Economic Regulation Authority

Our Ref: D160399
Contact: Richard Begley

Mr Rob Heferen
Chair
COAG Energy Council Senior Committee of Officials
GPO Box 9839
CANBERRA ACT 2601

Dear Mr Heferen

The Economic Regulation Authority of Western Australia (**ERA**) welcomes the opportunity to respond to the COAG Energy Council Senior Committee of Officials' Review of the Limited Merits Review Regime Consultation Paper.

The ERA believes that the LMR regime should be retained, albeit with some changes to better meet the policy intent for the regime set out by CoAG in December 2012.

Major change – for example abolition of the LMR – should not be considered until the current round of access arrangement appeals have run their course. That will allow a proper evaluation of the merits or otherwise of LMR to be made.

Please find attached the ERA's submission expanding on these conclusions.

If you have any questions regarding this matter please contact Mr Richard Begley on (08) 6557 7968.

Yours sincerely

NICOLA CUSWORTH
CHAIR

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Level 4, Albert Facey House
469-489 Wellington Street
Perth Western Australia 6000

PO Box 8469
Perth Business Centre
Western Australia 6849

Telephone 61 8 6557 7900
Email records@erawa.com.au
Website www.erawa.com.au

Submission to the CoAG Energy Council's 2016 review of the Limited Merits Regime

7 October 2016

Economic Regulation Authority
WESTERN AUSTRALIA

For further information, contact:

Economic Regulation Authority
Perth, Western Australia
Phone: (08) 6557 7900

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Summary

The Economic Regulation Authority (**ERA**) is the Western Australian regulator for the purposes of the *National Gas Access (WA) Act 2009*, which gives effect to the National Gas Law.

The ERA recently participated in an application for Limited Merits Review (**LMR**) by ATCO Gas Australia in relation to its Mid-West and South-West Gas Distribution Systems access arrangement. The ERA therefore has practical insight into the recent operation of the LMR regime.

The policy principles for LMR, and the approach by which the Australian Competition Tribunal (**Tribunal**) could deliver on those principles, were clearly articulated by the CoAG Standing Council on Energy and Resources (**SCER**) in December 2012 and June 2013. SCER, among other things:

- affirmed that, in interpreting the National Gas Objective, the long-term interests of consumers (with respect to price, quality, safety, reliability and security of supply) are paramount;
- considered that achieving the most preferable decision in the pursuit of this objective should be the aim of both regulator and review body alike;
- confirmed and clarified that LMR should:
  - providing a balanced outcome between competing interests and protect the property rights of all stakeholders;
  - maximise accountability by allowing review of decisions;
  - drive continual improvement in initial decision making;
  - minimise the risk of gaming, time delays and cost;
- considered that the LMR regime should:
  - be transparent around how the review and decision-making processes have taken into account the long term interests of consumers;
  - enable the review body to review the decision using information that was available at the time of the original decision;
  - require the review body to remit more complex matters to the original decision-maker where it considers major revisions are required.

An important element in assessing the effectiveness of the LMR regime is its ability to establish a body of precedent which – over time – works to clarify the law and rules, and at the same time limit subsequent appeals activity. That precedent drives the 'continual improvement' referred to by SCER, quoted above.

However, the revised (post-2013) LMR regime is still relatively new. There have been very few completed appeals processes since the 2013 changes to LMR were made. Importantly, at the same time, there were the concurrent November 2012 rule changes by the Australian Energy Market Commission, which had the effect of re-opening the regulatory approach to the determination of the rate of return. The previous precedent for the rate of return was overturned.

The ERA considers that many of the perceived problems with LMR, including the recent:

- frequent appeals;
- increasing complexity of decisions; and
- time taken to achieve decisions;

were exacerbated by those 2012 concurrent National Gas Rule changes.

It therefore is not possible to fully evaluate the effectiveness of the LMR regime at the current time. Nonetheless, the ERA's experience is that LMR has already done much to constrain subsequent appeals activity, such that the perceived problems will attenuate with time. Accordingly, the ERA considers that the LMR regime should be given more time to prove its worth before any major change is made.

However, the ERA considers that some aspects of the current LMR regime have not been functioning as intended:

- the LMR regime generally achieves materially preferable decisions, that are in the long term interests of consumers, but some aspects of the regime appear less than optimal, including:
  - the potential under-resourcing of the Tribunal, which may be impeding its ability to deal adequately with the complexities of regulatory decisions in the allowed time;
  - the Tribunal's apparent reluctance to remit complex matters back to the regulator, which exacerbates the tendency for appellants to view it as a de facto second regulator;
  - the sometimes less than clear communication of Tribunal decisions, with at times apparent inconsistencies between the reasons and orders;
- the fact that less than material issues are being brought to appeal, on which subsequent orders are made;
- the ability for consumers to effectively participate is problematic.

The ERA considers that it is difficult to avoid formal legal approaches or adversarial process under the current *rules based* approach. It follows that many of the concerns with LMR stem from the incentives established by the framework for error and discretion correction, rather than from the LMR regime or review body per se. The ERA considers that changing the review body would do little to change the key features of the regime, while the error correction framework remained.

The only way to effect real change to the adversarial system and the related incentives for appeal would be to change the regulatory framework – away from a rules based approach – to one that provided incentives for the service providers and consumers to work towards a mutually beneficial regime. This is an objective of some new regulatory approaches overseas. However, the costs and benefits of such a change are beyond the scope of this review, and of this submission.

Overall, despite these concerns, the ERA considers that merits appeal is an important and worthwhile objective. Provided that the Tribunal makes *materially* preferable decisions in the long term interests of consumers – consistent with the relevant provisions of the National Gas Law and National Electricity Law – then consumers should, by definition, be better off after an LMR appeal.

The ERA therefore considers that the best option at this time would be to make incremental changes to the existing LMR framework. Those changes should involve:

- clarifying the role of the Tribunal, and then illustrating how that role might have been exercised and communicated, with reference to recent decisions;
- applying materiality thresholds to *individual* matters, inclusive of inter-related constituent elements;
    - the resulting threshold could perhaps be lowered to 1 per cent, or $2.5 million, whichever is the lesser;
- allowing for Tribunal resources to be increased, flexibly, as circumstances require it;
- removing the requirement for the Tribunal to 'consult' with consumers, instead continuing to resource the ability of consumer groups to engage formally in the appeal process.

The ERA believes that abolition of the LMR should not be considered until the next review, say in a further three years' time. That should allow time for the current round of appeals to run their course, such that a better evaluation of the merits or otherwise of LMR, and the resulting body of precedent, could be made.

Finally, the ERA considers that relying on judicial review alone provides the best alternative to LMR, should it be determined that LMR is no longer warranted. This option is preferred to establishing a new investigatory body, with a single ground of appeal, as such an approach would tend to further entrench the problems with having a second/ultimate regulator.

Introduction

1. This submission to the Limited Merits Review Project Team evaluates a range of issues associated with the existing Limited Merits Review (**LMR**) regime.

Context

2. The Economic Regulation Authority (**ERA**) is the Western Australian regulator for the purposes of the *National Gas Access (WA) Act 2009* and the National Gas Law. It has participated in several recent reviews before the Australian Competition Tribunal, including one under the revised post-2013 regime:

   - Western Australian Gas Networks – ACompT 14 & 15 of 2011;
   - DBNGP (WA) Transmission – ACompT 14 of 2012 (this appeal was also subject to judicial review before the Western Australian Supreme Court);
   - ATCO Gas Australia – ACompT 10 of 2016.

