 *Ibid.*

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

11 Gamma is used to determine the corporate tax allowance.

12 Application by Energex Limited (No 2) [2010] ACompT 7.

13 Application by Energex Limited (No 2) [2010] ACompT 7, paras. 57-58.

14 ACCC, Pricing principles for price approvals and determinations under the Water Charge (Infrastructure) Rules 2010, 1 July 2011, p.51.

15 ACCC, Review of Water Charge Rules: Draft Advice, November 2015, p.155.

CONTACT	**Dinesh Kumareswaran** dinesh.kumareswaran@frontier-economics.com.au
	Danny Price danny.price@frontier-economics.com.au
	Frontier Economics Pty Ltd
	FRONTIER ECONOMICS AUSTRALIA MELBOURNE | SYDNEY | BRISBANE
	www.frontier-economics.com.au