Committee Secretary
Senate Standing Committee on Environment and Communications
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19 September 2017

Dear Sir/Madam

Competition and Consumer Amendment (Abolition of Limited Merits Review) Bill 2017

Thank you for the opportunity to make this submission to the Senate Standing Committee on Environment and Communications (**the Committee**) on the Competition and Consumer Amendment (Abolition of Limited Merits Review) Bill 2017 (**the Bill**).

The Bill seeks to amend the *Competition and Consumer Act 2010* to prevent the Australian Competition Tribunal (**the Tribunal**) from reviewing certain regulatory decisions made under the national energy laws[1] and to ensure that decisions made by the Australian Energy Regulator (**AER**) under those laws are not subject to merits review by any other State or Territory body.

The passing of the Bill into law would effectively remove the ability of anyone in Australia affected by the decisions of the AER to challenge the merits of those decisions via an independent appeals process. In this submission, we make the following key points:

- The abolition of limited merits review (**LMR**) rights would do serious damage to the integrity of the regulatory framework that applies to regulated energy networks in Australia by removing crucial checks and balances on the AER's decision-making. As I elaborate below, this, in turn, is likely to result in outcomes that would harm consumers over the long-term.
- As the Federal Energy Minister (**the Minister**) has acknowledged, since 2008 the AER has been found by the Tribunal and the Courts to have erred repeatedly in its decisions. According to the Minister, the AER's decisions have been appealed 52 times and on 31

1 'National energy laws' refers collectively to the National Electricity Law and the National Gas Law.

occasions the AER's decisions have been found by the Tribunal and the Courts to have been made incorrectly. Many of these errors have involved the AER systematically setting the revenues that regulated energy networks are allowed to recover *below* their efficient costs – which is not permitted under the regulatory rules that the AER must apply under the national energy laws.

- Under the current law, the merits review of an AER decision can only succeed if it can be established that (a) the AER's decision contained an error, and (b) correcting that error is likely to lead to a materially preferable decision in the long-term interest of consumers. Logically then, abolishing LMR would have no effect if the AER's decisions were free from error. So the proposed abolition of LMR will only have an effect insofar as it allows an erroneous AER decision to go unchallenged and therefore uncorrected.
- Given the AER's very poor track record in this regard, it is predictable that removal of the accountability provided by LMR is likely to encourage the AER to make more erroneous decisions in future that force regulated businesses to under-recover their efficient costs.
- Under these circumstances, a rational response from regulated businesses would be to withhold future network investments for fear that the AER may not allow the recovery of the efficient cost of those investments. Sustained under-investment would, over the medium-to-long-term, compromise the safety, reliability and security of the electricity grid and gas supply system that millions of Australian households and businesses rely on. Australian energy consumers would need to content themselves with unsafe and unreliable energy supply — exacerbating the existing energy crisis — and possibly pay billions of dollars in the future to fund catch-up investment, once the system approaches breaking point. Neither of these outcomes would promote the long-term interests of energy consumers.
- It is precisely to avoid these undesirable outcomes that most mature regulatory regimes around the world — including in New Zealand, the United Kingdom and Germany — have some form of merits review regime. The abolition of LMR would be regressive and put Australia out of step with other advanced economies.
- In September 2016, the Council of Australian Governments Energy Council (**COAG**) commenced a consultation of potential reforms to the existing LMR arrangements. One of the options canvassed by COAG was the abolition of LMR. The responses to the COAG consultation — including from consumer groups, who this Bill purports to protect — indicated overwhelming support for the idea that the existing LMR arrangements should be retained but improved. Indeed, some consumer groups submitted to COAG that abolition of LMR would remove an important legal protection that consumers currently benefit from. I agree very strongly with these sentiments. The Federal Government's efforts to remove LMR ignores the submissions received by COAG. It is difficult to see how the removal of legal protections to consumers serves their long-term interests.
- It is also worth noting that the Federal Government's decision to unilaterally abolish LMR tramples on an agreement with the Commonwealth, which was entered into in good faith by the States when the National Electricity Market (**NEM**) was first established. At that time, the States ceded their powers (including powers to regulate the energy networks

within their jurisdictions) to the Commonwealth on the basis that any changes to arrangements governing the NEM and the Australian gas market would occur only with the unanimous support of COAG. Under the original agreement, the Commonwealth and the States were to be equal partners. There was not unanimous agreement within COAG to abolish LMR. COAG was in the process of reviewing the LMR arrangements when the Federal Government, impatient for an 'announceable', declared that it would unilaterally scrap LMR. This demonstration of contempt by the Federal Government for the COAG process and for the original agreement with the States should be a concern to all members of the Committee.