3. The ERA notes that regulators' decisions have been increasingly subject to complex, lengthy and costly appeals processes. The Consultation Paper reports that over 50 per cent of regulatory decisions on electricity network revenue and gas access arrangements – since the 2013 reforms were implemented – have been subject to applications for review.[1] Two out of the ERA's three recent 2015-16 decisions have been appealed.[2]

4. Recourse to appeal by service providers is a reflection of the potential rewards. These rewards establish strong incentives for service providers to target high value elements of the regulatory decision through appeal:

   - With error correction, the expected value of an appeal can be very large. For example, a 20 basis point swing on the rate of return – given an illustrative regulated asset base of $2 billion – is worth $4 million per annum to the service provider, or $20 million over a five year access arrangement period. Even with only a one in three chance of success, the expected value is in excess of $6 million over the next regulatory period, and potentially more again in net present value terms over multiple future regulatory periods.
   - The downside to failure of appeal are the legal costs, but at an estimated $1 – 2 million for the service provider, these costs are potentially only a small proportion of the expected return. The service provider at no stage is liable for the costs of appeal for other parties, such as the regulator or a consumer body.

5. There is little downside risk for service providers in appealing.

6. Fundamental to these incentives is the 'error correction' framework. Error correction is a feature of the rules based approach in the law, and of the potential for appeal under the law. Accordingly, these incentives would persist irrespective of the appeal

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[1] CoAG Energy Council Limited Merits Review Project Team, *Review of the Limited Merits Review Regime Consultation Paper*, 6 September 2016, p. 10.

[2] These include the ATCO decision referred to above, as well as the ERA's 30 June 2016 Dampier Bunbury Natural Gas Pipeline decision.

body (whether that body be LMR, judicial review, or perhaps even some new investigative body).

7. The incentives to appeal delivered by the error correction focus of the LMR were to have been moderated by the 2013 reforms, specifically, through the introduction of the concept of a materially preferable decision.[3] However, this measure appears to have met with limited success in limiting appeals.[4]

8. As a related point, with the current approach involving *limited* error correction there are no (unknown) potential 'collateral' costs for the appellant, as might occur with a single ground of 'error' review.

9. The only way to remove completely such incentives for appeal which result from error correction would be to move away from allowing appeals entirely. The ERA notes that this is an objective of some new regulatory approaches in the United Kingdom (for example Scottish water regulation). However, the costs and benefits of such a change are beyond the scope of this review, and this submission.

10. Given the incentives, service providers and their consultants are innovative in probing for areas of high return where new material might make a difference in appeal:

    - A common practice is to pursue incremental complexity, based on learning from previous (often failed) review processes. This has been typical in the approach to the rate of return, where the models proposed and related issues have become ever more complex over time.[5]
    - The potential to appeal establishes an adversarial approach during the regulator's review.
    - The outcome is a very formal legalistic process for the regulatory review itself. Legal experts are involved from the outset, adding to costs.

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[3] The CoAG Energy Council noted (Standing Council on Energy Resources, Regulation Impact Statement Limited Merits Review of Decision-Making in the Electricity and Gas Regulatory Frameworks Decision Paper, 6 June 2013, p. 26):

> '…changing the requirements for being granted leave for reviews, such as through requiring an applicant to make a prima facie case that a materially preferable decision exists, is likely to have implications for the number of appeals for review of covered decisions…'

and (Standing Council on Energy Resources, Regulation Impact Statement Limited Merits Review of Decision-Making in the Electricity and Gas Regulatory Frameworks Decision Paper, 6 June 2013, p. 39):

> '…given the objective of the limited merits review framework is to ensure that outcomes from this process are those that are materially preferable in the context of the long term interests of consumers as set out in the NEO and NGO, the existing grounds for review will be amended so that an additional obligation will be placed on the applicant to establish a prima facie case that addressing a matter raised in its application for review (in the case of revenue determinations…
>
> SCER considers that the above changes will introduce a higher threshold for reviews (in addition to the existing materiality threshold of $5,000,000 or 2 per cent of the overall revenue determination) and is likely to reduce the use of the review mechanism as a routine part of the regulatory process as well as address current concerns regarding 'cherry-picking' of issues for review.'

[4] There is evidence that appeals are targeted by service providers as the backstop throughout the determination process. For example, most consultants' reports received from service providers are prefaced by the standard language setting out knowledge of the requirements of the Court.

[5] ATCO's recent appeal of the ERA's decision on depreciation (see Australian Competition Tribunal, *Application by ATCO Gas*, [2016] ACompT10, 13 July 2016), for example, 'learnt' from and responded to the previous unsuccessful appeal by APA GasNet (see Australian Competition Tribunal, *Application by APA GasNet (No. 2)*, [2013] ACompT8, 18 September 2013).

11. The ERA considers there is also a further incentive to try to lead the regulator into 'error' during the access arrangement review. Service providers have the following means at their disposal to do this:

- swamping the regulator with information – bulking up submissions with numerous complex consultants' reports, each raising multiple issues.[6] The regulator then needs to respond to each point, lest it be found to not have considered all the relevant material. That exerts pressure on the regulator in the limited time available, particularly where ever more complex issues are raised;
- making key points in submissions, but perhaps not expanding on them fully, thereby obscuring the path to the best decision (holding over clarity or amplification for the appeal);[7]
- responding slowly to information requests from the regulator, and then providing a less than full explanation.[8]

12. These factors combine to allow the service provider some leeway to restrict full information disclosure until a matter is before the Tribunal, even though, strictly speaking, this is not allowed under the rules of appeal. There is then an increased likelihood that the regulator will not satisfactorily have addressed an issue during its regulatory review. This increases the chances that the Tribunal will find error on the part of the regulator and if the matter is not remitted to the regulator, the Tribunal may seek to rectify the error in favour of the service provider. This potential to game the process enhances the incentives for the service provider to target the appeal through the regulatory review process.

13. As noted however, such practices are a by-product of allowing rules-based appeal. Changing the review body might do little to remove these incentives, although judicial review alone might attenuate them (at the expense of some loss of 'merits' review – see below).

14. Despite these issues, once an application for review is granted leave to proceed,[9] then the ability of the LMR process to deliver a preferable decision is determined by

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[6] Service providers often take the opportunity to submit further material when the ERA calls for public submissions on its draft decision and the service provider's response to that draft decision. Dampier Bunbury Pipeline (**DBP**), for example, made a further submission in response to the ERA's 22 December 2015 call for public submissions on its Draft Decision. DBP first responded to the Draft Decision on 22 February 2016 (meeting the ERA's timeframe for DBP's 'revision period'). That response contained 10 consultant reports dealing with the rate of return and gamma. In a further submission on 22 March 2016 – within the time period allowed for public submissions, but after the revision period – DBP included a further consultant report on gamma.

[7] This was a clear issue with the submission of ATCO on the matter of the method for depreciation. The Tribunal ultimately found that the ERA was not in error in rejecting ATCO's proposed depreciation approach.

[8] For example, spreadsheet models were not provided by ATCO, initially, in relation to its evidence on the impact of its proposed depreciation method. When provided in response to the ERA's request, the provided spreadsheets contained links to other spreadsheets, which were not provided. Dealing with this process absorbed decision time.

[9] The materially preferable test must also be satisfied in the application for leave. That is, the applicant must show a prima facie case that if it there is an error, correcting the error will result in a 'materially preferable' outcome for the long term interests of consumers.

the quality of the Tribunal's analysis and decision making. The Tribunal's LMR decision may be to either:

- find the regulator's decision was not affected by a relevant error and therefore the decision is upheld; or
- find the regulator in error and either:
  - uphold the existing decision as materially preferable; or
  - find that correction of the error will result in a materially preferable decision.

15. In the latter case, either a substitute decision is made by the Tribunal, or the decision is remitted back to the regulator to be remade.

Concerns with the LMR regime

16. The ERA considers that some aspects of the current LMR regime have not been functioning as intended:

- the regime generally achieves materially preferable decisions, that are in the long term interests of consumers, but some aspects of the regime appear less than optimal, including:
  - the potential under-resourcing of the Australian Competition Tribunal, which may be preventing its ability to deal adequately with the complexities of regulatory decisions in the allowed time;
  - the Tribunal's apparent reluctance to remit complex matters back to the regulator, which exacerbates the tendency for appellants to view it as a de facto second regulator;
  - the sometimes less than clear communication of Tribunal decisions, with at times apparent inconsistencies between the reasons and orders;
- the fact that less than material issues are being brought to appeal, on which subsequent orders are made;
- the ability for consumers to effectively participate is problematic.

17. These issues are discussed in what follows.

Achieving materially preferable decisions

18. Generally, the ERA's experience has been that the Tribunal has been effective. Orders to vary regulator's decisions appear intended to be materially preferable.[10]

[10] The ERA notes that CoAG in its 2013 Decision RIS (Council of Australian Government Standing Council on Energy and Resources, *Regulation Impact Statement: Limited Merits Review of Decision-Making in the Electricity and Gas Regulatory Frameworks: Decision Paper*, 6 June 2013) did not explicitly define what it meant by 'materially preferable'. The Yarrow Review linked the term to the materiality threshold (Professor George Yarrow, The Hon Michael Egan, and Dr John Tamblyn, *Review of the Limited Merits Review Regime, Stage Two Report*, 30th September 2012, p. 39). The ERA takes materially preferable to mean:

- a decision is 'preferable' in the sense that it better meets the National Gas Objective; and

19. A complicating element for the evaluation of the LMR framework – in relation to the recent 2015 appeals under LMR – relates to the major gas and electricity rule changes made by the Australian Energy Market Commission (**AEMC**) in 2012.[11] Those rule changes had the effect of 'throwing the gate wide open' for acceptable approaches to the rate of return.

20. Prior to that point, the rate of return method had been more tightly bound by a number of prior decisions by the Tribunal. The Tribunal – in rejecting the appeals of Dampier Bunbury Pipeline and Western Australian Gas Networks through 2010 to 2012, and in earlier appeals – had clearly defined an acceptable approach for estimating the rate of return. The resulting body of precedent was, in effect, equivalent to a 'rate of return guideline'.

21. However, the AEMC's rule changes rendered that body of precedent redundant. The ERA considers that the ensuing 'Rate of Return Guidelines' did little to provide substitute bounds, as they were non-binding. Despite much effort going into the Rate of Return Guidelines, they were largely ignored by the service providers. In the ERA's case, the Rate of Return Guidelines contributed to development of Final Decisions. However, the ERA's position necessarily evolved over time in response to service providers' submissions, post the Guidelines (those submissions also moved on from positions submitted for the Guidelines development).

22. The Tribunal's PIAC-Ausgrid decision was the first test of a regulator's decision-making under the new rules. The scope was broad. The volume of material was overwhelming, given the timeframe of the appeal.[12] The ERA has concerns that the Tribunal was under-resourced to deal with such a large task within the allotted time. Nonetheless, despite that possible limitation, much was done by the Tribunal to set 'bounds' on what were, and were not, reasonable discretions by the regulator, particularly with regard to the rate of return. That precedent worked immediately to constrain subsequent appeal activity.[13]

- a preferable decision is 'material' when it contributes to overall achievement of the materiality threshold set out in the National Gas Law at s. 249, being the lesser of $5 million or 2 per cent of the average annual regulated revenue of the covered pipeline service provider.

As an example, the Tribunal, in its gamma decision for the ERA stated (Australian Competition Tribunal, *Determination*, ACompT 10 of 2015, 13 July 2016, p. 157, [693]):

> The Tribunal is satisfied that in so acting in setting aside the relevant decisions of the ERA, and in remitting, will likely result in a decision that is materially preferable to the relevant decision set aside in making a contribution to the achievement of the NGO.

The irony is that the resulting variation in revenue resulting from the ATCO gamma decision is estimated by the ERA to be around $0.25 million, which is considerably below the threshold of materiality. However, the ERA did not dispute, at the outset of proceedings, ATCO's claim of materiality for this item ($3.61 million). Hence, the Tribunal cannot be criticised for its decision, given the facts that were before it.

[11] Australian Energy Market Commission, *Rule Determination: National Electricity Amendment Rule 2012 and National Gas Amendment Rule 2012*, 29 November 2012.

[12] The Tribunal members for the AER's 2015 PIAC-Ausgrid etc appeals were required to deal with a million pages of material in a very compressed timeframe. Australian Competition Tribunal, *Applications by Public Interest Advocacy Centre and Ausgrid*, [2016] ACompT1, 26 February 2016, p. 304.

[13] For example, ATCO in 2016 dropped its appeal against the reliance by the ERA on a single model – the Sharpe Lintner Capital Asset Pricing Model – for estimating the return on equity, following the separate PIAC-Ausgrid Tribunal finding of no error with regard to the similar reliance by the Australian Energy Regulator. Further bounds on what constituted reasonable discretion for the return on equity were established by the (separate) 2016 ATCO decision.

23. However, some aspects of the Tribunal's 2015 PIAC-Ausgrid decision appear less than optimal. Two case studies – relating to gamma and to the definition of the benchmark efficient entity – are described in detail in Appendix A as a means to illustrate this. In this context, the ERA considers that the PIAC-Ausgrid decision provides an instructive example to examine the effectiveness of the current application of the LMR.

24. Specifically, in relation to the gamma decision, the Tribunal did not remit the matter back to the AER, but rather selected a value for gamma of 0.25. In its deliberations, the Tribunal acknowledged: [14]

> …that the SFG 2013 Study represents one point of view. As in a number of instances in these matters, there are conflicting expert views. Without the benefit of learning further from the experts, the Tribunal (like the AER) is faced with the selection between competing views.
>
> There are finely balanced decisions to be made in that light.

25. The ERA considers that the Tribunal, in not remitting such a complex technical matter back to the regulator, did not fully incorporate into its decisions the intent of the 2013 changes.

26. The ERA observes that the Tribunal could have instead:

- set out clearly its logic in rejecting the value for the utilisation rate as being the 'complex weighted average' – by wealth and risk aversion, across individual investors – thereby supporting its decision that the value of the utilisation rate is given by the marginal investor in the stock market;[15]
- remitted the matter back to the AER to remake its decision on basis that the value for theta be derived from implied market values.

27. In that way, the Tribunal would have communicated its reasoning clearly, and also ensured that the best estimate was made from an implied market value perspective, rather than relying on a single study of (in our view) questionable validity.

Materiality thresholds can be gamed

28. The post-2013 LMR regime requires that materiality be established from the outset, before grounds of review can be granted. There can be no question as to the threshold for the materiality of the appeal. The legislated threshold is the lesser of $5 million or 2 per cent of average annual regulated revenue.

29. However, service providers are able to combine a number of small issues with one larger issue for the purpose of meeting the materiality threshold. Once the criteria on one item is met – which is relatively easy when there is a rate of return ground – the service provider can then add a range of small, non-material items. That leads to higher regulatory costs on the Australian economy.

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[14] Australian Competition Tribunal, *Applications by Public Interest Advocacy Centre Ltd and Ausgrid*, [2016] ACompT1, 26 February 2016, p. 292.