- As I explain in this submission, it is certainly possible to improve the LMR regime, by streamlining the AER's regulatory process as well as any subsequent LMR process. A number of recommendations in this regard were made to COAG by consumer groups and others. However, the Federal Government has simply brushed these proposals aside for reasons of political expediency.
- To date, the entire debate surrounding the LMR arrangements has ignored a fundamental question: why has the AER erred so frequently and egregiously in its application of the rules, such that the Tribunal and the Courts have had to step in repeatedly to correct the AER's decisions? It should be clear to any objective observer that the AER, in its current form, is incapable of applying the regulatory rules that it is charged by law to administer. Rather than diagnosing this as the real problem, and addressing it squarely, the Federal Government is seeking, with this Bill, to give the AER carte blanche to continue making more bad decisions with impunity. Any serious review of the LMR arrangements should involve a root-and-branch investigation of the AER's decision-making track record, the way in which it assesses and evaluates evidence, its competence to deal with fundamental economic and regulatory issues, and the value-for-money the AER is providing to the Australian public.

For these reasons, I urge the Parliament to reject the Bill.

The regulatory framework and the role of LMR

Monopoly energy networks in Australia are regulated. The rules that govern how these businesses are to be regulated are set by an independent rule maker, the Australian Energy Market Commission (**AEMC**). These rules are then applied by the AER to periodically set the revenues that the networks are allowed to earn.

The rules essentially say that the AER must approve revenues that allow the networks to recover their minimum efficient costs, but no more.

Merits review arrangements in relation to revenue reset decisions made by AER have been an integral part of the regulatory framework since 2008. Australia is not alone in having such arrangements. Internationally, merits review arrangements are a standard part of developed, high-quality regulatory regimes that involve industries with significant private sector investment. Examples of developed economies that have merits review regimes include New Zealand, the United Kingdom and Germany – to name just three.

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

- Merits reviews offer protection to regulated businesses and to consumers against erroneous regulatory decisions that would otherwise go uncorrected. The AER's track record in the Courts demonstrates that regulatory errors do occur, and therefore protection against material regulatory error is necessary. It is important to recognise that abolition of the LMR regime would remove consumers' rights to challenge the merits of AER determinations as much as those of regulated businesses.
- Review by an independent adjudicator can protect society against partisan regulatory decisions arising from inappropriate political influence, regulatory capture, where the regulator favours the vested interests it regulates, or from a mistaken notion that it should act as a champion of consumers to the detriment of the legitimate commercial interests of the businesses it regulates.
- Merits reviews can help clarify how complex regulatory rules, and economic and legal principles, should be interpreted and applied. The regulator can use interpretive precedents to refine and improve its future decisions. Indeed, without merits reviews, it is not clear how the AER would even know that one of its decisions contains an error.
- By providing checks and balances, merits reviews can enhance the accountability of the regulator, and also promote confidence (amongst consumers and investors) in the regulatory process.
- The safeguards against regulatory errors and caprice provided by merits reviews reduces uncertainty for investors in regulated networks, who are typically making very long-lived investments, so face cost recovery over long and otherwise uncertain horizons. Such safeguards should keep regulated networks' cost of capital low and, therefore, the costs borne by consumers over the long-run.

The AER's track record

As the Federal Energy Minister's own analysis reveals, the AER has a very poor track record of applying the rules correctly, and the Tribunal and the Courts have repeatedly had to step in to correct those errors in the long-term interests of consumers. The Minister notes in a recent media release that since 2008, regulated businesses have appealed the AER's decisions 52 times, and on 31 occasions the Courts have found error in the AER's decisions.[2] In nearly all of the instances the AER was found to have erred, its decision had the effect of setting the revenues that regulated businesses would be permitted to earn below their efficient costs – contrary to the requirements of the regulatory rules.

It is important to note that under the current LMR regime, a business or consumer group can successfully challenge an aspect of an AER decision only if they can establish that:

- The AER has made one of a specified set of errors; and

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2 Josh Frydenberg, Securing our energy future, media release, 20 June 2017. http://www.joshfrydenberg.com.au/guest/mediaReleasesDetails.aspx?id=379 (accessed 18 September 2017).

- Correcting that error would result in a materially preferable decision in the long term interests of consumers.

This prevents parties from pursuing frivolous appeals that favour only the interests of regulated businesses.