[15] The ERA considers this is a key hinge for the gamma decision, but the Tribunal did not address it at all.

30. An example of the problem associated with the combined threshold is provided by the recent ATCO appeal:

- In ACT 10 of 2015, ATCO was successful in seeking leave for review of a number of grounds which individually did not meet the materiality threshold. This is permissible under the current materiality thresholds of $5 million or 2 per cent of average annual regulated revenue for the total grounds.
- Specifically, with the revenue impacts stated by ATCO in its leave application to the Tribunal, two items would not have individually met the materiality threshold.
  - One of these items was indeterminable at the stage of application as it related to the cost pass-through mechanism. However, ATCO did note in its application that if it was successful on this ground it might increase revenue by some $85,000 or more.
  - The 'corporate support opex' item was estimated to increase revenue by only $1.32 million.

31. The consideration of such matters in both of these cases caused a significant cost to society (the Western Australian taxpayer for the ERA's costs and ATCO for its costs which would lower its actual return). The legal costs of litigating such grounds – both in terms of time and money – do not justify the amounts under appeal.

Smaller consumers find it difficult to engage with the process

32. The ERA considers that effective consumer engagement can be a challenge.

- Some larger consumers – such as major mining companies – do engage effectively in gas transmission reviews. For example, BHP provided submissions to the ERA's recent Goldfields Gas Pipeline review.
- However, there is an issue regarding input from smaller consumers.
  - The ERA specifically alerted the Western Australian Council of Social Services of the opportunity for it to make a submission in the ATCO access arrangement review, but no submission was received (the issues may have been too technical for the Council to be able to engage).
  - Alinta and Kleenheat – the Western Australian gas retailers for small gas users – did submit, although their interests may be more aligned with those of a major user than of small customers.

33. In the recent ATCO decision, the Tribunal invited stakeholders to meet with it, but only two attended – Dampier Bunbury Pipeline and Alinta. Neither party made any form of submission.

Evaluation of options to address concerns

34. This section provides the ERA's views on changes that might be implemented to improve the review process at the current time.

35. The ERA considers that providing for review of regulatory decisions recognises that regulators can make errors in law or of fact, or exercise unreasonable discretion. The ERA considers that regulators should be held accountable for their decisions

through a review process of some kind. Doing so is clearly in the long term interests of consumers.

36. Options are to:

- make no change (Option 1);
- improve the LMR framework (Option 2); or, adopt one of the alternatives to limited error correction through LMR, which are:
- a 'single ground for appeal' merits review[16] – or error and discretion correction writ large – to be considered by a new investigative body (Option 3);[17]
- no merits review (Option 4), but rather only 'judicial review', relating only to the possible errors at law.

No change

37. The ERA considers that the no change option is not preferred at the current time. A number of quite modest incremental changes could be undertaken with option 2 to improve the functioning of the LMR regime.

Improve the LMR framework

Clarifying the role of the Tribunal

38. The ERA notes that Justice Mansfield made comments at the recent Australian Competition and Consumer Commission Regulatory Conference regarding a lack of clarity as to the role of administrative review.[18]

39. Given that concern, the ERA considers that a clear restatement of the role of the LMR regime by CoAG would be beneficial. The review might benchmark the Tribunal's recent decisions against that role and the related framework.

40. CoAG SCER already has provided direction, through the 2013 legislated changes, by means of the following statements, that it: [19]

> Affirms that, in interpreting the National Electricity Objective and the National Gas Objective, the long-term interests of consumers (with respect to price, quality, safety, reliability and security of supply) are paramount in the regulation of the energy industry.
>
> Affirms that the objective of the review framework, in common with the objectives of the laws, is to ensure that relevant decisions promote efficient investment, operation, and use of energy infrastructure, and are consistent with the revenue and pricing

[16] There should only be a 'single ground of appeal to the effect that there are reasons for believing that a preferable decision exists, and hence that the primary regulator's decision does not promote efficiency for the long run interests of consumers (and, in that sense, the determination is 'wrong on the merits')' (Professor George Yarrow, The Hon Michael Egan, and Dr John Tamblyn, *Review of the Limited Merits Review Regime, Stage Two Report*, , 30th September 2012, pp. 34-35).

[17] The 2012 Yarrow review recommended that such a task not be undertaken by a judicial body such as the Australian Competition Tribunal (Professor George Yarrow, The Hon Michael Egan, and Dr John Tamblyn, *Review of the Limited Merits Review Regime, Stage Two Report*, 30th September 2012, pp. 4-5).

[18] See https://www.accc.gov.au/about-us/conferences-events/accc/aer-regulatory-conference/accc-aer-regulatory-conference-2016.

[19] Council of Australian Government Standing Council on Energy and Resources, *Statement of Policy Intent: Review Framework for the Electricity and Gas Regulatory Decision Making*, December 2012.

principles of the National Electricity Law and National Gas Law, in ways that best serve the long-term interests of consumers.

Considers that, consistent with the Australian Administrative Law Policy Guide, achieving the most preferable decision in the pursuit of this objective should be the aim of both regulator and review body alike.

Considers furthermore that the long-term interests of consumers should be the sole criterion for determining the preferable decision, both at the initial decision-making stage and at merits review.

Considers that the review process should promote an accountable and high performing regulator such that material error is minimised and notes that the focus on the correction of selected errors is not equivalent to – and may not in itself lead to – the achievement of the most preferable overall decision in the long term interests of consumers.

Considers that a well designed limited merits review process can achieve the policy objectives outlined above.

41. SCER went on to confirm and clarify that the LMR should deliver on the above principles through:[20]

- providing a balanced outcome between competing interests and protect the property rights of all stakeholders by:
  - ensuring that all stakeholders' interests are taken into account, including those of network service providers, and consumers; and
  - recognising efforts of stakeholders to manage competing expectations through early and continued consultation during the decision making process;
- maximising accountability by:
  - allowing parties affected by decisions appropriate recourse to have decisions reviewed.
- maximising regulatory certainty by:
  - providing due process to network service providers, consumers and other stakeholders; and
  - providing a robust review mechanism that encourages increased stakeholder confidence in the regulatory framework
- maximising the conditions for the decision-maker to make a correct initial decision by:
  - providing an accountability framework that drives continual improvement in initial decision making;
- achieving the best decisions possible by:
  - ensuring that the review process reaches justifiable overall decisions against the energy objectives;
- minimising the risk of "gaming" through:
  - balancing the incentives to initiate reviews with the objective of ensuring regulatory decisions are in the long term interests of consumers; and

[20] Ibid.

- minimising time delays and cost by:
  - placing limitations on the review process that avoid or reduce unwarranted costs and minimise the risk of time delays for reaching the final review decision.

42. SCER also noted that the Tribunal, in undertaking a review, should:[21]

- demonstrate that it provides, compared to the original decision, a materially preferable outcome in the long term interests of consumers as set out in the NEO and NGO;
- seek guidance from the parties to the review and any interveners on interlinked areas;
- demonstrate how it has taken into account interlinked areas when determining whether a materially preferable overall decision in the long term interests of consumers as set out in the NEO and NGO exists;
- remit decisions to the original decision-maker routinely and only vary decisions where these are not of a highly technical or economic nature; and
- remit decisions to the original decision-maker where there is likely to be a materially preferable outcome in the long term interests of consumers as set out in the NEO and NGO, but where establishing this would require redoing the entire, or a significant proportion of, the original decision-making process.

43. Those are clear instructions.

44. At the least, the ERA considers that the intent that the Tribunal remit matters back to the regulator should be re-emphasised. As noted above at paragraph 24, the ERA considers that the Tribunal has not always done so, when perhaps it should have.