Furthermore, under refinements made to the LMR regime in 2013, the Tribunal can only vary, set aside or remit a decision back to the AER if an alternative decision would be materially preferable in that it would, or would likely, *promote the long term interests of consumers*.

This means that, contrary to the Federal Government's assertions, in all of the recent appeals in which the AER's decisions were set aside or varied, the Tribunal (and Federal Court) did so to promote the long term interests of consumers. The Courts have not, as the Minister asserts, "ruled against consumers" – to do so would be contrary to the law.

Removal of LMR would undermine confidence in the regulatory system and deter efficient investment

Given the AER's extremely poor track record, it is predictable that any move to remove LMR rights would cause regulated businesses to worry that the AER will, in future, continue to make erroneous decisions that force businesses to recover revenues below the efficient costs they need to incur in order to supply energy services safely, reliably and securely to consumers. A rational response to such concerns would be for regulated businesses to withhold otherwise efficient and necessary investments.

Sustained under-investment would, over the medium-to-long-term, degrade the safety, reliability and security of the electricity grid and gas supply system that millions of Australian households and businesses rely on. This country is already suffering from an energy crisis stemming from investment uncertainty created by the Federal Government's incoherent energy policy and ad hoc, unpredictable interventions in the Australian energy markets. Further meddling by the Federal Government, for reasons of short-term political expediency, will only make the investment problem worse, and extend the current energy crisis for decades to come.

The long-term interests of consumers are promoted not only through low prices today

The Federal Government's explicit objective in seeking to abolish LMR rights is to lower prices to consumers in the short-run. For example, the Minister's media release announcing the Federal Government's intention to scrap LMR begins with the words:[3]

> The Turnbull Government is taking immediate action to put downward pressure on power prices and ensure reliable energy for all Australians.

The Minister goes on to say:[4]

> The Turnbull Government will also take immediate action to address escalating electricity prices.

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3 Josh Frydenberg, Securing our energy future, media release, 20 June 2017.

4 Josh Frydenberg, Securing our energy future, media release, 20 June 2017.

> We will stop big electricity companies from running to the courts to try to overturn the Australian Energy Regulator's decisions.

However, it is worth noting that the national energy laws do not express the long-term interests of energy consumers, as a regulatory objective, solely in terms of price. Rather, the National Electricity Law (NEL) and the National Gas Law (NGL) define the long-term interests of energy consumers:[5]

> …with respect to price, quality, safety, reliability and security of supply.

Whilst it may be convenient politically to force through laws that would result in energy prices being suppressed in the short-term below a level that would allow recovery of regulated businesses' efficient costs — as the AER's past decisions have repeatedly attempted to do — this would eventually come at the cost of quality, safety, reliability and security of supply of electricity and gas.

There are many examples around the world of under-investment in essential infrastructure eventually resulting in disastrous consequences for consumers. A well-known case is that of the UK's rail system. Chronic under-funding led to decades of underspending renewals investment in the UK's railway network, then owned by Railtrack (now National Rail). This caused a gradual deterioration in the quality and safety of rail services, which culminated in a number of major crashes in the late 1990s and early 2000s (such as the Ladbroke Grove rail crash, which killed 31 people and injured more than 520; and the Hatfield crash in October 2000, which killed four people and injured more than 70). This episode became known as "the great rail crisis."[6]

In response to this crisis, a major program of catch-up renewal investment had to be launched, to restore the safety of the railway network. This led to the National Rail's regulated asset base increasing by £29 billion between 2002 and 2010 — a period of just eight years. Over this period, National Rail's annual regulated revenue requirement more than doubled from approximately £2.5 billion to over £5.5 billion (see Figure below), resulting in a material increase in rail fares to passengers.[7]

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

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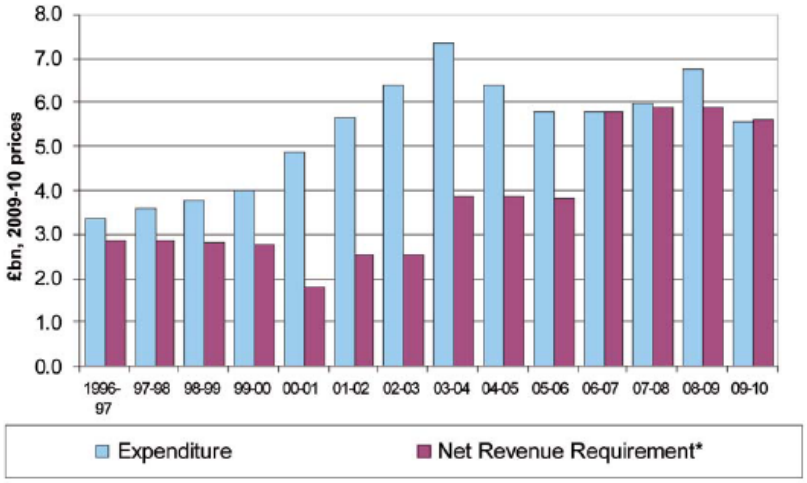
5 NEL s.7 and NGL s.23.

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

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



The AER has demonstrated on many occasions a willingness to set the revenues that regulated businesses are allowed to recover lower than the efficient level, despite warnings that the accompanying scaling back of investment and maintenance activity would eventually compromise the quality, reliability, safety and security of the network in question. It is more than likely that the removal of LMR regime, which would minimise the risk of such erroneous decisions, will result in Australia's energy system becoming less safe, reliable and secure. Eventually, Australian consumers may need to foot a multi-billion dollar bill to fund massive catch-up investment. Neither of these outcomes would promote the long-term interest of energy consumers.

If all these things come to pass, the Australian experience will be used as an example, alongside the UK rail industry, of how *not* to regulate an industry.

The Federal Government has ignored calls – including from consumers – to retain and reform LMR

The Explanatory Memorandum accompanying the Bill claims that COAG concluded in December 2016 that the LMR regime is failing to meet its policy intent and is leading to higher prices for consumers. The Explanatory Memorandum goes on to say that:[8]

> The Commonwealth has decided that the most effective way to address these failings, and reduce pressure on energy prices, is to abolish the regime.

It is somewhat ironic that the Federal Government, in tabling the Bill, claims that it is acting in the interests of consumers when, in fact, a number of consumer groups have argued that the LMR regime should be retained.

In September 2016, COAG commenced a consultation on potential reforms to the LMR regime. One of the options canvassed by COAG was the abolition of LMR rights. The overwhelming response to this consultation, including by consumer groups, was that the LMR regime should be kept but improved. For example, the Public Interest Advocacy Centre

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8 Explanatory Memorandum, Competition and Consumer Amendment (Abolition of Limited Merits Review) Bill 2017, paragraph 1.14.

(PIAC), which has itself challenged AER decisions via merits review, did not support the abolition of LMR. PIAC submitted that:[9]

> …it is too early to fully assess the efficacy of the LMR process following the 2013 reforms

and that removing access to LMR:[10]

> would reduce scope for consumer participation.

PIAC concluded that:[11]

> On balance, however, PIAC considers that the LMR regime would benefit from targeted reforms to improve protection for consumer interests.

Similarly, Energy Consumers Australia, which was established by the COAG Energy Council as the peak national body to represent the interests of Australian energy consumers (and is therefore uniquely-placed to comment on the consumer perspective in this matter), submitted to COAG that:[12]

> While it is clear to ECA that the LMR regime is not performing as intended, it may be premature to conclude that LMR cannot work. The reason for this view is the fact that the current round of appeals has not fully played out, and that the Tribunal affirmed the AER's original decision in relation to a number of grounds of review in the Ausgrid matter (indicating that review is not necessarily a one-way street). Like the Expert Panel, we are also very mindful that there is a legitimate role for LMR in promoting accountability of the regulator for the quality of their decision making and helping to drive continuous improvement in regulatory performance. Further, we also see examples in other jurisdictions internationally where retailers have used LMR regimes to challenge revenue determinations on behalf of their customers. This would be a welcome development in the Australian context.

PIAC, ECA and other submitters put forward serious proposals for the improvement of the LMR regime. However, the Federal Government's Bill brushes aside all of these submissions by seeking to abolish rather than improve the LMR regime. This indicates strongly that the Federal Government's motivation for this Bill is not to promote consumers' interests. Rather, I suspect, it is a cynical attempt to be seen by the public to be doing something — anything — in response to the energy policy crisis that is of its own making.

Finally, I note that even the Economic Regulation Authority (**ERA**) of WA, which is subject to the same LMR regime as is the AER, argued that it is premature to abolish the LMR regime. The ERA's submission to COAG noted that:

- 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.
- There were important changes to the LMR regime itself in 2013, and there have been few completed appeals since those reforms were implemented.

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9 PIAC, Paved with good intentions: an assessment of practical outcome against policy intent, Submission in response to the COAG Energy Council Review of the Limited Merits Review Regime Consultation Paper, 7 October 2016, p.2.