45. The ERA considers that one important contributor to ensuring that the decisions of the Tribunal are materially preferable would be to clearly define what is meant by the term, and then to revisit the materiality thresholds requirements of the regime. This is discussed in the next section.

Threshold for review

46. The materiality of the appeal must meet the legislated threshold.

47. However, as noted, service providers are able to aggregate a number of small issues into one larger issue for the materiality threshold. Once the criteria on one item of appeal is met – which is relatively easy when there is a rate of return ground – the service provider can then add a range of small, non-material items. The ERA's experience with the ATCO appeal was that a number of very small items took up a significant proportion of the appeal process (see paragraph 30). That leads to higher regulatory costs on the Australian economy.

48. To address this, the ERA considers that *each* ground of appeal, *inclusive of inter-related constituent elements*, should be subject to a materiality provision. The resulting threshold could then perhaps be lowered to 1 per cent, or $2.5 million,

[21] Council of Australian Government Standing Council on Energy and Resources, *Regulation Impact Statement: Limited Merits Review of Decision-Making in the Electricity and Gas Regulatory Frameworks: Decision Paper*, 6 June 2013, p. 4.

whichever is the lesser. That would then appear more commensurate with the legal costs of appeal.

49. Such a threshold would have removed the two non-material elements of ATCO's recent appeal, which were worth only $1.47 million ($1.32 million and $0.85 million combined – see paragraph 30), but which are estimated by the ERA have consumed legal and staff resources in the appeal approaching $0.5 million.

50. In addition, the gamma issue was contended by ATCO in its application to be worth $3.6 million. The ERA did not question this given the overall (combined) materiality of ATCO's application. However, the ERA in ACompT 10 of 2016 was found to have erred with respect to the value of gamma for ATCO, and the decision was remitted back. The end revenue impact of the change in the value of imputation credits – taking account of interrelated constituent elements (tax, the market risk premium estimate) – is estimated by the ERA to be around only $0.25 million in total over the whole access arrangement. Again, this item would not individually meet the materiality thresholds of $5 million or 2 per cent of average annual regulated revenue.

51. A benefit of an individual materiality threshold for each ground of appeal would be that the Tribunal (and the ERA) would examine service providers' claims for the materiality of individual items much more closely at the time of application for appeal. As illustrated by the ATCO appeal, a significant number of items would have not been granted leave. That would save time and resources.

Resourcing of the Tribunal

52. The ERA perceives that the increasing complexity of decisions – particularly with regard to the rate of return – may be stretching the ability of the Tribunal to fully consider the issues. The Tribunal would appear relatively under-resourced in this light. This is particularly the case for the 2015 decisions, given the extensive rule changes relating to the determination of the rate of return that were promulgated in 2012.

53. With time, the Tribunal may review and amend some of its decisions. After all, the legal process works with a body of precedent, which can evolve over time with new relevant information, and the ERA's view is that the Tribunal LMR process is no different.

54. However, one way of ensuring materially preferable decisions would be for the Tribunal to seek the assistance of the AER for information and making reports particularly when there is an extensive range of matters to be considered (Section 267 NGL). However, the Tribunal appears to be reluctant to use these provisions, which may be reasonable, given conflict of interest issues.

55. An alternative may be to appoint each member of the Tribunal a relevant associate, who could assist with drafting and background research. Such an option would then free up the Tribunal members' ability to spend time on the priority considerations, leaving some of the matters to the associate.

56. Overall, the ERA considers that some means should be established to increase the resources available to the Tribunal for certain complex matters. This need not be

automatic, but should be considered on a case by case basis. Such additional resources could be tailored to the task at hand.[22]

Communication of decisions

57. The ERA considers that the Tribunal could better communicate the reasoning of its decisions.

58. Such communication could be aided by a clear framework for its role and decision making, although, as noted above at paragraph 39, the ERA considers that the framework has already been spelt out. Nonetheless, the ERA considers that further clarification or reiteration of the role of the Tribunal, by CoAG, could assist. Evaluation by this LMR review of a selection of the Tribunal's recent decisions – in light of the objectives and framework for LMR – could be instructive for all stakeholders.

59. In addition, the ERA considers that poor communication is possibly an issue of resourcing. As noted above, better utilisation of existing assistance available to the Tribunal, or providing additional resources, could assist with the communication of resulting materially preferable decisions.

Limiting the extent of review material

60. The ERA considers that the material before the Tribunal should be limited to that which was before the regulator, as is currently the case under the National Gas Law (s. 258). Any further limitation however would not be desirable, in that it would limit the review process.

61. However, consideration could be given to limiting the frequency with which new material is contested before the Tribunal. For example, the suggestion that the Rate of Return Guidelines become binding could limit the frequency and cost of considering what is always likely to be a large body of material.

62. Regulator's decisions on binding Guidelines would need to be appealable. However, suitably constrained, there might be only one appeal on the *approach* to estimating the rate of return, every five years, rather than multiple appeals at each individual access arrangement review. That would work to limit costs, by combining all the relevant parties into a single determination.

63. The Guidelines development process could also benefit from the introduction of experts to the process (such as through roundtables, combined recommendations to the regulator from an expert panel etc). Ultimately though, a single body needs to decide on what is reasonable. The review for such a process – whether by LMR or by some other body – would need to judge whether the regulator was 'reasonable' in the way it took any expert views into account.

64. Subsequent individual network decisions could only be appealed if the regulator had not followed the prescriptions of the binding Guidelines. Some provision would need to be made for exceptional circumstances; however, that would necessarily need to

[22] For example, it may be possible within the legislation to engage topic experts, who were not conflicted, for specific matters.

have a very high threshold if the binding nature of the Guidelines was to be effective.[23]

65. If the Guidelines are not made binding, then they should be dispensed with. The ERA considers that there has been very little gained through the establishment of the current guidelines (although they did provide the first engagement between the regulated entities and the regulators on the newly introduced rate of return rules). Unfortunately, the twelve months it took to develop the Guidelines did not materially alter the incentive for the service providers to agitate preferred views that were not favourably addressed during the Guideline development process. The less-contentious parameters were not challenged when the service providers put forward their access arrangement revisions.

66. Overall, the ERA's preference is that the Guidelines are dispensed with. The ERA's preference is that the LMR process be given time to establish precedent, which effectively creates a 'guideline' for what are acceptable methods that are in the long term interests of consumers.

Consumer engagement

67. The ERA considers that effective consumer engagement can be a challenge.

- In the west, some larger consumers – such as major mining companies – do have the means to engage effectively in gas transmission pipeline reviews. For example, BHP provided submissions to the ERA's recent Goldfields Gas Pipeline review.
- However, there is an issue for the smaller consumer.

68. The ERA considers that a first best approach to engaging consumers is to ensure that the service provider does so from the outset when it is developing its proposed revisions.

69. The regulator then needs to ensure that it has processes in place to engage with consumers.

70. Following on from that, smaller consumers do need an effective body, which is sufficiently resourced to enable it to be an effective intervener in LMR matters. The new Energy Consumers Australia representative body could play an important role in this regard.[24]

71. The ERA does not consider that the Tribunal needs to meet with consumers. That goes beyond considering the material that was before the regulator. The current mechanism for consumer engagement by the Tribunal has not worked, and should be abolished.

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[23] That five yearly appeal would necessarily need to be absent *exceptional* circumstances, which would need to be defined. Such exceptional circumstances, for example, might be limited to:

- rule changes;
- Related non-rate of return matters impinging on the ability of the guidelines to achieve the rate of return objective.

[24] Energy Consumers Australia has a remit to advance the long term interests of consumers in national energy markets (that is, a market for energy established or regulated by one of the national energy laws, such as the National Gas Law).

A new investigatory body with single ground for appeal

72. With a single ground of review, aspects of the decision that were favourable to the service provider – and not appealed – could be re-examined, and subsequently adjusted to be less favourable.[25] Such an approach, while not completely removing the incentives to appeal, could attenuate them. However, such attenuation would depend on the extent to which the review body re-examined regulators' decisions in their entirety, or at least was perceived to be willing to do so.

73. Nonetheless, the ERA considers that a single ground of merit review potentially creates more problems than it solves. It goes beyond error correction and could become 'de novo' review, expanding the scope for error correction (the ERA notes the proposal under Option 3 for a new investigatory review body). It effectively makes the new investigatory body the second regulator, or even the ultimate regulator. That is an unnecessary duplication, adding costs for the parties. There could be additional costs in terms of establishing a body that is sufficiently resourced to deal with every aspect of a regulator's decision. There are likely to be further time delays and regulatory uncertainty. The ERA therefore does not favour a single ground of review.

Judicial review only

74. Judicial review does little to narrow the scope of any error correction, compared to merits review. However, it does tend to limit the examination of the regulator's discretion with regard to the achievement of a materially preferable outcome.

75. The judicial review process in Western Australia differs to that for the other states:

- The Australian Energy Regulator (**AER**) is subject to judicial review under the *Administrative Decisions (Judicial Review) Act 1977 (Cth)* (**ADJR Act**). Judicial review proceedings under the ADJR Act are required to take place in the Federal Court,[26] and State Courts are prohibited from reviewing any decision to which the ADJR Act applies.[27]
  - the AER's ADJR appeal on gamma and other aspects of the Tribunal's 2015 PIAC-Ausgrid decision is currently on foot.
- The *National Gas Access (WA) Act 2009* (**NGAA**) expressly provides that both judicial and merits reviews are available in respect of certain decisions made under the NGAA.[28]
  - The ADJR Act does not apply to a decision of the ERA but the Supreme Court of Western Australia has the power to review administrative decisions by reason of its inherent jurisdiction as a superior court to supervise the procedure of an inferior court or administrative tribunal.

[25] The Yarrow review recommended a single ground of review to remove the current asymmetry of the risk inherent in the current limited error correction framework. G. Yarrow et al, *Review of the Limited Merits Review Regime Stage 2 Report*, 30 September 2012, p. 4.

[26] See section 15 of the ADJR Act

[27] See section 9 of the ADJR Act

[28] See Part 4 of the ADJR Act

- ATCO and DBP both lodged appeals under the Supreme Court of Western Australia's rules for the recent ERA decisions:[29]

76. Recourse to judicial review under the *Administrative Decision (Judicial Review) Act 1977* (**ADJR**), or, in the case of Western Australia, the Supreme Court's jurisdiction to grant prerogative writs under the Supreme Court Rules, could:

- have potential advantages in limiting redress to errors of law only (that is, the review would not seek to move beyond the identification of the legal error and would not therefore delve into the merits of the regulatory decision, as occurs with LMR);
  - The point of discretion could be placed firmly with the regulator; although any error of law would be expected to be corrected through orders.
  - Such a step could see appeal activity decline markedly. Over time, a body of judicial review precedent would serve to constrain appeal activity.
- remove the LMR 'layer' of review, potentially saving on costs and time.

77. However, problems with judicial review arise in that:

- the adversarial nature of the process and the incentives related to error correction would remain;
- the amount of time taken to finalise matters may be considerably longer than where only LMR is involved;
- the 'merits' of a decision with respect to the legislated Objective are not reviewable, only to the extent that there has been an error of law and the regulator's decision is quashed and is to be remade;
  - the ERA understands that the judicial review process would only seek to identify errors of law and would not seek to re-make a final complex decision on the merits but would refer the matter back to the original decision maker. The relief sought in such an Application are writs of certiorari and mandamus. If the court grants a writ of certiorari, the decisions are set aside (or 'quashed'), while writ of mandamus would result in an order requiring the decision maker (the regulator) to re-make the Decisions according to law. Nonetheless, there is no requirement for the Court to remit, unless it considers it would otherwise become involved in undertaking an unduly complicated assessment;
- the judiciary may not be as well placed to make informed decisions which rely on economic expert judgment;
  - the ability to utilise concurrent expert evidence may mitigate such problems;
- consumer participation is not easily facilitated:
  - however, a first best policy approach to consumer participation is to fund an expert body which can participate effectively in the whole process, including ADJR/judicial review. Nonetheless, the ERA is sceptical that consumer groups will ever have the means to participate effectively in

[29] ATCO discontinued the ADJR appeal after the Tribunal's appeal decision in July 2016. However, the ERA still incurred some legal costs from that step.

the review process (this reinforces the importance of facilitating consumer input at the outset of reviews, with the onus on the service provider and the regulator to manage that input);

- the current national electricity and gas laws explicitly afford standing to consumer representative organisations to participate in limited merits review processes. These organisations may have standing for judicial review; however, to remove any doubt on this issue, legislation should guarantee standing for consumer groups in judicial review;
- in addition, where action was taken, consumer representatives would not be afforded the same cost protections that exist in the energy legislation. Further consideration should be given to how these protections can be preserved for judicial review hearings;
- the recently established Energy Consumers Australia is an example of such an entity;

- the regulator may then have less of a role in judicial review, as compared to LMR;
  - this would raise the importance of ensuring adequate consumer engagement in any ADJR/judicial review process, otherwise recourse to review could become one sided.

78. On balance, the ERA considers that abolition of LMR – moving to reliance on judicial review alone – is a significant step. There are as many downsides as upsides to such a move. The ERA is particularly concerned that judicial review:

- does not have the benefit of expert economic opinion – the likelihood that there would be decisions which are not materially preferable would be increased, not reduced;
- would remove an element of 'merits review' – possibly reducing the administrative fairness for stakeholders;
- potentially increases the amount of time taken to finalise decisions.

Conclusions

79. The LMR regime should be given more time to prove its worth before a major change is made. After all, there have been very few completed appeals processes since the complex 2013 changes were effected.

80. The ERA considers that it is difficult to avoid formal legal approaches or adversarial process under the current rules based approach. In particular, the concerns stem from the incentives established by the framework for limited error and discretion correction, rather than from the LMR regime itself. The ERA considers that changing the review body would do little to change this aspect, while the error and correction framework remained.

81. The only way to effect real change in those behaviours would be to change the whole framework – away from a rules based approach – to one that provided incentives for the service providers and consumers to work towards a mutually beneficial outcome.

82. Nonetheless, the ERA considers that the LMR framework *is* focussed on the long term interests of consumers. It can be argued that materially preferable decisions can be achieved, provided that the LMR process is clear about what that means, and

that there are no barriers within the regime to such an outcome. Materially preferable decisions can provide a clear benefit for consumers.

83. The ERA considers that the legal and other costs of the LMR process are proportionate to the benefits. Nor does the process take an unreasonable amount of time, provided that decisions are not further referred on to judicial review (although there is some evidence that the latter course is increasing in frequency).

84. A process where an appeals body attempts to identify a materially preferable outcome is a worthwhile objective. Provided that the Tribunal makes materially preferable decisions – consistent with the relevant provisions of the National Gas Law and National Electricity Law – then consumers should, by definition, be better off after an appeal.