10 PIAC submission to COAG, p.1.

11 PIAC submission to COAG, p.1.

12 ECA, Review of Limited Merits Review, ECA submission to Review of LMR Consultation Paper, October 2017, p.10.

- The AEMC made major changes to the Rules in 2012, which had the effect of re-opening the regulatory approach in a number of key areas (e.g., the approach to estimating the rate of return that regulated businesses are permitted to earn on their regulated assets). The perceived problems with LMR (e.g., the frequency of appeals, increasing complexity of appeal decisions, and the time taken to achieve decisions) were exacerbated by the 2012 changes to the rules.

The ERA went on to conclude:[13]

> 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.

Here is another regulator, subject to the same LMR arrangements as the AER, and who has itself had a number of its decisions reviewed by the Tribunal, arguing that the LMR regime should be allowed more time to operate and settle down before any major changes are pursued. As with consumers' views on this matter, the ERA's submission has been ignored by the Federal Government.

Meaningful reforms to the LMR regime

I agree with the vast majority of submitters to COAG that the LMR regime should be retained but improved. Three examples of meaningful improvements that could be pursued are these:

- *Introduction of a more investigative and collaborative (rather than adversarial) approach by the AER to making its decisions.* Proper engagement with the evidence put forward by businesses and consumers through the regulatory process (combined with the retention of LMR rights) is likely to lead to better, more well-reasoned decisions that are less likely to be appealed.
- *Enhancement of the investigative powers of the Tribunal.* At present the appeal proceedings are highly legalistic, with only senior barristers presenting evidence to the Tribunal on very technical economic and engineering matters. The Tribunal is prevented from hearing directly from technical experts, or benefiting from observing the cross-examination of, or discussion between, experts. Removing these restrictions would allow the Tribunal to cut through the issues more efficiently, and to resolve any matters of dispute more quickly. Reducing the legalism of the LMR process would also make the appeals process more accessible to consumers.
- *Introduction of new powers that would allow the Tribunal limit the ability of different parties launching separate LMR proceedings on substantively similar issues.* The Tribunal could be given additional powers to defer the granting of leave to seek merits reviews to parties if the same or similar grounds are being dealt with by the Tribunal as part of an ongoing appeal.[14] At present, the

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13 ERA, Submission to the COAG Energy Council's 2016 review of the Limited Merits Review Regime, 7 October 2016, p.2.

14 Further technical details about this proposal are set out in: Frontier Economics, Herbert Smith Freehills, Options for enhancing the Australian Limited Merits Review regime, October 2016.

AER makes decisions for groups of networks at a time, in sequence. Under this system, networks in the first batch may appeal on a particular issue, thus launching LMR process. The next batch of networks to be regulated by the AER may launch appeals on substantively similar issues, before the Tribunal is able to hand down a decision for the first group — simply to keep their legal options alive. This can result in a proliferation of appeals on essentially the same issues, tying up the resources of the Tribunal and the AER. The introduction of new powers that would allow the Tribunal to avoid serial and overlapping appeals would reduce the number of appeals in aggregate, and also lessen the burden of appeals on the Tribunal and the AER.

Review and reform of the AER is necessary

To date, the entire debate surrounding LMR arrangements has focussed (incorrectly) on a concern that regulated businesses are using the appeals mechanism process to thwart the regulator and to rip-off consumers. This misses the point entirely. The parties that have exercised their LMR rights have simply sought to ensure that the regulator has applied the rules correctly when making its decisions. Virtually no scrutiny has been given to why the AER has erred so frequently and egregiously in its application of the rules, such that the Tribunal and the Courts have had to step in repeatedly to correct the AER's decisions. It is clear to any objective observer that the AER, in its current form, is incapable of applying the regulatory rules that it is charged by law to administer. Its repeated failures before various Tribunals and Courts demonstrate this. Rather than diagnosing this as the real problem, and addressing it squarely, the Federal Government is seeking, with this Bill, to give the AER carte blanche to continue making more bad decisions with impunity.

Any serious review of the LMR arrangements should involve a root-and-branch investigation of the AER's decision-making track record, the way in which it assesses and evaluates evidence, its competence to deal with fundamental economic and regulatory issues, and the value-for-money the AER is providing to the Australian public.

I urge the Parliament to reject this Bill. Supporting this Bill to abolish important consumer rights, by definition, is plainly contrary to the long-term interests of consumers.

I would be pleased to assist the Committee further in its deliberations on this matter in any way I can.

Yours sincerely,

Daniel Price
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