85. The ERA therefore considers that the best option at this time would be to make incremental changes to the existing LMR framework. Those changes should involve:

- clarifying the role of the Tribunal, and then illustrating how that role should be exercised and communicated, with reference to recent decisions;
- applying materiality thresholds to individual matters, *inclusive of inter-related constituent elements;*
  - the resulting threshold could perhaps be lowered to 1 per cent, or $2.5 million, whichever is the lesser;
- allowing for the Tribunal resources to be increased, flexibly, as circumstances required it;
- removing the requirement for the Tribunal to consult with consumers.

86. The ERA believes that an abolition of the LMR should not be considered until the next review, say in a further three years' time. That should allow time for the current round of appeals to run their course, such that a better evaluation of the merits or otherwise of LMR could be made.

87. However, the ERA considers that judicial review provides the best alternative to LMR, should it be determined that LMR is no longer warranted. It is preferred to a new investigatory body overseeing review based on a single ground of appeal, as this would perpetuate issues relating to having a second/ultimate regulator.

88. As a final point, the ERA considers that the Rate of Return Guidelines are just another opportunity for testing the regulatory process and probing regulatory reasoning through the process of setting non-binding guidelines. Service Providers use the guideline process as another opportunity to build the case for new perspectives, which would otherwise have been dealt with during a regulatory decision making process. This has been the experience in the recent full cycle of regulatory resets. The ERA considers instead that if the review process is given time, it will establish an effective 'guideline' through precedent. On balance then, the ERA considers that the Guidelines should either be made binding (subject to a single/combined LMR appeal), or preferably, dispensed with.[30]

[30] In the event that the Guidelines were binding, say once every five years, and then appealable, the Tribunal would be able to deal with any (joint) appeal in one sitting. The Guidelines would then carry through to precedent. That would then help to narrow recourse to the Tribunal on rate of return matters for five years.

Appendix A Two case studies of Tribunal decision making

The gamma issue

89. In the recent PIAC-Ausgrid gamma decision, the Tribunal overturned the AER's decision to determine gamma at a value of 0.4.[31]

90. In making its decision, the Tribunal determined that the AER had erred in accepting the arguments of one set of experts over another. The Tribunal therefore considered that the AER's interpretation of gamma was misplaced. The Tribunal substituted its own decision.

91. However, key elements in the AER's argument appear to have been overlooked (at least to an informed outsider reading the Tribunal's decision). For example, the Tribunal in its PIAC-Ausgrid decision does not once reference the following statement by the AER, which we consider provides the key rationale for the AER's position:[32]

> We understand the utilisation rate to be the utilisation value to investors in the market per dollar of imputation credits distributed. In the Monkhouse framework, **the utilisation rate is equal to the weighted average, by wealth and risk aversion, of the utilisation rates of individual investors**.

92. Instead, the Tribunal hinges its decision on the following:

> ..we accept the Network Applicants' submission that these [dividend drop off] market prices reflect every consideration that investors make in determining the worth of shares to them and that the bond prices, and the yields that are derived from them, reflect every consideration that investors make in determining the worth of the asset to them, including "personal costs". Consequently, placing significant weight on market value studies is, in the Tribunal's view, consistent with evidence relied on by the AER to calculate the rate of return on capital.

93. In substituting its own decision, the Tribunal elects to stand in the decision maker's shoes, then prefers one set of expert views over another. The Tribunal itself says the following (which should be considered in light of the requirement under LMR that it find error with the AER discretion, not substitute its own view):[33]

> The Tribunal notes that the SFG 2013 Study represents one point of view. As in a number of instances in these matters, there are conflicting expert views. Without the benefit of learning further from the experts, the Tribunal (like the AER) is faced with the selection between competing views.
>
> There are finely balanced decisions to be made in that light.

94. However, despite that insight, the Tribunal, in its directions, is unequivocal in determining that the value for gamma should be 0.25. That the Tribunal would make such a decision, counter to the view of acknowledged experts, leaves many

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[31] Australian Competition Tribunal, *Applications by Public Interest Advocacy Centre Ltd and Ausgrid*, [2016] ACompT1, 26 February 2016.

[32] Australian Energy Regulator, p. 4-22.

[33] Australian Competition Tribunal, *Applications by Public Interest Advocacy Centre Ltd and Ausgrid*, [2016] ACompT1, 26 February 2016, p. 292.

unanswered questions. It is not clear, from reading its decision, why the Tribunal considered that the AER's exercise of discretion was in error. The ERA, in its recent GGP decision, in responding to the Tribunal's decision, stated:[34,35]

> In a recent decision on gamma, the ACT also, like Gray, concludes that the utilisation rate is the market value of the credits, and is therefore best estimated by studies using market data. The source of the ACT's belief that theta is a market value is claimed to be the Officer model, but the ACT does not explain at what point this conclusion is apparent in Officer's analysis.

and:[36]

> In its most recent decision on the value of gamma, the ACT provisionally concluded that the best estimate of theta is that provided by Gray, of 0.35. Given the ACT's view that theta is the market value of the credits, it is natural that the ACT would prefer market studies to other types of evidence. However, there are types of market evidence other than DDOs [Dividend Drop Off studies]. Implicitly, the ACT prefers DDOs over these alternatives but fails to explain why. Furthermore, there are DDO studies other than Gray's, most particularly that by the Authority. Implicitly, the ACT prefers Gray's study but again it fails to explain why. Furthermore, even if it had explained its preference for Gray's study, it has failed to explain why it prefers the methodology favoured by Gray. Inter alia, that methodology involves 'robust regression' with the default value for the tuning coefficient, and the Authority's study shows that alternative choices for that tuning coefficient produce significantly different estimates of the coefficient on imputation credits. So, implicitly, the ACT favours the default option for this tuning coefficient but has not provided reasons for its preference.
>
> In addition, the credibility of any statistical estimates depends upon how robust they are to the deletion of outliers. Gray's results are robust to the deletion of outliers if Gray's method of selecting them is adopted. By contrast, the Authority's results are not robust to the deletion of outliers using a different method of choosing them. This raises the possibility that Gray's results from his preferred approach would not be robust to the deletion of outliers if they were chosen by the Authority's method. So, implicitly, the ACT favours Gray's method of deleting outliers but has not explained why.
>
> In addition, any estimate of theta from a DDO study is sensitive to the degree of tax arbitrage, anomalous behaviour around ex-days, and market microstructure issues. So, implicitly, the ACT favours an estimate of theta that is exposed to all of these extraneous factors but fails to explain its reasons for doing so. It may be that the ACT has sound reasons for all of these implicit views but, without revealing them, there remain valid questions around these issues.

and:[37]

> In respect of the ACT's recent decision on gamma, the ACT states that 'it is appropriate to follow past practice', and this leads to an estimate of 70 per cent for all equities using ATO data. The ACT offers no reason for this decision. As discussed above, there are concerns about the accuracy of the ATO FAB and dividend data. Additionally, the natural comparators for regulated businesses are listed companies because the private regulated businesses are typically listed companies or

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[34] Economic Regulation Authority, *Final Decision on Proposed Revisions to the Access Arrangement for the Goldfields Gas Pipeline*, 30 June 2016, p. 313.

[35] The ERA's decision was not appealed by GGT. It follows that the ERA's value for gamma of 0.4 stands, not the Tribunal's value of 0.25.

[36] Economic Regulation Authority, *Final Decision on Proposed Revisions to the Access Arrangement for the Goldfields Gas Pipeline*, 30 June 2016, p. 333.

[37] Economic Regulation Authority, *Final Decision on Proposed Revisions to the Access Arrangement for the Goldfields Gas Pipeline*, 30 June 2016, p. 337.

> subsidiaries of listed companies, the distribution rates of listed companies are significantly higher than unlisted companies, and explanations for this are readily apparent. Furthermore, the ACT acknowledges that the ATO data are flawed.

95. However, the ERA in its recent ATCO appeal accepted the Tribunal's PIAC-Ausgrid decision, in the interests of regulatory certainty, cost, and materiality (the ERA's remitted decision of the revenue impact over the fourth access arrangement of varying the value for imputation credits to meet the Tribunal's direction is approximately $250,000). In finding that the ERA erred on gamma, the Tribunal noted:[38]

> The ERA accepted that it would undermine the effectiveness of the regulatory regime and would be against the public interest in consistency of decision-making for it to re-argue matters that have recently been considered and decided by the Tribunal in that matter, notwithstanding that aspects of the PIAC and Ausgrid decision relating to the value of imputation credits are currently the subject of an application for judicial review before the Federal Court.

The benchmark efficient entity issue

96. In its Ausgrid determination, the Tribunal considered, at length, the issue of whether the benchmark efficient entity (**BEE**) should be deemed to be regulated or not.[39] The Tribunal was unequivocal:

> It is the Tribunal's view that the BEE referred to in the RoR Objective is not a regulated entity. It need not necessarily be the one entity for the purpose of all regulatory decision-making in a particular regulatory period for all regulated service providers. [40]

97. In support, the Tribunal made the following points:

- The general underlying purpose of the economic regulation of regulated service providers is to:

  > …secure, so far as practicable, the… NGO in accordance with the RPP. To achieve that, the AER is required to make its regulatory determinations in relation to a regulated service provider, in an environment where there is no competition for the services it provides, but broadly speaking as if the relevant provider were operating in a competitive environment.[41]

- The benchmark efficient entity is to have a similar degree of risk as that which applies to the relevant DNSP in respect of the provision of standard control services.[42]

- The benchmark efficient entity, in the view of the Tribunal, is likely to refer to the hypothetical efficient competitor in a competitive market for those services:

  > Such a BEE is not a regulated competitor, because the regulation is imposed as a proxy for the hypothetical unregulated competitor. Otherwise, the starting point would be a regulated competitor in a hypothetically regulated market. That would not be consistent with the policy underlying

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[38] Australian Competition Tribunal, ACompT[10]2015,

[39] Australian Competition Tribunal, Applications by Public Interest Advocacy Centre Ltd and Ausgrid [2016] ACompT 1, 26 February 2016, pp. 242 – 248.

[40] Ibid, p. 245.

[41] Ibid.

[42] Ibid, p. 246.

> the purpose of the NEL and the NGL in relation to the fixing of terms on which monopoly providers may operate. Indeed, the concept of a regulated efficient entity as the base comparator would divert the AER from the role of fixing the terms for supply of services on a proxy basis compared to those likely to obtain in a competitive market, and focus its attention on some different and unidentified regulated market. [43]

- The Tribunal does not accept the AER's argument that a regulated service provider is insulated from comparative risk, which is implied by the reference in the rate of return objective to the need for the benchmark efficient entity to have a 'similar degree of risk' as the relevant service provider. Nor did the Tribunal accept the AER's argument that 'the BEE must be a regulated entity because it is otherwise an entity with a risk profile different from, rather than similar to, the risk profile of the regulated DNSP or network provider'. The logic of the Tribunal then is to reject the AER's contention that the rates of return of investors for investing in regulated service providers is commensurately lower than would occur in a competitive market.[44] The Tribunal considered that the AER's analysis in this context involved a degree of circularity.[45] Importantly, the Tribunal states that:

  > … it is not likely that within the structure of the NER and NGR, premised (as the AER acknowledges) on imposing by regulation a pricing structure for monopoly service providers by reference to the hypothesised efficient pricing structure in a workably competitive market, there would be a discrete subset of tests prescribing a comparison with a regulated service provider. There is nothing in the AEMC materials leading to the 2012 Rule Amendments which indicates such an intention.[46]

98. The Authority notes that if the Tribunal's position is taken to its logical conclusion, the decisions on the all the parameters in the cost of capital will have to be remade. This is because these parameters have been set with reference to service providers that have been defined as electricity and gas network service providers. These service providers are often natural monopolies and are therefore regulated. In Australia, service providers that have publically available information useful in benchmarking, also tend to have regulated operations.

99. The evaluation of efficiency needs to be made with reference to a benchmark. In practice, excluding regulated firms in the Australian market in the benchmarking process would lead to the exclusion of firms which are natural monopolies. Using a benchmark that operates in the same industry as the 'service provider' is of primary importance if it is to be of any relevance. The Australian Energy Market Commission (**AEMC**) defined 'service provider' as 'electricity and gas network service providers'.[47] If the definition of the service being provided by the benchmark is considered to be secondary to the requirement of using unregulated firms in benchmarking, the concept of efficiency in a competitive market becomes nebulous. This is because efficient practices are industry specific – this is well recognised in

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[43] Ibid, p. 246.

[44] Ibid, p. 247.

[45] Ibid, p. 248.

[46] Ibid.

[47] Australian Energy Market Commission, *Final Position Paper: National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012 -National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2012*, 29 November 2012, p. i.

investment analysts' application of the method of comparables.[48] If this practical reality is not acknowledged there is a strong possibility that strict adherence to exclusion of regulated firms in benchmarking and interpreting the Allowed Rate of Return Objective could lead to the application of regulation that is detrimental to the long term interests of consumers. Strict adherence will likely lead to:

- poor comparators being used for benchmarks that have operations and/or risks that are not comparable; and
- greater instability and uncertainty in the definition of the benchmark and in the subsequent decisions based on the benchmark.

100. With reference to the second point, the Authority notes the AEMC's comments in its Final Position Paper on this issue:

> Arguably, it is even more important that the benchmark is defined very clearly and can be measured, because it needs to be estimated periodically in the future. The measurability of the approach would be a factor that the regulator would have to consider as part of its assessment of different approaches.[49]

101. Viewing the definition of the industry as anything other than of primary importance and in isolation of the purpose of the National Gas Law (**NGL**) will therefore likely lead to a result that in practice is inconsistent with the object and purpose underlying the NGL. On this basis the requirement for the benchmark service provider to be an electricity or gas network service provider is more important than the requirement that the benchmark be an unregulated entity.

102. As noted above, if strict adherence to exclusion of regulated firms is required this would necessitate the Authority remaking its Decision on many of the interrelated cost of capital parameters for consistency. This would apply to:

- the benchmark gearing;
- equity beta; and
- the benchmark credit rating.

103. Strict adherence to the exclusion of regulated firms would also necessitate consideration of the implications for the cost pass through events and optimisation of the regulated asset base to ensure consistent application of the unregulated BEE concept across all aspects of the Access Arrangement.

104. It is not clear in the Tribunal's explanation of this decision whether it considered all these ramifications. This raises a further point. The Tribunal's lack of resources may imply that its decisions have only limited third party review. That contrasts with the regulator's decisions, which a produced by a larger team, in a longer timeframe, through a more sequenced process, which is therefore subject to a range of checks and balances. This lack of review for the Tribunal's work appears to be an issue, particularly now that energy decisions have become so complex.

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[48] J. Stein, S. Usher, D. Lagattuta and J. Youngen, 'A comparables approach to measuring cashflow-at-risk for non-financial firms', *Journal of Applied Corporate Finance*, vol.13, no.4, 2001, p. 101.

[49] AEMC, Final Position Paper, National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012, National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2012, 29 November 2012, p. 70.